Surgent's Individual Tax Planning Ideas

ITP4/25/V1-X1

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Revised July 2025

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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permanently extends, with certain modifications, key individual, business, and international tax measures that were originally enacted under the 2017 Tax Cuts and Jobs Act (TCJA).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The OBBBA permanently extends the lower individual income tax rates and brackets originally enacted by the TCJA, effective for tax years beginning after December 31, 2025.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.

What Does the 1040 Tell You?

What Does the 1040 Tell You?

Learning objectives

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

- Develop an approach to reviewing a taxpayer's return for planning purposes;
- Identify strategies relevant to particular circumstances of individual taxpayers;
- Discuss how recent tax law changes the dynamics of tax strategies;
- Explain how inter-family loans may be used;
- Describe how income may be shifted;
- Discuss how a loss may be recognized and how a gain may be protected economically while deferring the taxation;
- Discuss exclusion opportunities running from principal residences to qualified small business stock;
- Discuss the use of tax-exempt vehicles, including qualified plans, IRAs, HSAs, and CESAs;
- Describe the differences between investment interest, home mortgage interest, and other interest; and
- Discuss why paying estimated taxes may not be the most effective way to pay taxes.

I. Introduction

At the end of the day – the tax day – when you've had a chance to take a deep breath and consider the tax returns you've prepared, what do they add up to? Perhaps the greatest service a CPA can provide a client is to explain the meaning of the tax return, and not just the bottom line. More important is divining from the return the missed opportunities to reduce the client's bottom line, and what can be done, starting right now, to formulate a plan of action the client can consider and implement. For the return-preparer professional, it is a critical skill to review a return now filed, and from it, imagine another return that would reflect different strategies.

Note:

> These post-tax season reflections are set in the context of the swirl of seemingly constant tax changes, including the Inflation Reduction Act (IRA) and SECURE 2.0.
>
> IRS guidance has been issued on many provisions, and more guidance is on the way. The tax practitioner should study the results of prior year returns and evaluate ways to better utilize the new tax provisions for tax year 2025.

This course will provide a roadmap through the high points of the return. No course can do full justice to all of the material on a Form 1040 and the potential tax issues raised by it, so we must be selective in the topics. Some will require additional information from a client to bring focus to the process. We will begin by stating issues that we have found, in practice or by inclination, most frequently relevant. We will then provide valuable detailed explanations of the issues and how they might relate in a particular circumstance.

We cannot address every possible issue and in the context of varying client needs, but we can provide a basis for initiating a valuable client service that can move into other areas not explored here. It is well worth creating a matrix of these issues for tax season, so that as returns are prepared, reviewed, or even just after filing, they may be preliminarily cross-referenced for potential further actions. The most important client contact a CPA has with a client begins with, “Did you know that you can…..” Just as important is one that notes, “After this year, you can no longer take advantage of….”

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return **2024** OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2024, or other tax year beginning ________, 2024, ending ________, 20____ See separate instructions.

Your first name and middle initial	Last name	**Your social security number**
If joint return, spouse's first name and middle initial	Last name	**Spouse's social security number**
Home address (number and street). If you have a P.O. box, see instructions.	Apt. no.	**Presidential Election Campaign** Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse
City, town, or post office. If you have a foreign address, also complete spaces below. State ZIP code		
Foreign country name Foreign province/state/county	Foreign postal code	

2

Filing Status
Check only one box.

☐ Single ☐ Head of household (HOH)
☐ Married filing jointly (even if only one had income)
☐ Married filing separately (MFS) ☐ Qualifying surviving spouse (QSS)

If you checked the MFS box, enter the name of your spouse. If you checked the HOH or QSS box, enter the child's name if the qualifying person is a child but not your dependent: ________

☐ If treating a nonresident alien or dual-status alien spouse as a U.S. resident for the entire tax year, check the box and enter their name (see instructions and attach statement if required): ________

Digital Assets At any time during 2024, did you: (a) receive (as a reward, award, or payment for property or services); or (b) sell, exchange, or otherwise dispose of a digital asset (or a financial interest in a digital asset)? (See instructions.) ☐ **Yes** ☐ **No**

Standard Deduction **Someone can claim:** ☐ You as a dependent ☐ Your spouse as a dependent
☐ Spouse itemizes on a separate return or you were a dual-status alien

1

Age/Blindness **You:** ☐ Were born before January 2, 1960 ☐ Are blind **Spouse:** ☐ Was born before January 2, 1960 ☐ Is blind

Dependents (see instructions):
If more than four dependents, see instructions and check here ☐

(1) First name Last name	(2) Social security number	(3) Relationship to you	(4) Check the box if qualifies for (see instructions): Child tax credit	Credit for other dependents
			☐	☐
3			☐	☐
			☐	☐
			☐	☐

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a Form W-2, see instructions.

1a	Total amount from Form(s) W-2, box 1 (see instructions)	1a	
b	Household employee wages not reported on Form(s) W-2	1b	
c	Tip income not reported on line 1a (see instructions)	1c	
d	Medicaid waiver payments not reported on Form(s) W-2 (see instructions)	1d	
e	Taxable dependent care benefits from Form 2441, line 26	1e	
f	Employer-provided adoption benefits from Form 8839, line 29	1f	
g	Wages from Form 8919, line 6	1g	
h	Other earned income (see instructions)	1h	
i	Nontaxable combat pay election (see instructions) 1i		4
z	Add lines 1a through 1h	1z	

Attach Sch. B if required.

2a	Tax-exempt interest	2a	b Taxable interest	2b	
3a	Qualified dividends	3a	b Ordinary dividends	3b	
4a	IRA distributions	4a	b Taxable amount	4b	
5a	Pensions and annuities	5a	b Taxable amount	5b	
6a	Social security benefits	6a	b Taxable amount	6b	
c	If you elect to use the lump-sum election method, check here (see instructions) ☐				
7	Capital gain or (loss). Attach Schedule D if required. If not required, check here ☐			7	
8	Additional income from Schedule 1, line 10			8	
9	Add lines 1z, 2b, 3b, 4b, 5b, 6b, 7, and 8. This is your **total income**			9	
10	Adjustments to income from Schedule 1, line 26		5	10	
11	Subtract line 10 from line 9. This is your **adjusted gross income**			11	
12	**Standard deduction or itemized deductions** (from Schedule A)			12	6
13	Qualified business income deduction from Form 8995 or Form 8995-A			13	
14	Add lines 12 and 13			14	
15	Subtract line 14 from line 11. If zero or less, enter -0-. This is your **taxable income**			15	

Standard Deduction for—
- Single or Married filing separately, $14,600
- Married filing jointly or Qualifying surviving spouse, $29,200
- Head of household, $21,900
- If you checked any box under *Standard Deduction*, see instructions.

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2024)

Tax and Credits	16	**Tax** (see instructions). Check if any from Form(s): 1 ☐ 8814 2 ☐ 4972 3 ☐	16
	17	Amount from Schedule 2, line 3	17
	18	Add lines 16 and 17	18
	19	Child tax credit or credit for other dependents from Schedule 8812	19
	20	Amount from Schedule 3, line 8	20
	21	Add lines 19 and 20	21
	22	Subtract line 21 from line 18. If zero or less, enter -0-	22
	23	Other taxes, including self-employment tax, from Schedule 2, line 21	23
	24	Add lines 22 and 23. This is your **total tax**	24
Payments	25	Federal income tax withheld from:	
	a	Form(s) W-2	25a
	b	Form(s) 1099	25b
	c	Other forms (see instructions)	25c
	d	Add lines 25a through 25c	25d
If you have a qualifying child, attach Sch. EIC.	26	2024 estimated tax payments and amount applied from 2023 return	26
	27	Earned income credit (EIC)	27
	28	Additional child tax credit from Schedule 8812	28
	29	American opportunity credit from Form 8863, line 8	29
	30	Reserved for future use	30
	31	Amount from Schedule 3, line 15	31
	32	Add lines 27, 28, 29, and 31. These are your **total other payments and refundable credits**	32
	33	Add lines 25d, 26, and 32. These are your **total payments**	33
Refund	34	If line 33 is more than line 24, subtract line 24 from line 33. This is the amount you **overpaid**	34
	35a	Amount of line 34 you want **refunded to you**. If Form 8888 is attached, check here ☐	35a
Direct deposit? See instructions.	b	Routing number	c Type: ☐ Checking ☐ Savings
	d	Account number	
	36	Amount of line 34 you want **applied to your 2025 estimated tax**	36
Amount You Owe	37	Subtract line 33 from line 24. This is the **amount you owe**. For details on how to pay, go to *www.irs.gov/Payments* or see instructions	37
	38	Estimated tax penalty (see instructions)	38

7

8

Third Party Designee

Do you want to allow another person to discuss this return with the IRS? See instructions ☐ **Yes.** Complete below. ☐ **No**

Designee's name | Phone no. | Personal identification number (PIN)

Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature	Date	Your occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.)
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	If the IRS sent your spouse an Identity Protection PIN, enter it here (see inst.)
Phone no.	Email address		

Joint return? See instructions. Keep a copy for your records.

Paid Preparer Use Only

Preparer's name	Preparer's signature	Date	PTIN	Check if: ☐ Self-employed
Firm's name				Phone no.
Firm's address				Firm's EIN

Go to *www.irs.gov/Form1040* for instructions and the latest information. Form **1040** (2024)

SCHEDULE 1 (Form 1040)

Department of the Treasury Internal Revenue Service

Additional Income and Adjustments to Income

Attach to Form 1040, 1040-SR, or 1040-NR.

Go to *www.irs.gov/Form1040* for instructions and the latest information.

OMB No. 1545-0074

2024

Attachment Sequence No. **01**

Name(s) shown on Form 1040, 1040-SR, or 1040-NR	**Your social security number**

For 2024, enter the amount reported to you on Form(s) 1099-K that was included in error or for personal items sold at a loss . . . .

Note: The remaining amounts reported to you on Form(s) 1099-K should be reported elsewhere on your return depending on the nature of the transaction. See *www.irs.gov/1099k*.

Part I Additional Income

1	Taxable refunds, credits, or offsets of state and local income taxes			1	
2a	Alimony received			2a	
b	Date of original divorce or separation agreement (see instructions):				
3	Business income or (loss). Attach Schedule C			3	
4	Other gains or (losses). Attach Form 4797			4	
5	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E			5	
6	Farm income or (loss). Attach Schedule F			6	
7	Unemployment compensation			7	
8	Other income:				
a	Net operating loss	8a	( )		
b	Gambling	8b			
c	Cancellation of debt	8c			
d	Foreign earned income exclusion from Form 2555	8d	( )		
e	Income from Form 8853	8e			
f	Income from Form 8889	8f			
g	Alaska Permanent Fund dividends	8g			
h	Jury duty pay	8h			
i	Prizes and awards	8i			
j	Activity not engaged in for profit income	8j			4
k	Stock options	8k			
l	Income from the rental of personal property if you engaged in the rental for profit but were not in the business of renting such property	8l			
m	Olympic and Paralympic medals and USOC prize money (see instructions)	8m			
n	Section 951(a) inclusion (see instructions)	8n			
o	Section 951A(a) inclusion (see instructions)	8o			
p	Section 461(l) excess business loss adjustment	8p			
q	Taxable distributions from an ABLE account (see instructions)	8q			
r	Scholarship and fellowship grants not reported on Form W-2	8r			
s	Nontaxable amount of Medicaid waiver payments included on Form 1040, line 1a or 1d	8s	( )		
t	Pension or annuity from a nonqualifed deferred compensation plan or a nongovernmental section 457 plan	8t			
u	Wages earned while incarcerated	8u			
v	Digital assets received as ordinary income not reported elsewhere. See instructions	8v			
z	Other income. List type and amount:	8z			
9	Total other income. Add lines 8a through 8z			9	
10	Combine lines 1 through 7 and 9. This is your **additional income**. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 8			10	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71479F **Schedule 1 (Form 1040) 2024**

Part II Adjustments to Income

11	Educator expenses		11
12	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106		12
13	Health savings account deduction. Attach Form 8889		13
14	Moving expenses for members of the Armed Forces. Attach Form 3903		14
15	Deductible part of self-employment tax. Attach Schedule SE		15
16	Self-employed SEP, SIMPLE, and qualified plans		16
17	Self-employed health insurance deduction		17
18	Penalty on early withdrawal of savings		18
19a	Alimony paid		19a
b	Recipient's SSN		
c	Date of original divorce or separation agreement (see instructions):		
20	IRA deduction		20
21	Student loan interest deduction		21
22	Reserved for future use		22
23	Archer MSA deduction		23
24	Other adjustments:		
a	Jury duty pay (see instructions)	24a	
b	Deductible expenses related to income reported on line 8l from the rental of personal property engaged in for profit	24b	
c	Nontaxable amount of the value of Olympic and Paralympic medals and USOC prize money reported on line 8m	24c	
d	Reforestation amortization and expenses	24d	
e	Repayment of supplemental unemployment benefits under the Trade Act of 1974	24e	
f	Contributions to section 501(c)(18)(D) pension plans	24f	
g	Contributions by certain chaplains to section 403(b) plans	24g	
h	Attorney fees and court costs for actions involving certain unlawful discrimination claims (see instructions)	24h	
i	Attorney fees and court costs you paid in connection with an award from the IRS for information you provided that helped the IRS detect tax law violations	24i	
j	Housing deduction from Form 2555	24j	
k	Excess deductions of section 67(e) expenses from Schedule K-1 (Form 1041)	24k	
z	Other adjustments. List type and amount:	24z	
25	Total other adjustments. Add lines 24a through 24z		25
26	Add lines 11 through 23 and 25. These are your **adjustments to income**. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 10		26

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Schedule 1 (Form 1040) 2024

SCHEDULE 2 (Form 1040)

Department of the Treasury
Internal Revenue Service

Additional Taxes

Attach to Form 1040, 1040-SR, or 1040-NR.
Go to *www.irs.gov/Form1040* for instructions and the latest information.

OMB No. 1545-0074

2024

Attachment Sequence No. **02**

Name(s) shown on Form 1040, 1040-SR, or 1040-NR | **Your social security number**

Part I Tax

1 Additions to tax:			
a Excess advance premium tax credit repayment. Attach Form 8962	**1a**		
b Repayment of new clean vehicle credit(s) transferred to a registered dealer from Schedule A (Form 8936), Part II. Attach Form 8936 and Schedule A (Form 8936)	**1b**		
c Repayment of previously owned clean vehicle credit(s) transferred to a registered dealer from Schedule A (Form 8936), Part IV. Attach Form 8936 and Schedule A (Form 8936)	**1c**		
d Recapture of net EPE from Form 4255, line 2a, column (l)	**1d**		
e Excessive payments (EP) from Form 4255. Check applicable box and enter amount. **(i)** ☐ Line 1a, column (n) **(ii)** ☐ Line 1c, column (n) **(iii)** ☐ Line 1d, column (n) **(iv)** ☐ Line 2a, column (n)	**1e**		
f 20% EP from Form 4255. Check applicable box and enter amount. See instructions. **(i)** ☐ Line 1a, column (o) **(ii)** ☐ Line 1c, column (o) **(iii)** ☐ Line 1d, column (o) **(iv)** ☐ Line 2a, column (o)	**1f**		
y Other additions to tax (see instructions): ______	**1y**		
z Add lines 1a through 1y		**1z**	
2 Alternative minimum tax. Attach Form 6251		**2**	
3 Add lines 1z and 2. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 17		**3**	

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Part II Other Taxes

4 Self-employment tax. Attach Schedule SE		**4**	
5 Social security and Medicare tax on unreported tip income. Attach Form 4137	**5**		
6 Uncollected social security and Medicare tax on wages. Attach Form 8919	**6**		
7 Total additional social security and Medicare tax. Add lines 5 and 6		**7**	
8 Additional tax on IRAs or other tax-favored accounts. Attach Form 5329 if required. If not required, check here ☐		**8**	
9 Household employment taxes. Attach Schedule H		**9**	
10 Repayment of first-time homebuyer credit. Attach Form 5405 if required		**10**	
11 Additional Medicare Tax. Attach Form 8959		**11**	
12 Net investment income tax. Attach Form 8960		**12**	
13 Uncollected social security and Medicare or RRTA tax on tips or group-term life insurance from Form W-2, box 12		**13**	
14 Interest on tax due on installment income from the sale of certain residential lots and timeshares		**14**	
15 Interest on the deferred tax on gain from certain installment sales with a sales price over $150,000		**15**	
16 Recapture of low-income housing credit. Attach Form 8611		**16**	

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(continued on page 2)

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71478U **Schedule 2 (Form 1040) 2024**

Part II **Other Taxes** *(continued)*

17	Other additional taxes:			
a	Recapture of other credits. List type, form number, and amount:	**17a**		
b	Recapture of federal mortgage subsidy, if you sold your home see instructions	**17b**		
c	Additional tax on HSA distributions. Attach Form 8889	**17c**		
d	Additional tax on an HSA because you didn't remain an eligible individual. Attach Form 8889	**17d**		
e	Additional tax on Archer MSA distributions. Attach Form 8853	**17e**		
f	Additional tax on Medicare Advantage MSA distributions. Attach Form 8853	**17f**		
g	Recapture of a charitable contribution deduction related to a fractional interest in tangible personal property	**17g**		
h	Income you received from a nonqualified deferred compensation plan that fails to meet the requirements of section 409A	**17h**		
i	Compensation you received from a nonqualified deferred compensation plan described in section 457A	**17i**		
j	Section 72(m)(5) excess benefits tax	**17j**		
k	Golden parachute payments	**17k**		
l	Tax on accumulation distribution of trusts	**17l**		
m	Excise tax on insider stock compensation from an expatriated corporation	**17m**		
n	Look-back interest under section 167(g) or 460(b) from Form 8697 or 8866	**17n**		
o	Tax on non-effectively connected income for any part of the year you were a nonresident alien from Form 1040-NR	**17o**		
p	Any interest from Form 8621, line 16f, relating to distributions from, and dispositions of, stock of a section 1291 fund	**17p**		
q	Any interest from Form 8621, line 24	**17q**		
z	Any other taxes. List type and amount:	**17z**		
18	Total additional taxes. Add lines 17a through 17z			**18**
19	Recapture of net EPE from Form 4255, line 1d, column (l)			**19**
20	Section 965 net tax liability installment from Form 965-A	**20**		
21	Add lines 4, 7 through 16, 18, and 19. These are your **total other taxes**. Enter here and on Form 1040 or 1040-SR, line 23, or Form 1040-NR, line 23b			**21**

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Schedule 2 (Form 1040) 2024

SCHEDULE 3 (Form 1040)

Department of the Treasury Internal Revenue Service

Additional Credits and Payments

Attach to Form 1040, 1040-SR, or 1040-NR.

Go to *www.irs.gov/Form1040* for instructions and the latest information.

OMB No. 1545-0074

2024

Attachment Sequence No. **03**

Name(s) shown on Form 1040, 1040-SR, or 1040-NR | **Your social security number**

Part I Nonrefundable Credits

1	Foreign tax credit. Attach Form 1116 if required			1	
2	Credit for child and dependent care expenses from Form 2441, line 11. Attach Form 2441			2	
3	Education credits from Form 8863, line 19			3	
4	Retirement savings contributions credit. Attach Form 8880			4	
5a	Residential clean energy credit from Form 5695, line 15			5a	
b	Energy efficient home improvement credit from Form 5695, line 32			5b	
6	Other nonrefundable credits:				
a	General business credit. Attach Form 3800	6a			
b	Credit for prior year minimum tax. Attach Form 8801	6b			
c	Adoption credit. Attach Form 8839	6c			
d	Credit for the elderly or disabled. Attach Schedule R	6d			
e	Reserved for future use	6e			
f	Clean vehicle credit. Attach Form 8936	6f			
g	Mortgage interest credit. Attach Form 8396	6g			7
h	District of Columbia first-time homebuyer credit. Attach Form 8859	6h			
i	Qualified electric vehicle credit. Attach Form 8834	6i			
j	Alternative fuel vehicle refueling property credit. Attach Form 8911	6j			
k	Credit to holders of tax credit bonds. Attach Form 8912	6k			
l	Amount on Form 8978, line 14. See instructions	6l			
m	Credit for previously owned clean vehicles. Attach Form 8936	6m			
z	Other nonrefundable credits. List type and amount:	6z			
7	Total other nonrefundable credits. Add lines 6a through 6z			7	
8	Add lines 1 through 4, 5a, 5b, and 7. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 20			8	

Part II Other Payments and Refundable Credits

9	Net premium tax credit. Attach Form 8962			9	
10	Amount paid with request for extension to file (see instructions)			10	
11	Excess social security and tier 1 RRTA tax withheld			11	
12	Credit for federal tax on fuels. Attach Form 4136			12	
13	Other payments or refundable credits:				
a	Form 2439	13a			
b	Section 1341 credit for repayment of amounts included in income from earlier years	13b			
c	Net elective payment election amount from Form 3800, Part III, line 6, column (j)	13c			
d	Deferred amount of net 965 tax liability (see instructions)	13d			
z	Other refundable credits (see instructions):	13z			
14	Total other payments or refundable credits. Add lines 13a through 13z			14	
15	Add lines 9 through 12 and 14. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 31			15	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71480G **Schedule 3 (Form 1040) 2024**

SCHEDULE A (Form 1040)

Department of the Treasury Internal Revenue Service

Itemized Deductions

Attach to Form 1040 or 1040-SR.

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

Caution: If you are claiming a net qualified disaster loss on Form 4684, see the instructions for line 16.

OMB No. 1545-0074

2024

Attachment Sequence No. **07**

Name(s) shown on Form 1040 or 1040-SR | **Your social security number**

Medical and Dental Expenses		**Caution:** Do not include expenses reimbursed or paid by others.		
	1	Medical and dental expenses (see instructions)	1	
	2	Enter amount from Form 1040 or 1040-SR, line 11 [2]		
	3	Multiply line 2 by 7.5% (0.075)	3	
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-		4
Taxes You Paid	5	State and local taxes.		
	a	State and local income taxes or general sales taxes. You may include either income taxes or general sales taxes on line 5a, but not both. If you elect to include general sales taxes instead of income taxes, check this box ☐	5a	
	b	State and local real estate taxes (see instructions)	5b	
	c	State and local personal property taxes	5c	
	d	Add lines 5a through 5c	5d	
	e	Enter the smaller of line 5d or $10,000 ($5,000 if married filing separately)	5e	
	6	Other taxes. List type and amount:	6	
	7	Add lines 5e and 6		7
Interest You Paid Caution: Your mortgage interest deduction may be limited. See instructions.	8	Home mortgage interest and points. If you didn't use all of your home mortgage loan(s) to buy, build, or improve your home, see instructions and check this box ☐		
	a	Home mortgage interest and points reported to you on Form 1098. See instructions if limited	8a	
	b	Home mortgage interest not reported to you on Form 1098. See instructions if limited. If paid to the person from whom you bought the home, see instructions and show that person's name, identifying no., and address	8b	
	c	Points not reported to you on Form 1098. See instructions for special rules	8c	
	d	Reserved for future use	8d	
	e	Add lines 8a through 8c	8e	
	9	Investment interest. Attach Form 4952 if required. See instructions	9	
	10	Add lines 8e and 9		10
Gifts to Charity Caution: If you made a gift and got a benefit for it, see instructions.	11	Gifts by cash or check. If you made any gift of $250 or more, see instructions	11	
	12	Other than by cash or check. If you made any gift of $250 or more, see instructions. You **must** attach Form 8283 if over $500	12	
	13	Carryover from prior year	13	
	14	Add lines 11 through 13		14
Casualty and Theft Losses	15	Casualty and theft loss(es) from a federally declared disaster (other than net qualified disaster losses). Attach Form 4684 and enter the amount from line 18 of that form. See instructions		15
Other Itemized Deductions	16	Other—from list in instructions. List type and amount:		16
Total Itemized Deductions	17	Add the amounts in the far right column for lines 4 through 16. Also, enter this amount on Form 1040 or 1040-SR, line 12		17
	18	If you elect to itemize deductions even though they are less than your standard deduction, check this box ☐		

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For Paperwork Reduction Act Notice, see the Instructions for Form 1040. Cat. No. 17145C **Schedule A (Form 1040) 2024**

II. Checklist for reviewing the 2024 Form 1040 for planning ideas -- Pages 1 and 2 and Schedules

A. Sections 1-3: Name, Filing Status, Exemptions, and Virtual Currency Question

☐ **Address:** A change of address can indicate a sale of a residence. If the taxpayer has more than one home, discuss planning for the **principal residence**. **Note: Practitioners should be especially mindful of residence, as many individuals worked from home during the COVID-19 pandemic.**

☐ **An entry in the Apt No. block**: Determine if this is part of a cooperative or condominium. If not, client is a renter, and you should calculate rent vs. buy analysis at `www.dinkytown.net`.

☐ **Filing Status:** There are significant changes in the standard deduction amount and in the rules for **filing status** regarding head of household.

☐ **Dependents:** If a dependent is not a child of the taxpayer, gather further information. You might discover a parent or relative who could be a **dependent**. The deductions for personal and dependent exemptions are suspended for years 2018 through 2025. However, the definition of dependent is still necessary for other provisions.

☐ **Digital Assets:** The Digital Asset question remains on Page 1 of Form 1040. The placement on the first page of Form 1040 means that all taxpayers are required to answer this question. In fact, the Form 1040 Instructions specifically state "Do not leave this question unanswered. You must answer "Yes" or "No" by checking the appropriate box." Additionally, the Form 1040 Instructions state that digital asset transactions include, but are not limited to:

- The receipt of digital assets as payment for goods or services provided;
- The receipt of digital assets as a result of a reward or award;
- The receipt or transfer of digital assets for free (without providing any consideration) that does not qualify as a bona fide gift;
- The receipt of new digital assets as a result of mining and staking activities;
- The receipt of digital assets as a result of a hard fork;
- An exchange of digital assets for property, goods, or services;
- An exchange/trade of a digital asset for another digital asset;
- A sale of a digital asset; and
- Any other disposition of a financial interest in a digital asset.

The wording of the digital assets question remains unchanged for the 2024 tax year. The question reads: "At any time during 2024, did you: (a) receive (as a reward, award, or payment for property or services); or (b) sell, exchange, or otherwise dispose of a digital asset (or a financial interest in a digital asset)?"

B. Section 4: Income -- Form 1040, page 1 and Schedule 1

☐ **Line 1a -- W-2:** Review carefully the information on the W-2, for what can lead to planning discussions. Review all **codes** on the form for planning and discussion points. Determine if withholdings should be adjusted due to the effect of the TCJA.

Practice note:

Line 1 of the 2024 Form 1040 provides multiple sublines for various types of income. The total amount of wages from Form(s) W-2 are reported on line 1a of Form 1040. Other forms of compensation are reported on lines 1b through 1i, with the aggregate value reported on line 1z.

Specifically, the IRS indicates that taxpayers should include the following compensation on lines 1a through line z:

- **Line 1a:** Taxpayers should report the total amount from Form(s) W-2, box 1. This includes any spousal amounts if filing a joint return.
- **Line 1b:** Taxpayers should report any wages they received as a household employee that were not reported on Form(s) W-2. Generally, employers are not required to provide household employees with Form W-2 if they paid less than $2,600 in wages.
- **Line 1c:** Taxpayers should report tip income that they did not report to their employer and any allocated tips shown in box 8 on Form W-2. Additionally, taxpayers should report the value of any noncash tips received, such as tickets, passes, or other items of value.
- **Line 1d:** Taxpayers should report any Medicaid waiver payments that they received and chose to include in earned income for purposes of claiming a credit or other tax benefit. It is important to note that if the taxpayer and his or her spouse both received nontaxable Medicaid waiver payments during the year, the taxpayer and his or her spouse can make different choices about including payments in earned income.
- **Line 1e:** Taxpayers should report the total of their taxable dependent care benefits from Form 2441, line 26. Dependent care benefits are reported in box 10 of Form(s) W-2.
- **Line 1f:** Taxpayers should report the aggregate employer-provided adoption benefits from Form 8839, line 29. These employer-provided adoption benefits are reported in Form(s) W-2, box 12, code T.
- **Line 1g:** Taxpayers should enter the total of wages for Form 8919, line 6.
- **Line 1h:** Taxpayers should report any other earned income on this line, including:
  - Strike or lockout benefits other than bona fide gifts;
  - Excess elective deferrals, as reported on Form W-2, box 12, with the "Retirement Plan" box checked in box 13;
  - Disability pensions shown on Form 1099-R if the taxpayer has not reached the minimum retirement age set by his or her employer; and
  - Corrective distributions from a retirement plan shown on Form 1099-R of excess elective deferrals and excess contributions (plus earnings).
- **Line 1i:** Taxpayers that elect to include their nontaxable combat pay in their earned income when computing the EIC should enter such amount on this line.

Some amounts that in prior years were reported on Form 1040 are now reported on Schedule 1, including:

- Scholarship and fellowship grants not reported to the taxpayer on Form W-2 are now reported on Schedule 1, line 8r.
- Pension or annuity from a nonqualified deferred compensation plan or a nongovernmental §457 plan are now reported on Schedule 1, line 8t.
- Wages a taxpayer earned while incarcerated are now reported on Schedule 1, line 8u.

☐ **Lines 2a and 2b -- Interest Income:** See Schedule B.

☐ **Loans to Individuals**: If the taxpayer has loaned money to individuals, especially a family member at a below-market rate, the **imputed interest** rules could apply. Consider shifting loans to meet a de minimis exception or other exceptions. Take advantage of low historical rates to shift income and unearned income.

☐ **Bond Income:** If interest rates have moved up, the value of a bond would generally decrease. A taxpayer could **swap a bond** for a similar bond and create a capital loss that could offset other capital gains as a planning strategy.

☐ **Review Form 1099 INT:** If the name on the 1099 is in a **joint name** does the client realize that these assets will not pass by operation of the will? This could be counterproductive to the estate's plan.

☐ **Discuss Bank CDs and Bank Money Market Accounts and Risk:** For example, the **FDIC** currently permanently insures up to $250,000 per person per financial institution. Consider having CDs in different names to get better protection (e.g., husband or wife). **Note**: Clients may be especially interested in FDIC insured accounts in light of recent banking failures.

☐ **Bonds and Bond Funds:** Consider whether the client understands risk of **bond mutual funds** vs. the purchase of individual bonds.

☐ **Bonds:** Consider discussing the **laddering** of bonds maturity to increase income and reduce risk.

☐ **Tax-Free or Taxable Bonds:** Discuss whether the client would be better served in **tax-free bonds** vs. taxable bonds or the opposite, now in light of both higher aggregate income and net investment income tax and Medicare tax rates. (Calculate breakeven.)

☐ **Interest:** Discuss with the client the tax aspects of **interest income** -- that it is all ordinary income and is taxed at higher rates.

☐ **OID Interest Income:** If the client has **OID interest income**, these investments can have very significant swings in value with very little change in interest rates. Is this an appropriate investment?

☐ **Bonds and Capital Gains:** If interest rates are declining and the client owns bonds for more than one year, then the client could **sell the bonds** and get favorable capital-gains rate. See discussion on Bond Premium below.

☐ **Bonds and Bond Funds:** If the client is investing in long-term, mid-term, or short-term bonds or bond funds, do they understand the risk of a **rising interest-rate** environment on their principal?

☐ **Bond Premium or Discounts:** If a taxpayer purchased a taxable bond at a **premium**, the taxpayer can elect to amortize the premium. If a bond is purchased at a **discount**, it might need to be accrued over the life of the bond.

☐ **U.S. Savings Bonds:** The interest could be tax-free if the proceeds are used to pay for a dependent's **college education** and the client's AGI is low enough. The bonds must be titled in the parent's name for this to apply.

☐ **U.S. Savings Bonds:** If a child has U.S. savings-bond income and no tax to pay, you can elect to pick up the **income each year instead of at maturity**, which could be a good planning idea that will ensure the income is tax-free. U.S. savings-bond income is now fixed for new bonds.

☐ **U.S. Savings Bonds:** Note that you can no longer convert EE U.S. savings bonds into **HH bonds**.

☐ **U.S. Savings Bonds:** In certain circumstances, you might wish to accelerate income into a given year. Selling U.S. savings bonds or electing to **accelerate the income** could be beneficial.

☐ **Treasury Inflation Protected Securities (TIPs):** If the client has TIPs, the principal is adjusted for inflation semiannually. Both the interest and the inflation adjustment to principal are treated as current income. Consider holding this **investment inside** of a pension or IRA plan.

<u>Line 3a and 3b Dividends -- See Schedule B</u>

☐ **Mutual Funds Shares:** Many funds calculate an average basis in shares for gain or loss purposes. Clients could use specific identification or sometimes the double category **method** to planning advantage.

☐ **Mutual Fund Shares: Timing** when mutual fund shares are **bought or sold** could create tax issues. For example, purchasing shares at year-end right before they pay a dividend can create a tax issue.

☐ **Index Funds or Tax Managed Funds:** These can create tax advantages by **avoiding turnover** of shares and deferring taxation.

☐ **Portfolio Analysis:** Have a discussion with the client to review the client's mutual-fund **yields against a benchmark index** to determine whether the purchase was a reasonable investment. You could help in calculating the return on the client's portfolio as an additional consulting project.

☐ **Investment Fees:** Explain that **investment fees** are netted in the mutual funds return and that it is more tax efficient than paying advisor fees, which have historically been miscellaneous deductions subject to the two-percent AGI limitation. All miscellaneous itemized deductions are suspended for tax years 2018 through 2025, making advisor fees paid out of pocket nondeductible for those years.

☐ **Portfolio Analysis:** Look for a large **concentration of assets** issued if the client has a very large dividend from one stock. Many older clients are unwilling to sell their appreciated stocks because they are unwilling to pay the tax on the gain. With a 20-percent or 15-percent long-term capital gains tax rate (for many taxpayers) and a 0-percent tax rate (for younger or other members of the client's family), the client should consider paying the tax and implementing a diversification strategy. Evaluate the impact of shifting the tax burden to other family members and how the changes to the "kiddie tax" rules by the SECURE Act might open up income-shifting opportunities.

☐ **Mutual Fund and Stock Dividend Reinvestments:** If the **dividends** are **reinvested**, then the tax basis in shares increases by the amount of the reinvestment. Does the client have detailed records to keep track of their basis?

☐ **Qualifying Dividends:** Discuss with the client the tax benefits of **qualifying dividends** at a 20-percent or a ZERO-percent tax rate.

☐ **Review all 1099 DIV Forms:** If a dividend is not a qualified dividend, then discuss with the client that this is ordinary income and is not **tax efficient**. Most publicly traded preferred stocks and REIT investments do not provide qualifying dividend income.

☐ **Review all 1099 DIV Forms:** The client could have a **capital-gain distribution** that could affect basis.

☐ **Money Market Accounts:** Mutual funds give out a 1099 DIV Form. These monies do not count as qualified dividends and are taxed as ordinary income. Further, these monies are **not FDIC** insured. Discuss this with the client.

☐ **Money Market Accounts:** Explain that the interest yield can be very different from one mutual fund to another. If they do not need the money immediately, consider buying weekly or monthly bonds issues that will increase the client's **overall yield**.

☐ **Owning Stock in a Child's Name:** If the client has children, you can gift stock that pays qualifying dividends to children up to present-interest gift limit of $19,000 (2025) and the child might pay no tax or only a 15-percent tax rate versus the parent's 20-percent rate. Section 501 of the SECURE Act eliminates the TCJA definition of "Kiddie Tax" on children's unearned income in excess of $2,700 (2025) at the highest trust and estate tax rates.

☐ **Owning Stock in a Child's Name:** Have a significant discussion on how best to hold **title** to assets for **children**.

<u>Line 4a & 4b -- IRA Distributions</u>

☐ **IRA Distributions:** If the client is receiving required minimum distributions, has the amount been **recomputed** based on recent IRS rulings? Review changes due to the SECURE Act and SECURE Act 2.0.

☐ **Conversions:** Consider **rolling regular IRAs to Roth IRAs**. Roth IRA distributions are not counted in determining the amount of Social Security payments that are taxable. Review changes due to the SECURE Act and SECURE Act 2.0.

☐ **Investment Expenses:** Ask if investment expenses were paid out of the IRA funds or other funds. Generally, it is a better tax strategy to have **fees paid from the client's other funds**.

☐ **Estate Planning:** Review primary **beneficiary designation** of IRA and estate-planning considerations Review estate planning implications due to the passage of the SECURE Act.

☐ **Reducing or Eliminating Estimated Tax Payments:** Consider taking distribution at the end of the year and putting the entire amount withdrawn to **federal withholding** to avoid or reduce estimated tax payments.

☐ **Avoiding 10-Percent Penalty:** If the client is under age 59-1/2, then explore the qualifications for taking the payments under §72(t) **substantially equal periodic payments**.

<u>Line 5a & 5b -- Pensions and Annuities</u>

☐ **Review 1099R:** Determine if the distribution is from a pension or from an annuity and applicable code.

☐ **Rollovers:** Consider rolling a pension to an IRA for **more flexibility of investing**. Then consider rolling a regular IRA to a Roth IRA.

☐ **Estate Planning:** Review primary **beneficiary designation** and estate-planning considerations. Review estate planning implications due to the passage of the SECURE Act.

☐ **Minimum Distributions:** If the client is over age 72/73, then they generally must calculate required minimum distribution (RMD). Assist the client in planning.

☐ **Retired:** If a client is retired they will be interested in managing their money in retirement and planning for pension or IRA distributions. Focus with the client on what they want to get out of retirement and what you can do to help.

Schedule 1 Line 2a/19a -- Alimony

☐ **Review Divorce Agreement:** Make sure payments are in fact taxable alimony and not a **nontaxable division of property or child support**.

☐ **Division of Property:** Discuss with the client that their tax basis in property from a division of assets in a divorce is a **carryover basis** and the assets DO NOT get a step up in basis.

☐ **Financial Planning:** Alimony is for a set term and the client might need to plan their financial affairs when the **alimony stops**.

☐ **Tax Planning:** Under the provisions of the TCJA, alimony is no longer deductible after 2018 and not included in the recipient's income. Existing agreements are grandfathered in unless the agreement is changed.

Schedule 1 Line 3 -- Business Income

☐ **Consulting Services:** Discuss with the client if they need consulting services to help them run a better business. Services could include helping them with pricing their goods or services, **cash management**, banking and financing services, reviewing insurance needs, and a host of other services.

☐ **Hobby Loss Rule:** If there are significant losses, especially if they have occurred for several years, are the losses allowed? Can we help the client better **document a for-profit activity**?

☐ **Manufacturing Deduction:** Evaluate the impact of the repeal of the Domestic Production Activities Deduction by the Tax Cuts and Jobs Act.[1]

☐ **Pass-Through Deduction:** Evaluate the impact of the 199A deduction on the taxable income of the taxpayer in 2025. Refer to Form 1040, Line 13 and Form 8995 / Form 8995-A.[2]

☐ **Form of Entity:** Consider whether the client might be better served as a **single-member LLC** to reduce legal liability.

☐ **Business Expenses:** Ask the client if they are taking advantage of all **deductible expenses** and if they have systems in place to track them. Consider the business interest limitation created by the TCJA.

☐ **Hiring Children:** If the client has children who are old enough, then they can provide services as employees and earn up to $15,000 federally tax-free. In addition, they can make a Roth or IRA

1 Pub. L. 115-97, Title I, §13305.
2 I.R.C. §199A, established by the Tax Cuts and Jobs Act, Pub. L. 115-97.

contribution up to $7,000 in 2025. Note that **no Social Security taxes** are due up to age 18 of the child.

☐ **Travel and Entertainment:** Discuss strategies of maximizing expenses for travel and meals, such as combined business and vacation travel, and documentation issues. Make sure the client is aware that entertainment expenses are no longer deductible after 2017. Remind taxpayers that 100% bonus depreciation was only in effect through 2022. In the 4-year period from 2023 through 2026, the 100% deduction is stepped-down 20% per year, until the rule sunsets in 2027.

☐ **Acquiring Business Assets:** Discuss strategies to reduce income such as taking advantage of the **§179 expense** election up to $1,250,000 in 2025, limited to taxable income. This also changed the phaseout threshold to $3,130,000. Also, consider the impact of the changes to bonus depreciation.

☐ **Home Office Deduction:** Determine if the client might be eligible and if the client can still qualify for the §121 **gain exclusion**. Remember – only certain self-employed individuals may claim the home office deduction, not employees.

☐ **Pension Plan Options:** Discuss strategies and plans to maximize pension contributions including single-member 401(k) plan, SEP, or defined benefit plan.

☐ **Hiring Spouse:** Enjoy three possible benefits:

- Get family health insurance on Schedule C to reduce SE taxes;
- Create medical expense reimbursement plan for spouse and get family benefit; and
- Get to put more money in a §401(k) plan based on spouse's wages.

(A problem is the possible increase in Social Security taxes in Schedule C if not over the SE limit of $176,100 in 2025.)

<u>Form 1040, Line 7 -- Capital Gain or Loss</u>

☐ **Asset Allocation:** Discuss with the client **investment planning** and asset allocation **strategies**.

☐ **Capital Loss Carry forward:** Review Schedule D form to determine if the client has capital loss carried forward. If one exists, the taxpayer should consider using capital losses to offset short-term gains rather than long-term gains. Short-term or long-term capital losses produce the most tax saving when offsetting **short-term gains**. Many clients find themselves with portfolios with built-in losses that should be harvested at the proper tax time to maximize tax savings to the greatest extent possible.

☐ **Need For One-Year Holding Period:** Review the client's stock and bond holdings and make sure the client understands that holding gains for at least one year qualifies for very **favorable** long-term capital-gains **rates**.

☐ **Calculating Basis:** Does the client have good records on basis in all securities? Does the client know that you can use the **specific identification method** for individual securities and an averaging method if desired for mutual funds?

☐ **Effective Tax Rate:** Review with the client that the marginal rate on recognizing capital gains can be quite high. Capital gains increases AGI, which can cause a phase out of medical deductions and the AMT exemption.

☐ **Principal residence:** Recent changes allow, for widows and widowers, a higher exclusion on sale of the principal residence.

☐ **Estate Planning:** If the client is in poor health, consider **selling loss assets** before death and holding gain assets until death for a step up in basis.

☐ **Worthless Securities:** Discuss with the client if they have **worthless securities**. To clearly establish worthlessness, the client can sell the security to an unrelated party (e.g., a broker, CPA, etc.).

☐ **Capital-Gain Distributions:** Discuss with the client mutual fund shares that pay capital-gain distributions. Purchasing shares just prior to the record date of a funds distribution of their capital gain is essentially **purchasing a tax liability** at the same time.

☐ **Mutual Fund Year-End Planning:** A client could sell mutual fund shares just prior to an income distribution and could **convert** what would have been ordinary income from the distribution **into capital gain** from the sale.

☐ **Options and Stop Loss:** If a client wants to sell a stock but does not have a one-year holding period, discuss strategies such as using **stock options** or executing a stop loss to limit risk while trying to hold the security for one year.

☐ **Wash Loss Rule:** Discuss with the client the wash loss rules if the client wants to **recognize a loss on securities**.

☐ **Installment Sales:** If the client is considering the sale of **real estate at a gain,** the installment method might be considered.

☐ **Ordinary loss on §1244 Stock:** If the taxpayer was the original owner of stock in a small business that was sold at a loss, the loss could be an **ordinary loss**.

☐ **Review of Securities Portfolio:** A taxpayer's securities portfolio should be reviewed each year to see if it would be **beneficial to recognize gain** or loss for tax purposes. This can be undertaken in connection with an analysis of the investment portfolio to determine what repositioning and redeployment of investments is necessary in light of the additional Medicare tax.

☐ **Trader vs. Investor:** If there are an exceptional number of trades, investigate whether the client would qualify as a **trader** and if this would be beneficial for tax purposes.

Schedule 1 Line 4 -- Other Gains and Losses: Form 4797

☐ **Investment Concern:** If the client has sale of real estate, discuss what the client is doing with the **cash from the sale**. (If more real estate will be purchased, consider a **like-kind exchange**.)

☐ **Equipment Sales:** If sale of equipment, discuss strategies for the purchase of new equipment and how best to finance it and get the **best tax write-offs**.

Schedule 1 Line 5 -- Rental Real Estate

☐ **Review page 1 of Schedule E Form:** Inquire if any property is used for **personal use**. With proper planning, property could qualify for the §121 gain exclusion.

☐ **Entity Ownership:** Consider owning property in a single-member LLC to **reduce liability**.

☐ **Expenses:** Review expenses including mortgage and discuss the best ways to **refinance property or payment of debt** and maximize deduction expenses.

☐ **Related Parties:** Determine if there is a rental to a related party, which could cause tax problems, including the fact that the rental income would not be passive income.

☐ **Family Income Splitting:** Consider creating a Family LLC or Limited Partnership and have the children own an interest in the property to **split income** and **reduce estate taxes**.

Schedule 1 Lines 8a – 8z -- Other Income

☐ **Directors or consulting fees:** This type of income is earned income and a client could establish a **pension plan** to reduce their tax liability.

Note that Line 8, *Other Income*, was previously reported on one line. The type of other income was noted either on the dotted line to the left of line 8 or on an attached statement. Similar to prior year, the 2023 Schedule 1 breaks out line 8, Other Income, into 17 sublines of common and uncommon forms of other income, making it easier for practitioners to add and review these amounts.

C. Section 5: Adjusted Gross Income – Form 1040 page 1

Line 11 – Adjusted gross income

☐ **Time to take Social Security:** As a taxpayer nears early or normal retirement age, the timing of the start of Social Security benefits is an increasingly important issue.

☐ **Taking distributions:** There may be a good reason to take distributions from IRAs in-kind.

☐ **Make a contribution of an IRA to a charity to reduce AGI**. Taxpayers age 72/73 and above are able to make a charitable contribution without having to include in gross income and AGI a distribution from an IRA and would increase the threshold for medical and casualty losses.

☐ **Convert IRAs to a ROTH**: Now might be the time to convert an existing traditional IRA to a Roth.

Schedule 1 Line 15 -- Self-employed SEP, SIMPLE, and qualified plans

☐ **Review Plan Document:** Determine what **kind of plan** the client is in, if this is the best kind for the client, and if it is up to date.

☐ **Maximize Contribution:** Determine if the client is putting the maximum contribution into the plan. If not, calculate the **future benefit** of a maximum contribution.

☐ **Hiring the Spouse:** Consider adding the spouse on the payroll to get a **larger pension contribution**.

Schedule 1 Line 17 -- Self-Employed Health Insurance Deduction

☐ **Health Insurance Plan:** Inquire if the client is happy with their health plan or looking for an alternative one. Do they understand the **limits** of their plan?

☐ **Health Savings Account:** Consider a **new** Health Savings Account and the impact for the client.

☐ **Hiring the Spouse:** If the taxpayer is self-employed, consider employing the spouse and offer them **family medical insurance**. This allows the client to take the deduction on the Schedule C Form, which will also reduce SE taxes.

☐ **Hiring the Spouse:** Further, if the taxpayer is self-employed, consider employing the spouse and setting up a self-insured medical reimbursement plan so that expenses can be deducted on the Schedule C Form, which will also **reduce SE taxes**.

Schedule 1 Line 20 -- IRA Deduction

☐ **Maximizing Contributions:** Is the client aware of the maximum limit of $7,000 in 2025 and the over age 50 catch-up contribution of $1,000? Calculate the future value of making contributions.

☐ **Spousal IRA:** If the spouse does not work, generally you could make a spousal IRA contribution dependent on the combined AGI of the couple, even if the working spouse is a participant in a qualified plan at work.

☐ **Roth IRA:** Consider whether a Roth IRA might be better to fund than a regular IRA. Run the calculation.

D. Section 6: Deductions to Arrive at Taxable Income – Form 1040 page 1

Lines 12 and 13

☐ **Standard Deduction:** Consider the impact of the increased standard deduction under the TCJA.

☐ **Section 199A / Qualified Business Income deduction:** Consider the trades or businesses of the taxpayer that qualify for the §199A deduction. Evaluate ways to maximize the deduction, such as electing the rental real estate safe harbor or aggregating businesses.

E. Section 7: Taxes and Non-Refundable Credits – Form 1040 page 2 and Schedules 2 and 3

Schedule 2 Line 1 -- Alternative Minimum Tax

☐ **Planning Considerations:** If the client is in the AMT, it is likely they will be in it in the future. Prepare a multi-year projection. Consider strategies to get the client out of AMT, which includes accelerating income or reducing expenses.

Schedule 3 Line 3 -- Education Credits

☐ **The American Opportunity and Lifetime Learning tax credits:** Determine optimal benefit. If the client is phased out of the credit, consider reducing AGI or having the client's **child claim credits,** instead of having the parent(s) claim the child as a dependent. Consider the refundable portion.

F. Section 8: Other Taxes, Payments and Refundable Credits – Form 1040 page 2 and Schedule 2

Schedule 2 Line 4 -- SE Tax

☐ **Reduce Earned Income:** Consider strategies to reduce income or incur expenses that would result in a reduction of SE taxes.

Schedule 2 Line 8 -- Tax on Qualified plans and IRAs

☐ **Review Form 5329:** Generally, it is poor tax planning to pay this penalty, and strategies can be developed to avoid it.

Schedule 2 Line 9 -- Household employment taxes

☐ **Workman's Compensation Insurance:** Does the client have workman's compensation insurance as required by state law?

☐ **Pension:** Has the client considered a pension plan for household workers?

Schedule 2 Line 12—Net Investment Income Tax

☐ **MAGI:** Is the client's AGI or MAGI close to or in excess of the threshold? Can taxable AGI be converted into nontaxable income? Can investment income be converted into noninvestment income?

☐ **Rental real estate**: Does the client own real property that is or could be a trade or business? Is the client a real estate professional? Can the client qualify for the safe harbor?

Form 1040 page 2 Line 26 -- Estimated Tax Payments

☐ **Planning:** Consider strategies to reduce the need for estimated taxes such as having more money withheld from W-2.

☐ **Planning:** Consider having money withheld from 1099R and reduce estimated taxes.

☐ **Planning:** Consider running a new projection for the client during the year to reduce estimated tax payments.

☐ **Planning:** Consider withdrawing money from an IRA and putting the entire balance to federal withholding in the amount needed to avoid underpayment penalty for not making estimated tax payments.

☐ **Planning**: Keep one eye on the future as many provisions have expired or are about to expire and may or may not be extended.

Form 1040 page 2 Line 25 -- Federal Income Tax Withheld

☐ **Amounts Withheld:** Review to determine if too much is being withheld and the client is losing time value of money.

G. Section 9: Schedule A -- Itemized Deductions

Lines 1-4 -- Medical and Dental Expenses

☐ **Nursing Home Costs:** Generally, all clients will qualify for the deduction if they have nursing home or in-home care expenses. Review to make sure all qualifying expenses are deducted.

☐ **Capital Expenditures:** A taxpayer can treat capital expenses, net of medical reimbursement other than on the home, as medical expenses if they are directly related to being sick or handicapped. Examples would be the extra cost of a specially modified van, removable air conditioner, and telephone equipment for the hearing impaired.

☐ **Elderly Parent:** A client may pay for medical expenses or long-term care costs of an elderly parent and get a better tax benefit if they are in a higher tax bracket.

☐ **Continuing Care Retirement Communities:** These generally require residents to pay a large one-time entrance fee in exchange for living accommodations and lifetime care, as well as a monthly fee. A significant portion of this cost could be a medical expense.

☐ **Terminal Illness:** When you see significant medical expenses, this could signal a terminal illness and the need for immediate estate planning and tax planning (e.g., sell loss assets before death).

☐ **Medical Expenses:** The Consolidated Appropriations Act of 2021 (CAA 2021) made 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.

<u>Lines 5a-7 -- Taxes You Paid</u>

☐ **State and Local Taxes:** Consider the impact of the $10,000 SALT limitation for years 2018 through 2025.[3] The total deduction for state and local income and property taxes cannot exceed $10,000. It is important to note that President Trump and Congress have proposed increasing or eliminating the SALT cap.

☐ **Real Estate Taxes:** If the taxpayer is in AMT, the real-estate taxes become nondeductible, so consider deferral if possible.

☐ **Real-Estate Taxes:** If there is a significant increase in real-estate taxes over the prior year, this is an indication of the purchase of a second home. Discuss the tax issues of owning a second home.

<u>Lines 8-10 -- Interest Expense</u>

☐ **Home Mortgage Interest:** Review with the client the principal amount, term, and interest rate of all loans. Consider running a projection showing the effect of making extra principal payments on a loan and the significant savings that can result.

☐ **Home Mortgage Interest:** If the client has two 1098 Forms, this might indicate a home-equity loan. Discuss whether a refinance might be warranted to lock in historically low rates. If a client has more than one home a discussion should ensue regarding what are their plans for these homes. Will they someday move full-time there? Is this a good investment? Check financial statements for value and debt. Discuss financing. Is qualified personal residence trust a good idea?

☐ **Home Mortgage Interest Other:** If a parent has loaned money to the child, make sure the parent has filed a lien on the property, otherwise it is nondeductible personal interest.

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[3] I.R.C. §164(b)(6).

☐ **Home Mortgage Interest Other:** If a parent loaned money to the child, consider having the parent charge the lowest interest rate available, maybe interest only, or set up a gifting strategy to eliminate the loan.

☐ **Home Mortgage Interest Other:** The CAA 2021 extended the treatment of mortgage insurance premiums as qualified residence interest for the mortgage interest deduction through 2021. This provision has not been extended since this time, although future legislation may reinstate this deduction.

☐ **Investment Interest Expense:** If the client is limited in their deduction, consider increasing the investment income by moving from a tax-free to a taxable bond, qualifying dividends to non-qualifying dividends, or electing qualifying dividend and capital gains to be ordinary income to create investment income.

☐ **Investment Interest Expense:** Consider paying cash for a car then getting a loan and putting the money back in a separate investment account. Since the tax law says the loan was used to purchase an investment you can create investment interest expense instead of nondeductible personal interest. How is interest allocated?

<u>Lines 11-14 -- Charity</u>

☐ **Maximizing the Deduction:** Run a projection for wealthy clients to determine the maximum charitable deduction that would offset income taxed at the top 37-percent tax rate without crossing over into the AMT. The CARES Act waived the 60% of AGI limit for cash donations made in 2020, and instead allowed for cash contributions of up to 100% of AGI. The CAA 2021 extended this 100% of AGI limit through 2021. In 2022 and beyond, the AGI limitation reverts to 60%.

☐ **Funding Vehicles:** Consider getting a charitable deduction today at a higher tax rate by using a donor advised fund or possibly setting up a private foundation.

☐ **Gifting Stock:** Consider gifting appreciated securities instead of cash. The client never pays tax on the sale, the property is out of the client’s estate, and the client gets to deduct the fair market value of the securities.

☐ **Gifting Property:** Consider if selling a home that the client makes a large gift of old furniture, clothing, and furnishings and then documents the value accurately.

☐ **Estate Planning:** Discuss with the client the advantage of making charitable contributions during life and getting income-tax benefits, compared to leaving assets to charity under a will.

<u>Line 15 – Casualty and Theft Losses</u>

☐ **Personal casualty losses:** Personal casualty losses are deductible only if they occur in a federal disaster area for 2018 through 2025.

<u>Line 16 -- Other Itemized Deductions</u>

☐ **Casualty losses from income producing property:** **C**asualty losses from businesses and income producing properties were not eliminated by the TCJA. Evaluate casualty losses to see if they fit into either of these categories.

III. Exemptions and filing status

A. The increased standard deduction (and the decreased personal exemption)

The Tax Cuts and Jobs Act of 2017 increased the standard deduction for 2018 to $24,000 for married filing joint and surviving spouses, $18,000 for head of household, and $12,000 for single individuals and married filing separately. For 2023, the standard deduction is $27,700 for married filing joint, $20,800 for head of household, and $13,850 for single individuals[4] For 2024, the standard deduction is $29,200 for married filing joint, $21,900 for head of household, and $14,600 for single individuals. For 2025, the standard deduction is $30,000 for married filing joint, $22,500 for head of household, and $15,000 for single individuals. The increase simplified filing for millions of Americans by eliminating the need for them to complete Schedule A to claim itemized deductions. However, the increase replaced the deduction for personal exemptions. This created a variety of scenarios to consider. For instance, a couple with three dependent children would have had a standard deduction of $13,000 for 2018 without the new law, and personal and dependent exemption deductions of $20,750 (5 x $4,150) for a total "tax free bracket" of $33,750. Under the TCJA, they had a "tax free bracket" of $24,000 for 2018, so their total standard deduction plus exemption amount actually decreased by $9,750. The impact of this reduced deduction was more than offset by other changes, such as the increased tax credit, the reduced tax brackets, the pass-through deduction, etc., so that most taxpayers enjoyed a tax cut for 2018.

Note regarding state income tax:

> Although the increased standard deduction simplified federal income tax filing for most taxpayers, many taxpayers still need to track and document expenditures for itemized deductions for state income tax purposes.

B. Who is a child?

1. Key concept: who is a qualifying child?

The centerpiece of the Working Families Taxpayer Relief Act reform with respect to dependency is the definition of a qualifying child. In general, the tax benefits are more easily obtained for a qualifying child than for a qualifying relative, as discussed later. Following are two points to bear in mind.

- Despite its name, a qualifying child may include an individual who is not a biological child of the taxpayer; for example, a brother or sister can be a taxpayer's qualifying child, as discussed below.
- Most of the provisions use a qualifying child in whole or in part as the eligibility standard. But remember that in some cases, a biological child may not be a qualifying child but nonetheless may qualify the taxpayer for the favored treatment by reason of meeting an alternative criterion, such as a qualifying relative, as discussed below.

2. Dependency exemption suspended

The TCJA suspended the dependency exemption for tax years 2018 through 2025. However, the definition of dependent is maintained in the code for other purposes. So, the code still defines dependent, but the TCJA reduces the dependency and personal exemption amounts to zero. Therefore, other code provisions that refer to the dependency exemption are still valid, but the exemption amount is

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[4] Rev. Proc. 2018-57 §3.16.; Rev. Proc. 2019-44; Rev. Proc 2020-45; Rev. Proc. 2021-45, Rev. Proc. 2022-38, Rev. Proc. 2023-34.

zero. The personal exemption amount to use for other code sections is $5,100 for 2025.[5] The definition of dependent has changed through the years. A dependent is still defined as a qualifying child or a qualifying relative, as discussed below.

a. The term "dependent" does not include an individual who is not a citizen or national of the United States unless such individual is a resident of the United States or a country contiguous to the United States.[6] However, this rule shall not exclude any child of a taxpayer from the definition of dependent if for the taxable year of the taxpayer, the child has the same principal place of abode as the taxpayer and is a member of the taxpayer's household, and the taxpayer is a citizen or national of the United States.[7]

b. An individual is not treated as a member of the taxpayer's household if at any time during the taxable year of the taxpayer the relationship between such individual and the taxpayer is in violation of local law.[8]

3. Qualifying child

A **qualifying child** means, with respect to any taxpayer for any taxable year, an individual who bears a relationship to the taxpayer,[9] has the same principal place of abode as the taxpayer for more than one-half of such taxable year,[10] meets the age requirements,[11] and has not provided over one-half of such individual's own support for the calendar year in which the taxable year of the taxpayer begins.[12]

a. An individual meets the relationship requirement if such individual is a child of the taxpayer or a descendant of such a child, or a brother, sister, stepbrother, or stepsister of the taxpayer or a descendant of any such relative.[13]
   - An individual who otherwise satisfies the uniform definition is **not treated as a qualifying child** unless he is either: (i) **younger than the individual claiming him** as a qualifying child; or (ii) permanently and totally disabled.
   - Another limitation on the personal exemption deduction is that **if a parent may claim a qualifying child, no other individual may claim that child**; but if no parent claims the qualifying child, another individual may claim the child if that individual: (i) is otherwise eligible to claim the child; and (ii) has a higher adjusted gross income for the tax year than any parent of the child.
   - In addition, the child tax credit is available only for a qualifying child for whom the taxpayer is allowed a personal exemption deduction.
   - Also, an individual who is married and files a joint return (unless the return is filed only to claim a refund) is not a qualifying child for child-related tax benefits, including the child tax credit.

b. An individual meets the age requirement if such individual has not attained the age of 19 as of the close of the calendar year in which the taxable year of the taxpayer begins, or is a student who has not attained the age of 24 as of the close of such calendar year.[14] However, in the case of an individual who is permanently and totally disabled at any time

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5 Rev. Proc. 2024-40.
6 I.R.C. §152(b)(3)(A).
7 I.R.C. §152(b)(3)(B).
8 I.R.C. §152(f)(3).
9 I.R.C. §152(c)(1)(A).
10 I.R.C. §152(c)(1)(B).
11 I.R.C. §152(c)(1)(C).
12 I.R.C. §152(c)(1)(D).
13 I.R.C. §152(c)(2).
14 I.R.C. §152(c)(3)(A).

during such calendar year, the age requirements are treated as met with respect to such individual.[15]

Planning point:

> However, a biological child may fail as a qualifying child but still qualify as a qualifying relative or other classification for purposes of eligibility. Thus, a taxpayer's biological child who is not a student but is over age 19 may still qualify for the family tax credit as a qualifying relative, as discussed below.

4. Qualifying relative

A **qualifying relative** is someone other than a qualifying child[16] who meets a relationship requirement with respect to the taxpayer,[17] must have **gross income** for the calendar year in which such taxable year begins of less than the deemed personal exemption amount $5,100 in 2025 (not $0), and must have over one-half of the individual's support for the calendar year in which such taxable year begins provided by the taxpayer.[18] 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.[19]

a. An individual bears a relationship to the taxpayer if the individual is any of the following with respect to the taxpayer:[20]
   - A child or a descendant of a child;
   - A brother, sister, stepbrother, or stepsister;
   - The father or mother, or an ancestor of either;
   - A stepfather or stepmother;
   - A son or daughter of a brother or sister of the taxpayer;
   - A brother or sister of the father or mother of the taxpayer;
   - A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law; or
   - An individual (other than an individual who at any time during the taxable year was the spouse, determined without regard to §7703, of the taxpayer) who, for the taxable year of the taxpayer, has the same principal place of abode as the taxpayer and is a member of the taxpayer's household.

Note:

> Although the dependency exemption amount is reduced to zero for the dependency deduction, the IRS will continue to publish the exemption amount indexed for inflation for other purposes, such as determining whether or not someone is a dependent.

b. Over one-half of the support of an individual for a calendar year shall be treated as received from the taxpayer if:[21]
   - No one person contributed over one-half of such support;

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15 I.R.C. §152(c)(3)(B).
16 I.R.C. §152(d)(1)(D).
17 I.R.C. §152(d)(1)(A).
18 I.R.C. §152(d)(1)(C).
19 T.D. 9913.
20 I.R.C. §152(d)(2).
21 I.R.C. §152(d)(3).

- Over one-half of such support was received from two or more persons each of whom, but for the fact that any such person alone did not contribute over one-half of such support, would have been entitled to claim such individual as a dependent for a taxable year beginning in such calendar year;
- The taxpayer contributed over 10 percent of such support; and
- Each person (other than the taxpayer) who contributed over 10 percent of such support files a written declaration (in such manner and form as the Secretary may by regulations prescribe) that such person will not claim such individual as a dependent for any taxable year beginning in such calendar year.

Note:

To be a qualifying relative of a taxpayer, the individual must not be a qualifying child of the taxpayer or of "any other taxpayer" for the taxable year.[22] A qualifying relative may include an individual who has the same principal place of abode as the taxpayer and who is a member of the taxpayer's household.[23] In the case of a taxpayer who supports as members of her household two minor orphans who are brother and sister, an argument could be raised as to whether the children are qualifying children of "any other taxpayer" (i.e., one another), thus making the taxpayer ineligible to claim the children as dependents.

The Service has determined[24] that a taxpayer otherwise eligible to claim an unrelated child as a dependent is not prohibited from doing so if the child's parent (or other person with respect to whom the child is defined as a qualifying child) is not required to file an income tax return[25] and: (i) does not file an income tax return; or (ii) files an income tax return solely to obtain a refund of withheld income taxes.[26]

5. Tie-breakers

As noted earlier, the new definition of a qualifying child now makes possible the existence of multiple taxpayers with respect to whom an individual could be a qualifying child. In general, if (but for these tie-breakers) an individual may be and is claimed as a qualifying child by two or more taxpayers for a taxable year beginning in the same calendar year, such individual is treated as the qualifying child of the taxpayer who is a parent of the individual, or where the parent is not one of the taxpayers who may claim the individual as a qualifying child, the taxpayer with the highest adjusted gross income for such taxable year.[27]

a. If the parents claiming any qualifying child do not file a joint return together, such child shall be treated as the qualifying child of: (i) the parent with whom the child resided for the longest period of time during the taxable year; or (ii) if the child resides with both parents for the same amount of time during such taxable year, the parent with the highest adjusted gross income.[28]

b. If a child would be a qualifying child with respect to more than one individual (e.g., a child lives with his or her mother and grandmother in the same residence) and more than one person claims a benefit with respect to that child, then the following "tie-breaking" rules apply. First, if only one of the individuals claiming the child as a qualifying child is the child's parent, the child is deemed the qualifying child of the parent. Second, if both parents claim the child and the parents do not file a joint return, then the child is deemed

22 I.R.C. §152(d)(1)(D).
23 I.R.C. §152(d)(2)(H).
24 Notice 2008-5, 2008-2 I.R.B. 1.
25 I.R.C. §6012.
26 See Rev. Rul. 54-567, 1954-2 C.B. 108, aff'd Rev. Rul. 65-34, 1965-1 C.B. 86.
27 I.R.C. §152(c)(4)(A).
28 I.R.C. §152(c)(4)(B).

a qualifying child first with respect to the parent with whom the child resides for the longest period of time, and second with respect to the parent with the highest adjusted gross income. Third, if the child's parents do not claim the child, then the child is deemed a qualifying child with respect to the claimant with the highest adjusted gross income.

6. Joint returns

The law denies dependent status of either a qualifying child or a qualifying relative if such individual has made a joint return with the individual's spouse for the taxable year beginning in the calendar year in which the taxable year of the taxpayer begins.[29]

7. Head-of-household filing status

A taxpayer is eligible for head-of-household filing status only with respect to a qualifying child or an individual for whom the taxpayer is entitled to a dependency exemption (even though the exemption amount is zero for 2018 through 2025). The taxpayer may claim head-of-household filing status if the taxpayer is unmarried (and not a surviving spouse) and pays more than one-half of the cost of maintaining as his or her home a household that is the principal place of abode for more than one-half the year of: (i) a qualifying child; or (ii) an individual for whom the taxpayer may claim a dependency exemption. For tax years 2018 through 2025, the dependency exemption is reduced to zero by the Tax Cuts and Jobs Act but is $5,100 for these purposes in 2025. However, the tests for dependency under §§151 and 152 remain and apply for purposes such as the head-of-household filing status, certain education provisions, and certain dependent-related credits. Head-of-household filing was added to the list of items for which a tax preparer must perform due diligence beginning in 2018.

8. Enhanced Child Tax Credit

For purposes of determining the Child Tax Credit, a qualifying child must meet all of the following conditions:

- The child is the taxpayer's son, daughter, stepchild, eligible foster child, brother, sister, stepbrother, stepsister, half brother, half sister, or a descendant of any of them (for example, the taxpayer's grandchild, niece, or nephew).
- The child was under age 17 at the end of 2025.
- The child did not provide over half of his or her own support for 2025.
- The child lived with the taxpayer for more than half of 2025.
- The child is claimed as a dependent on the taxpayer's return.
- The child does not file a joint return for the year (or files it only to claim a refund of withheld income tax or estimated tax paid).
- The child was a U.S. citizen, U.S. national, or U.S. resident alien.

The $2,000 CTC is phased out for taxpayers with modified AGI in excess of $400,000 for joint filers and $200,000 for all other filers. The $2,000 CTC is partially refundable to the extent of 15% of the taxpayer's earned income exceeding $2,500. As such, the maximum refundable portion of the credit is $1,700.

Note:

ARPA made a variety of temporary changes to the CTC for the 2021 tax year only, including:

- Expanding eligibility to include 17-year-old children;
- Increasing the maximum CTC to $3,000 per child, or $3,600 for children under age 6;

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29 I.R.C. §152(b)(2).

- Making the CTC fully refundable; and
- Issuing monthly advanced payments of the CTC.

Proposed legislation sought to extend the expanded CTC, but Congress ultimately did not pass an extension. It is possible that future legislation could extend the expanded CTC.

C. Planning issues

1. Key elements

a. Parents should consider the effective use of the dependency exemption for children. Even though the exemption is currently zero dollars, the person who qualifies for the dependency exemption qualifies for the child credit.

b. The qualification for the exemption is also important for kiddie tax and education credit issues.

c. It is important to keep in mind that the winner of the tie-breaker can waive the exemption, letting the exemption in respect of the child be claimed to the formal loser, generally another individual at the same residence.

2. Shifting the identity of who can claim a qualifying child

The tie-breaker system inherently recognizes that in many cases more than one taxpayer could claim the same individual as a qualifying child. These potential claimants will all live in the same household, so in theory they can determine who will benefit most from dependency status, considering the taxpayer profiles of the various candidates. The tie-breaker rules apply only when more than one taxpayer claims the same individual as an exemption, so those who would otherwise “win” can merely not claim the exemption, permitting other taxpayers to do so.

a. A somewhat counter-intuitive example of this lies in the expansion of the definition of a child that is not in the strict biological sense is the inclusion of the **sibling relationship**.

b. Families with children in college for whom tax benefits like the personal exemption and the Hope and Lifetime Learning tax credits provide valuable tax reductions formerly had only to show more than one-half of the support to qualify. Under the new rules, the college child who is away from the abode and has no intention of returning does not qualify the parent for these benefits. Examples of losers are those children who have established out-of-parents’-state residency in order to qualify for admission and tuition purposes available to in-state students. In addition, some students establish an employment relationship, including summers, which is an indication that the child has no intention of returning to the parent’s state let alone the parent’s house. Thus, even though the parents are providing more than one-half of the support -- all that was required prior to 2005 -- these benefits are now not available. While these factual circumstances may be too remote for the Service to uncover, taxpayers are put to making in essence an assertion that they know, should know, or have reason to know, is false.

Example: Jerry is 18 years old and lives with his brother Dean. Jerry has gross income of $5,100, but does not provide more than 50 percent of his own support. Because Jerry is a qualifying child with respect to Dean, Dean may claim him as a dependent. Dean could not have claimed Jerry as a dependent under earlier law because of the gross income test. The former exception to the gross income test for dependents under age 19 applied to only the biological children of the taxpayer and would not have been available to Jerry.

3. The college student

A credit that is never even on the horizon for many parents, the earned income tax credit, again may be of use to the college student. Since the credit no longer requires the student to care for the sibling, the mere commonality of residency enables the college child to claim the earned income tax credit for his or her earned income in relation to the sibling.

4. Tie-breaker strategies

If none of the taxpayers is the child's parent, the child is treated as a qualifying child of the person with the highest AGI. Because many of the tax benefits associated with supporting children are phased out at higher levels of AGI, the taxpayer with the highest AGI may receive a lesser benefit from claiming a child as a qualifying child. Thus, overall tax savings can sometimes be achieved if a higher-AGI taxpayer refrains from claiming a child so that qualifying child status may be claimed by another taxpayer who will receive more benefit. Conversely, the "winner" of the tie-breaker may be in so low an income level that the tax benefits cannot be fully utilized.

Planning point:

> The tie-breaking rules apply only if an individual "may be and is" claimed as a qualifying child by two or more taxpayers. The simple expedient of not claiming prevents the "is" condition from occurring, so taxpayers may have considerable planning opportunities to obtain the maximum tax benefit.

Example: Lucy lives in her grandmother's home along with her mother Eve. Gladys, the grandmother, provides only 20 percent of Lucy's support while Eve provides the balance. Since Eve is Lucy's mother, she wins all tie-breakers against a non-parent.

5. Qualifying relatives

Example 1: Dick provides more than one-half of the support for his girlfriend Jane and her minor daughter Sally, who both live in Dick's home. Dick may claim Jane as a qualifying relative but cannot claim Sally because she could be claimed by Jane as a qualifying child.

Example 2: The facts are the same as above, except Sally is 19 and is not a student. While Dick can still claim Jane as a qualifying relative, since Jane cannot claim Sally as a qualifying child, Dick may now claim her as a qualifying relative.

D. Medical expenses

1. The AGI floor for medical expenses

A taxpayer is allowed a deduction for medical expenses paid during the tax year to the extent that the expenses exceed a certain percentage of the taxpayer's adjusted gross income. The medical expense deduction floor was set to increase to 10 percent of AGI in 2020 prior to the passage of the Consolidated Appropriations Act of 2021 (CAA 2021). The CAA 2021 made 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. The medical expense deduction is available only to those expenses incurred by the taxpayer, the taxpayer's spouse, or a medical dependent.

Note: Expanded HSA Medical Expenses

The CARES Act §3702 expanded coverage for health savings accounts (HSAs), health reimbursement arrangements (HRAs), health flexible spending accounts (health FSAs), and Archer medical savings accounts (Archer MSAs), allowing for tax-free reimbursement of feminine hygiene products.

The Affordable Care Act, signed into law over 10 years ago on March 23, 2010, repealed the ability for individuals to use HSA accounts to purchase OTC drugs. In addition to expanding coverage for tax-free reimbursement of feminine hygiene products, §3702 of the CARES Act eliminates §9003 of the Affordable Care Act that limited the use of HSAs to only prescribed medicines or drugs. In other words, individuals will be able to use their HSAs, HRAs, health FSAs, and Archer MSAs to purchase over-the-counter medicine. This provision is effective for expenses incurred after December 31, 2019.

The IRS issued IR-2021-66, on March 26, 2021, clarifying that the purchase of personal protective equipment, including masks, hand sanitizer and sanitizing wipes, used to prevent the spread of COVID-19, are deductible medical expenses. The amounts paid for PPE are also eligible to be paid or reimbursed under health FSAs, Archer MSAs, HRAs, and HSAs.

2. Who is a medical dependent?

The test for whether a person qualifies as a medical dependent for these purposes is the same as for purposes of the dependency personal exemption, which requires that a person be a qualifying child or a qualifying relative of the taxpayer, but:

a. In determining whether a person is a dependent for medical expense deduction purposes two exceptions and one requirement for being a qualifying child are disregarded:
   - (i) The exception that precludes a person from being a dependent of the taxpayer if the taxpayer is the **dependent of another person** is not taken into account;
   - (ii) The exception that precludes a person from being a dependent of the taxpayer if the person files a **joint return** for the taxable year is not taken into account; and
   - (iii) The requirement that the individual have **gross income** less than the annual amount for the personal exemption does not apply. The medical expense deduction may be available even though the individual is not a personal exemption dependent.

Note:

For example, a parent in the older generation having gross income in excess of the personal exemption amount or who files a joint return (or both) cannot be a qualifying relative for personal exemption purposes but might still be a medical dependent for whom deductible medical expenses may be deducted because the gross income limitation does not apply and the prohibition against joint return filing does not apply for purposes of the medical expense deduction.

b. The taxpayer must, however, still meet the following requirements with respect to a parent (or any **qualifying relative**):
   - (i) **Provide more than one-half of the older generation's support**; and
   - (ii) The individual is not a qualifying child (always the case for a parent).

Note:

> A child of the taxpayer may be a qualifying relative in circumstances in which the child is not a qualifying child, because (1) the child exceeds the age limitations[30] that apply to a qualifying child, or (2) the child did not share the same principal place of abode as the taxpayer for more than one-half of the year.

c. Medical expenses paid by a taxpayer for the care of a dependent are deductible only if the person is a dependent either at the time the medical care is rendered or at the time the expenses are paid.[31] F

Example: F is T's father. During the current year, F incurred $5,200 of medical expenses while providing more than one-half of his own support. T is planning to provide more than one-half of the support in the following year. F is not a dependent of T at the time these expenses were incurred so current payment by T is not deductible. If, however, T waits until the following year to make the payment on behalf of F, F will then be a dependent and T may deduct the $5,200 of medical expenses.

3. Support

a. There is authority that in determining the percentage of support provided a dependent, financial assistance provided by a state for room, board, and tuition of a child in a school for the mentally retarded is not considered. Hospital costs covered by Part A Medicare payments are not taken into account in determining whether the support test has been met.[32]

b. Payment of medical bills of an older generation's medical liabilities that the older generation pays, either directly or through Medicare/Medicaid, is an issue that siblings in the sandwich generation often have to confront and then reach agreement upon. A multiple support agreement (Form 2120, *Multiple Support Declaration*) is used when multiple persons are involved, none of whom provides more than 50 percent of an individual's support, but who in combination provide more than one-half of the support; under the general rule no one could claim the individual as a dependent, but a multiple support agreement treats one of the contributors as having supplied more than one-half of the support for purposes of qualifying the individual as a dependent or medical dependent, if all other contributors waive their own right to claim the individual as a dependent.

Note:

> However, although one is deemed to have contributed more than one-half of the support, this does not mean one can claim all such medical expenses as a deductible expense for a medical dependent. A taxpayer who pays a dependent parent's medical bills and is allowed to claim the dependency exemption deduction under a multiple support agreement relating to the parent is treated as having been compensated otherwise for the expense to the extent of the contributions by others. Thus, in a case where one taxpayer and his two brothers each contributed one-third of their mother's medical costs, the taxpayer entitled to the dependency deduction had to reduce the amount of deductible medical expenses by the amount of reimbursement from his brothers rather

[30] The child must not have attained age 19 as of the close of the calendar year in which the tax year begins, or is a student who has not attained age 24 by the close of the calendar year. These age requirements do not apply to a child who is totally disabled, i.e., is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months

[31] Treas. Regs. §1.213-1(e)(3).

[32] *Turecamo v. Commissioner*, 554 F.2d 564 (2d Cir. 1977), aff'g 64 T.C. 720 (1975); *Archer v. Commissioner*, 73 T.C. 963 (1980).

than to claim the full amount the taxpayer paid.[33] This automatic sourcing rule has also been applied to amounts received by the taxpayer from state assistance programs[34] so that only to the extent that the medical expenses paid exceed these amounts is the taxpayer entitled to a deduction for medical expenses.

4. Payment

Medical expenses are automatically established by the cash method of accounting, so only amounts paid in a taxable year are then deductible. If a taxpayer charges medical expenses on a credit card, the expenses are deductible in the year charged, regardless of when the amount charged is actually paid by the taxpayer.[35] In addition, a taxpayer is allowed to deduct medical expenses paid by the taxpayer's parent in exchange for a promissory note issued by the taxpayer to the parent in the year the parent pays them.[36]

a. Generally, a prepaid expense for future medical care is not deductible in the year paid.

   (i) Advance payments made to institutions required as a condition for future acceptance of a handicapped child for lifetime care if the parents become unable to care for the child are deductible in the year paid. The taxpayers, both of whom were 54 years of age, were parents of an 18-year-old daughter who was physically and mentally handicapped to the extent that she was confined to a wheelchair and required continual and extensive care. To ensure that their daughter received appropriate care after their death, or at such time as they were otherwise unable to care for her, the taxpayers entered into a contract with a private institution specializing in the care and custody of such individuals to provide for her care, supervision, treatment, and training in that institution during her lifetime. In order for the girl to be accepted in the institution and receive lifetime care, the institution required payments from the taxpayers of 250x dollars as follows: 50x dollars upon the signing of the contract, 25x dollars within 12 months, an additional 25x dollars within 24 months, and the final 150x dollars when their daughter enters the institution. No portion of any of the payments made was refundable. The fee was calculated without regard to contracts for care involving other patients and, therefore, was not medical insurance.[37]

   (ii) However, if the payment is for care that is not lifetime care but extends substantially beyond the end of the taxable year in which the payment is made,

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33 *Litchfield v. Commissioner*, 330 F.2d 509 (1st Cir. 1964), aff'g 40 T.C. 967 (1963).

34 Some states pay a medical stipend to the caregiver who is responsible for reporting to state courts.

35 Rev. Rul. 78-39, 1978-1 C.B. 73.

36 Rev. Rul. 78-173, 1978-1 C.B. 73.

37 Rev. Rul. 75-303, 1975-2 C.B. 87, clarified by Rev Rul. 93-72, 1993-2 C.B. 77. In rev. Rul. 75-302, 1975-2 C.B. 86, a taxpayer, 78 years of age, entered into an agreement with a retirement home under which he became entitled to live in the home and to receive lifetime care. In consideration for the promise of the lifetime care that he desired, the taxpayer agreed to pay 170x dollars in a lump-sum as the life-care fee. The fee was calculated without regard to any similar contracts with other patients at the institution and assured the taxpayer lifetime care at no additional cost and, therefore, was not medical insurance. The retirement home demonstrated that the life-care fee of 170x dollars included 51x dollars to cover the home's obligation to provide medical care, medicine, and hospitalization, and gave the taxpayer a separate statement to that effect. The allocation made by the retirement home was found to be appropriate in this case, since it was made on the basis of prior experience, which showed that the cost of furnishing these items averaged about 30 percent of its life-care budget. The agreement further provided that in the event a member terminated his membership he would, under certain circumstances, be entitled to a refund of a portion of the life-care fee paid. Such refund would be computed in accordance with a specified formula that included a penalty provision. The obligation to pay was incurred at the time payment was made in return for the retirement home's promise to provide lifetime care, and the payment was made in order to secure medical services despite the fact that the medical services were not to be performed until a future time if at all. The portion of the lump-sum life-care fee payment, made by the taxpayer pursuant to a contract, that was properly allocable to his medical care, is deductible as an expense for medical care in the year paid,

the deduction is treated as a prepaid expense and is deductible in the taxable year in which the care is provided.[38]

(iii) The Code provides that a taxpayer who pays premiums paid during the taxable year by a taxpayer before he attains the age of 65 for insurance covering medical care for the taxpayer, spouse or dependent after the taxpayer attains age 65 may deduct, in the year paid, such health insurance premiums.[39] Premiums for such insurance must be payable (on a level payment basis) under the contract for a period of 10 years or more or until the year in which the taxpayer attains the age of 65 (but in no case for a period of less than 5 years).

5. What is medical care?

Medical care includes the diagnosis, cure, mitigation, treatment, or prevention of disease. Expenses paid for medical care include those paid for the purpose of affecting any structure or function of the body or for transportation primarily for and essential to medical care. It may also include medical insurance as described below.

a. Amounts paid for operations or treatments affecting any portion of the body, including obstetrical expenses and expenses of therapy or X-ray treatments, are deemed to be for the purpose of affecting any structure or function of the body and are therefore paid for medical care. Amounts expended for illegal operations or treatments are not deductible. Deductions for expenditures for medical care allowable are confined strictly to expenses incurred primarily for the prevention or alleviation of a physical or mental defect or illness. Thus, payments for the following are payments for medical care: hospital services, nursing services (including nurses' board where paid by the taxpayer), medical, laboratory, surgical, dental and other diagnostic and healing services, X-rays, medicine and drugs, artificial teeth or limbs, and ambulance hire. However, an expenditure which is merely beneficial to the general health of an individual, such as an expenditure for a vacation, is not an expenditure for medical care.

b. Capital expenditures are generally not deductible for federal income tax purposes. However, an expenditure that otherwise qualifies as a medical expense is not disqualified merely because it is a capital expenditure. For these purposes, a capital expenditure made by the taxpayer may qualify as a medical expense, if it has as its primary purpose the medical care of the taxpayer, his spouse, or his dependent. Thus, a capital expenditure which is related only to the sick person and is not related to permanent improvement or betterment of property, if it otherwise qualifies as an expenditure for medical care, is deductible; for example, an expenditure for eye glasses, a seeing eye dog, artificial teeth and limbs, a wheel chair, crutches, an inclinator or an air conditioner which is detachable from the property and purchased only for the use of a sick person, etc. Moreover, a capital expenditure for permanent improvement or betterment of property which would not ordinarily be for the purpose of medical care may, nevertheless, qualify as a medical expense to the extent that the expenditure exceeds the increase in the value of the related property if the particular expenditure is related directly to medical care.

Example: A taxpayer is advised by a physician to install an elevator in his residence so that the taxpayer's wife who is afflicted with heart disease will not be required to climb stairs. If the cost of installing the elevator is $1,000 and the increase in the value

38 Rev. Rul. 93-72, 1993-2 C.B. 77.

39 I.R.C. §213(d)(7); Treas. Regs. §1.213-1(e)(4)(i)(b).

of the residence is determined to be only $700, the difference of $300, which is the amount in excess of the value enhancement, is deductible as a medical expense.

If, however, by reason of this expenditure, it is determined that the value of the residence has not been increased, the entire cost of installing the elevator would qualify as a medical expense.

c. The cost of in-patient hospital care (including the cost of meals and lodging therein) is an expenditure for medical care. The extent to which expenses for care in an institution other than a hospital shall constitute medical care is primarily a question of fact which depends upon the condition of the individual and the nature of the services he receives (rather than the nature of the institution). A private establishment which is regularly engaged in providing the types of care or services is considered an institution for these purposes.

(i) Where an individual is in an institution because his condition is such that the availability of medical care in such institution is a principal reason for his presence there, and meals and lodging are furnished as a necessary incident to such care, the entire cost of medical care and meals and lodging at the institution, which are furnished while the individual requires continual medical care, shall constitute an expense for medical care.

Example: Medical care includes the entire cost of institutional care for a person who is mentally ill and unsafe when left alone. While ordinary education is not medical care, the cost of medical care includes the cost of attending a special school for a mentally or physically handicapped individual, if his condition is such that the resources of the institution for alleviating such mental or physical handicap are a principal reason for his presence there. In such a case, the cost of attending such a special school will include the cost of meals and lodging, if supplied, and the cost of ordinary education furnished which is incidental to the special services furnished by the school. Thus, the cost of medical care includes the cost of attending a special school designed to compensate for or overcome a physical handicap, in order to qualify the individual for future normal education or for normal living, such as a school for the teaching of braille or lip reading. Similarly, the cost of care and supervision, or of treatment and training, of a mentally retarded or physically handicapped individual at an institution is within the meaning of the term "medical care."

Note:

This may be of use to the sandwich generation whether in respect of a disabled child or an older generation member suffering from dementia and related individuals.

(ii) Where an individual is in an institution, and his condition is such that the availability of medical care in such institution is not a principal reason for his presence there, only that part of the cost of care in the institution as is attributable to medical care shall be considered as a cost of medical care; meals and lodging at the institution in such a case are not considered a cost of medical care for these purposes.

Example: An individual is in a home for the aged for personal or family considerations and not because he requires medical or nursing attention. In such case, medical care consists only of that part of the cost for care in the home which is attributable to medical care or nursing attention furnished to him; his meals and lodging at the home are not considered a cost of medical care.

6. Long-term care

A qualified long-term care insurance contract is treated as an accident and health insurance contract and hence is currently deductible as a medical expense. 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**, such 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, such contract is guaranteed renewable, such 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, any dividends are required and refunds of premiums must be applied as a reduction of future premiums, and contains certain consumer protection provisions.

a. 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**.

Note:

A plan of care is not the equivalent of institutionalization and may be conducted at home.

(i) 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).

(ii) A licensed health care practitioner means any physician and any registered professional nurse, licensed social worker, or other individual who meets such requirements as may be prescribed by the Treasury.

(iii) A chronically ill individual means any individual certified by a licensed health practitioner as: (i) being unable to perform (without substantial assistance from another individual) at least 2 **activities of daily living** for a period of at least 90 days due to a loss of functional capacity; (ii) having a level of disability similar (as determined under regulations prescribed by the Secretary in consultation with the Secretary of Health and Human Services) to the level of disability described in (i); or (iii) requiring substantial supervision to protect such individual from threats to health and safety due to severe cognitive impairment. Such term shall 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. Activities of daily living include:

- Eating;
- Toileting;
- Transferring;
- Bathing;
- Dressing; and
- Incontinence.[40]

40 A contract is not 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 5 of such activities.

Note:

When parents go into a facility, the level of care may determine the extent of the medical deduction. In most cases, the costs billed for a nursing home providing continuing care will most likely be fully deductible. As the level of care moves down to assisted living, adult home care or home assistance involves both medical services and other non-medical services and present sometimes difficult questions of allocation. If the primary reason for the placement (or the care) is personal, only the direct medical costs (e.g., doctor's visits, medication, etc.) are deductible; room and board will not be deductible.

b. The federal income tax medical deduction is limited to only that portion of expenses exceeding 7.5% of adjusted gross income and to only those expenses not reimbursed by insurance or otherwise. Nevertheless, a sandwich generation member who is unable to deduct any of his or her own medical expenses may exceed the threshold on account of such long-term care costs if the older (or younger) generation qualifies as a medical dependent.

c. The cost of hiring a personal attendant to perform in-home medical services for a taxpayer, spouse, or medical dependent is a deductible medical expense. [41] The deductible cost of hiring an attendant includes wages paid, and, if the attendant lives in the home, the out-of-pocket costs for meals as well as lodging costs that are in excess of the normal costs of maintaining the home.

Note:

The leading revenue ruling involved the various expenses attributable to a personal attendant at the home of a medical dependent:[42] some of the services provided by the attendant are in the nature of nursing services, payments for which are deductible within the limitations of §213 of the Code. In this case, the attendant's services in taking care of the condition resulting from the ileostomy, and in dressing, grooming, and bathing the taxpayer are as such nursing-type services. However, household and other personal services are nonmedical services, payments for which are nondeductible. Thus, an apportionment must be made as between the time spent by the attendant in performing nursing-type services, and the time spent performing household and other personal services. The portion of the attendant's wages allocable to the nursing-type services is deductible by the taxpayer as medical expenses within the limitations of §213. The portion of the wages allocable to household and other personal services is nondeductible under §262.

(i) With respect to the meals furnished the attendant, since an allocable portion of the related wages is deductible as a medical expense, a similar portion of the taxpayer's out-of-pocket expenditures for the attendant's meals is likewise deductible. The deductible amount is determined by allocating food expenditures among the members of the household to find the amount of the expenditure attributable to the attendant, and by then apportioning that amount in the same manner that the wages of the attendant are apportioned as between deductible and nondeductible amounts, as described above.

(ii) With respect to the lodging furnished as part of the attendant's compensation, since the maintenance of a household is a personal expense normally incurred by a taxpayer, the lodging furnished to an attendant is not a deductible medical expense unless it can be shown that the taxpayer made out-of-pocket expenditures directly attributable to the lodging of the attendant that were in

41 *Estate of Dodge v. Commissioner*, 20 T.C. Memo. 1961-346.
42 Rev. Rul. 76-106, 1976-1 C.B. 71.

addition to normal expenditures for maintaining the household as, for example, additional rent required when the taxpayer moves to an apartment with an additional bedroom to accommodate the attendant and additional utilities attributable to the attendant. To the extent that the taxpayer can show additional expenditures for lodging for the attendant in the instant case, the taxpayer is entitled to a medical expense deduction for the lodging furnished the attendant. The additional expenditures must be apportioned in the same manner that the wages of the attendant are apportioned as between deductible and nondeductible amounts, as described above.

(iii) The personal attendant need not be a nurse or a practical nurse, as the deduction depends on the nature of the services performed and not on the qualifications of the person performing them. However, payments made to a blood relative or step-relative are not deductible unless that individual is a licensed health practitioner.

7. Continuing care retirement communities

Now the older generation's very longevity may signal planning for retirement living even without regard to current medical conditions. They are likely to require some form of care, and flexibility is often structured with different levels of care. In each case, a taxpayer generally may deduct a portion of the fees paid for residence in a continuing care retirement community (CCRC). These arrangements involve a taxpayer to acquire a residence in a CCRC under an agreement that provides for the payment of certain fees to the CCRC. The fees take the form of either or both (1) an immediate lump-sum payment or (2) monthly payments during the period of residence. Payment of the fees generally entitles the retiree to certain lifetime medical and long-term care services, in addition to residence in the CCRC.

a. The flexibility of the CCRC is reflected in the tiers of units and facilities/services that are present in the same location.

(i) At the top is independent living unit (ILU). This is perfect for older generation members who do not have current significant medical issues and who can currently care for themselves. The cost of such units is higher than apartment living in part because of the possibility of conveniently administered medical services. The portion of the fees must be allocated between medical and other expenses, but the Tax Court has permitted as much as 30 percent in a leading case on this issue.[43]

(ii) Equally relevant is the endorsement of a percentage method rather than an actuarial method (which would have taken into account the ages of the residents) in making this allocation.

- The percentage method assumes that the medical care portion of entrance fees and monthly service fees is the same portion or percentage as the CCRC's medical expenses to total costs because the sum of the fees over the resident's lifetime is expected to cover the costs of care for residents in a CCRC. Thus, the percentage method generally involves analyzing each expense category to determine what portion of each category's total costs is for medical purposes. This allocation process is fairly straightforward for CCRCs that provide medical care through stand-alone detached units with budgets separate from the

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43 *Baker v. Commissioner*, 122 T.C. 143 (2004)

nonmedical center or that purchase medical services from a third party. The allocation is done by the facility, not the taxpayer.

- Under the percentage method, once total medical expenses are determined, this amount is divided by the CCRC's costs to determine the medical expense allocation percentage. This percentage is then multiplied by the total monthly fees collected from ILU residents for the year to find the total medical costs allocable to monthly fees revenue. This total is then divided by the number of ILU residents to determine the portion of the fees that is allocable to medical care.

(iii) The CCRC may operate at the same location as an assisted living facility (ALF), a skilled nursing facility (SNF), or an Alzheimer's and dementia facility (ADF). As would be expected, a skilled nursing facility (SNF) is a facility providing accommodations for retirees who are in need of full-time skilled nursing care.

- The ALF normally provides apartments and long-term care for retirees who need assistance with the normal activities of daily living but who do not need full-time skilled nursing care.
- An ADF generally provides accommodations and supervision for retirees who suffer from mental impairments so severe that it is unsafe to leave them alone.

Note:

Taxpayers may normally take medical expense deductions for **all amounts** paid for care in an SNF, ALF, or ADF—subject to the usual overall limitations on medical deductions. In addition to the usual types of medical expenses, the portion of the fee representing cost of meals and lodging paid to an institution other than a hospital will be deductible as medical expenses dependent upon the condition of the individual and the nature of the services he receives (rather than the nature of the institution). A private establishment which is regularly engaged in providing the types of care or services outlined above is considered an institution for purposes of the rules provided.

Planning point:

Where an individual is in an institution because his condition is such that the availability of medical care in such institution is a principal reason for his presence there, and meals and lodging are furnished as a necessary incident to such care, the entire cost of medical care and meals and lodging at the institution, which are furnished while the individual requires continual medical care, constitutes an expense for medical care.

For example, medical care includes the entire cost of institutional care for a person who is mentally ill and unsafe when left alone. While ordinary education is not medical care, the cost of medical care includes the cost of attending a special school for a mentally or physically handicapped individual, if his condition is such that the resources of the institution for alleviating such mental or physical handicap are a principal reason for his presence there. In such a case, the cost of attending such a special school will include the cost of meals and lodging, if supplied, and the cost of ordinary education furnished which is incidental to the special services furnished by the school. Thus, the cost of medical care includes the cost of attending a special school designed to compensate for or overcome a physical handicap, in order to qualify the individual for future normal education or for normal living, such as a school for the teaching of braille or lip reading. Similarly, the cost of care and supervision, or of treatment and training, of a mentally retarded or physically handicapped individual at an institution is within the meaning of the term “medical care.”

Where an individual is in an institution, and his condition is such that the availability of medical care in such institution is not a principal reason for his presence there, only that part of the cost of care in the institution as is attributable to medical care is considered as a cost of medical care; meals and lodging at the institution in such a case are not considered a cost of medical care for these purposes.

If for example, an individual is in a home for the aged for personal or family considerations and not because he requires medical or nursing attention, the medical care costs consist only of that part of the cost for care in the home which is attributable to medical care or nursing attention furnished to him; his meals and lodging at the home are not considered a cost of medical care.

Thus, in most instances, fees paid to such a facility will constitute fully deductible payments for meals, lodging, and normal medical expenses (including qualified long-term care expenses). As with hospital bills, it would be unusual (though possible) for such fees to include other kinds of expenses that are not deductible. The expenses are the same as they were for an individual in an ILU but the additional medical expense deduction may make taking the steps to treat the older generation as a medical dependent more attractive to the sandwich generation.

Note:

Interestingly, the taxpayer essentially is prepaying expenses in this case and making an interest-free loan (discussed elsewhere in this material) to the facility. The imputed interest income rules do not apply for any calendar year to any below-market loan owed by a facility if, on the last day of such year the facility is a **qualified continuing care facility**, **and** the loan was made pursuant to a **continuing care contract** and if the lender (or the lender's spouse) attains age 62 before the close of such year.

b. A continuing care contract is a written contract between an individual and a qualified continuing care facility under which the individual or individual's spouse may use a qualified continuing care facility for their life or lives, the individual or individual's spouse will be provided with housing, as appropriate for the health of such individual or individual's spouse (i) in an independent living unit (which has additional available facilities outside such unit for the provision of meals and other personal care), and (ii) in an assisted living facility or a nursing facility, as is available in the continuing care facility; and the individual or individual's spouse will be provided assisted living or nursing care as the health of such individual or individual's spouse requires, and as is available in the continuing care facility.

c. A qualified continuing care facility means one or more facilities that are designed to provide services under continuing care contracts, which include an independent living unit, plus an assisted living or nursing facility, or both, and substantially all of the independent living unit residents of which are covered by continuing care contracts.

d. However, a qualified continuing care facility does not include any facility that is of a type which is traditionally considered a nursing home.

8. Substantiation

According to the regulations, a taxpayer claiming a medical expense deduction must be prepared to substantiate expenses with date, amount, and name of each person to whom a payment for medical expenses was made.[44] Upon request by the Service medical expense deductions must be substantiated by a statement or itemized invoice from the individual or entity to which payment for medical services was made showing the nature of the service rendered, and to or for whom rendered; the nature of any other item of expense and for whom incurred and for what specific purpose, the amount paid therefor and the date of the payment thereof. Proof that the taxpayer paid medical expenses requires more than invoices, because invoices alone do not prove that the taxpayer, and not someone else, paid the medical bill.[45]

Note:

In addition, where the issue of the percentage of support by the taxpayer is implicated, taxpayers will be called on to establish both taxpayer's support and the total support of any would-be medical dependent.

E. Child and Dependent Care Credit

A variety of taxpayers incur child or dependent care expenses. The child and dependent care credit is a nonrefundable credit that allows taxpayers to receive a credit for qualified employment-related expenses paid for the care of qualifying individuals. To be eligible for the child and dependent care credit, certain criteria has to be met, including:

- **The Qualifying Person Test**: A person is a qualifying individual if he or she satisfies any one of three conditions:
  - The person is a dependent of the taxpayer by reason of being a qualifying child of the taxpayer and has not attained age 13.
  - The person is a dependent of the taxpayer, is physically or mentally incapable of caring for himself or herself and has the same principal place of abode as the taxpayer for more than one-half of the taxable year.
  - The person is the spouse of the taxpayer, is physically or mentally incapable of caring for himself or herself and has the same place of abode as the taxpayer for more than one-half of the taxable year.
- **The Earned Income Test**: The taxpayer(s) must have earned income during the year, such as wages, salaries, tips, and net earnings from self-employment.
- **The Work-Related Expense Test**: The child and dependent care expenses must be work related in order to qualify for the child and dependent care credit. Expenses meet this test if both of the following statements are true:

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44 Treas. Regs. §1.213-1(h).

45 See *Oji v. Commissioner*, 95 T.C.M. 1333 (2008).

   - The expenses allow the taxpayer (and spouse, if filing joint) to work or look for work. If the taxpayers are married and filing a joint return, both must generally work or look for work.
   - The expenses are for a qualifying person's care.
- **Joint Return Test:** Married couples must file a joint return (not married filing separately) in order to take the child and dependent care credit, unless they are legally separated or living apart from each other.
- **Care Provider Identification Test:** The taxpayer must identify all persons or organizations that provide care for the qualifying child or dependent on Form 2441, *Child and Dependent Care Expenses.*
- **Qualifying Expense Test:** The total deduction is required to be less than the dollar limitation for qualifying expenses, which is generally $3,000 if one qualifying person is cared for, and $6,000 if two or more qualifying persons are cared for.
   - The credit is equal to 35% of employment-related expenses for taxpayers whose AGI is $15,000 or less. As such, the maximum credit is $1,050 ($3,000 x 35%) for one qualifying individual and $2,100 ($6,000 x 35%) for two or more qualifying individuals. This 35% amount is decreased by one percentage point for each $2,000 of additional AGI until it is reduced to 20%. Once AGI is in excess of $43,000, the 20% credit applies.

Note:

Similar to the CTC, ARPA made several temporary changes to the child and dependent care credit for the 2021 tax year only, including:

- Making the child and dependent care credit fully refundable for certain taxpayers;
- Increasing the dollar limitation for qualifying expenses from 3,000 to $8,000 for one qualifying individual, and from $6,000 to $16,000 for two or more qualifying individuals; and
- Increasing the applicable credit percentage from 35% to 50% for taxpayers whose AGI is $125,000 or less.

It is possible that these provisions could be reinstated by future legislation.

F. FSA and Dependent Care Assistance

A Dependent Care Assistance Plan (DCAP) allows an employee to be reimbursed for eligible dependent care expenses so that the employee and his or her spouse may work, look for work, or attend school full time. The employer sets the minimum and maximum an employee contributes, subject to an annual limitation. Employer-provided contributions to FSAs for dependent care assistance are limited to $5,000 per year for married couples filing jointly, $2,500 for married couples filing separately in 2025. Any employer-provided assistance above the annual maximum amounts is included in taxable income.

For purposes of these amounts excluded from taxable wages, an employee is considered:

- A current employee;
- A leased employee who has provided services to the employer on a substantially full-time basis for at least 12 months if the services are performed under the employer's primary direction and control;
- A sole proprietor; and
- A partner who performs services for a partnership.

IV. Individual items

A. Loans to individuals

Note:

> Below-market loans continue to be an effective, albeit limited, income-shifting tactic. There is a gift element that is subject to gift tax, but the reason for the use of a loan rather than an outright gift is the lesser gift tax consequences. Where the transfer of funds is structured as a below-market loan, the gift element consists solely in the foregone interest, i.e., the excess of a hypothetical level of interest that could have been earned on the loan and the interest actually charged. For example, if a parent loans a child on January 1 a demand loan of $19,000 at zero interest that remains unpaid on December 31, where the standard interest charge is 2 percent, the foregone interest of $380 during the year is a reportable gift (only if, in the aggregate, gifts to the child exceed gift for gift tax purposes), regardless of the income tax consequences described below. On the other hand, if the parent were to make a gift of the $19,000, the gift for gift tax purpose would be $19,000. For estate planning purposes, the lower gift tax cost provides great leverage to the donor, particularly if the child makes in effect the same investment the parent would have made with the funds. This shifts the appreciation and income element out of the estate.
>
> However, the outright gift to a child severs the income tax consequences to the parent where the below-market loan may not necessarily do so.

1. In general

In general, the interest rates now applicable to inter-family loans have reached historic lows.

Note:

> Gifts are usually limited to the annual exclusion amount ($19,000, $38,000 with gift-splitting, in 2025). This has had the effect of limiting transfers to donees. But transfers made as bona fide loans are not taxable gifts.

Example: Peggy makes a below-market loan to Linc that results in foregone interest of $5,000. Peggy includes $5,000 in income as taxable interest but Linc cannot deduct the $5,000 interest he is deemed to have paid her.

Accordingly, §7872 recharacterizes a below-market loan as two transactions:

- An arm's-length transaction in which the lender makes a loan to the borrower in exchange for a note requiring the payment of interest at the applicable federal rate; and
- A transfer of funds by the lender to the borrower ("imputed transfer").

Note:

> If the imputed transfer by the lender is characterized as a gift, the provisions of chapter 12 of the Internal Revenue Code, relating to gift tax, also apply.
>
> In the case of a gift, the lender is treated as making a gift of the interest to the borrower but the borrower nonetheless still is treated as transferring that amount to the lender as interest. However, if a taxpayer makes a gift loan that is a term loan, the excess of the amount loaned over the present value of all payments which are required to be made under the terms of the loan agreement is treated as a gift from the lender to the borrower on the date the loan is made. If a taxpayer makes a gift loan that is a demand loan, the amount of foregone interest attributable to that calendar period is treated as a gift from the lender to the borrower.
>
> The **de minimis exception** applies to the gift-tax treatment of a gift loan. This excepts from the application of the income tax or gift tax a below-market loan that does not exceed $10,000. In the case of a term-gift loan, however, once §7872 applies to the loan, the de minimis exception will not apply to the loan at some later date regardless of whether the aggregate outstanding amount of loans does not continue to exceed the limitation amount.

2. Loans to children

Persons can enhance their investment return by providing funds at above the historically low current interest rates to children or other related parties at rates that also are below the rate that the related party might otherwise have to pay. The Code provides a backstop to such loans by also requiring generally that they bear a market rate of interest or trigger adverse income tax consequences. Section 7872 generally treats certain loans in which the interest rate charged is less than the applicable federal rate as economically equivalent to loans bearing interest at the applicable federal rate, coupled with a payment by the lender to the borrower sufficient to fund all or part of the payment of interest by the borrower. Such loans are referred to as "below-market loans." This has the effect of including taxable interest in the income of the lender and treating the borrower as paying interest, a payment that is generally not deductible. Not only is the interest income taxable at the lender's highest rate, but even if the borrower is in the same tax bracket -- and this is generally not the case -- there is a creation of net income out of nothing.

a. Ideally, these loans could be made at very low or no interest. Up to $10,000 can be loaned interest-free without income-tax consequences. However, generally, such loans do have an income-tax effect. But with interest-rates at historical lows, now is the time to take advantage of them at very little tax cost. This tactic can be used now to lock in current interest rates before the rates return to higher levels.

Note:

> Care should be taken in documenting the transaction to preserve any potential bad-debt deduction in the event of nonrepayment.

b. The rules regard foregone interest in the context of a gift as a gift loan. The forgone interest on a gift loan is treated as having been transferred by the lender to the borrower as a gift, and then transferred back by the borrower to the lender as interest. In determining the amount of the gift, the AFR discount rate is applied to the required payments to be made. The differences in valuation for different types of loans are discussed below.

Note:

> In many cases, the amount of the interest deduction would be largely irrelevant to a low-bracket taxpayer, and in cases not involving the mortgaging of the principal residence largely precluded by reason of the interest-tracing rules. While the borrower has no interest income, the lender can have interest income and potential gift-tax liability (or application of some part of the applicable exclusion amount). However, if the foregone interest is less than the annual exclusion, the entire amount may escape the gift-tax system.

c. Another opportunity lies in making gift loans that do not exceed $100,000. As long as the aggregate principal amount of loans between the borrower and the lender does not exceed $100,000, the interest deemed transferred by the borrower to the lender is limited to the borrower's net investment income.

Planning point:

> This is particularly appropriate in circumstances where the borrower has little or no investment income. In fact, if the borrower has investment income of less than $1,000, the borrower is treated as having no investment income, so in that case, the lender has no imputed interest income at all. (Of course, since investment income is defined the same as that used in the context of the investment-interest-expense provisions, the election by the borrower to include capital-gains income could have adverse income-tax consequences to the lender either by increasing investment income above the $1,000 floor or by increasing the amount that may be treated as imputed interest.) Investment in a growth stock that can be held by the borrower for several years places the ultimate capital gain in the hands of the presumably lower-bracket (regular and NII) taxpayer.

Example: On January 1, 2025, parent P makes a $50,000 below-market gift loan to C, P's child, who uses the calendar year as the taxable year. Assume that C's net investment income for 2025 is $500. The limitation on the amount of imputed interest payment applies to the $50,000 loan for the entire year beginning on January 1, 2025. Accordingly, the imputed interest payment on the $50,000 loan for 2025 is $0.

d. The mechanics of §7872 turns on the concept of the applicable federal rate (AFR), which depends upon the term of the loan.

Term of the loan	Interest rate[46]
No more than three years	Federal short-term rate
More than three years, but no more than nine years	Federal midterm rate
More than nine years	Federal long-term rate

e. In the case of a term loan, the interest rate is considered **below market** if the amount loaned exceeds the **present value** of all payments received under the loan.[47] Generally, the present value is determined by using a discount rate equal to the applicable federal rate compounded semiannually -- that is, the AFR in effect the day the loan was made.[48]

46 I.R.C. §7872(e)(1)(A).
47 These are the same as used in original-issue-discount rules under I.R.C. §1274.
48 I.R.C. §7872(e)(1)(B).

Planning point:

> What is often a disadvantage of a term loan may be advantageous in the current environment. The entire amount of the imputed interest over the term of the loan is included but will be calculated using only the interest rate when the loan is entered into. This creates a tax arbitrage where the rate of return on the borrowed money is greater than the AFR. It shifts the taxation on such income to the lower-bracket child.

f. A demand loan is considered as carrying a below-market interest rate if its interest rate is below the applicable federal short-term interest rate (i.e., three years or less) that is in effect during the period for which the interest rate is being determined.[49] Amounts are treated as transferred on a daily basis. Thus, the AFR for any day is the relevant rate for the month in which such day falls. This is in contrast to term loans in which the AFR is always the rate in effect for the day in which the loan was made.

Note:

> If interest rates continue to rise (and they probably will), the interest differential and imputed interest will rise for a demand loan and will be recalculated each year the loan is outstanding, while the benefits of a low-interest rate may be fixed in a term loan.

g. Alternatively, the client can make a low-interest-rate loan of the down payment or the full mortgage amount. Such loans are generally subject to §7872 rules that require a minimum (or will be deemed to have) interest rate at the AFR. This produces taxable interest income to the parent’s tax rate (including the net investment income tax and later years), thereby reducing the amount of the subsidy as calculated above. The child, even if the loan from the parent is collateralized by the residence, may not be able to deduct the interest if the child cannot itemize deductions. The benefit of the credit will be reduced by the additional taxes paid by the parent. However, no interest rate need be (and none will be deemed to be) applicable **if the gift loan does not exceed $10,000, and applies to loans in excess of $10,000 but not in excess of $100,000 only to the extent of the child’s net investment income for the year**. Avoiding the imputed interest could save the lender up to 43.4 percent of the interest that in theory could be imputed.

Planning point:

> Although we will discuss circumstances where the imputation of interest does not apply, it is important to note that where the imputed interest rate is far below the return that can be earned by the lender, the inclusion of interest income as computed where interest rates are low may be an acceptable trade-off in shifting income to the child because it can reduce the lender’s AGI (and investment income) that the lender would have had had he invested the lent amount in the investment the borrower makes. It is important to keep track of interest rates to determine whether an exemption or limitation should be aimed for or whether a below-market loan nonetheless produces an acceptable outcome on balance.

49 I.R.C. §7872(f)(2)(B).

Note:

Most gift loans between parents and children are structured as demand loans. One reason for that is that for gift-tax purposes, the amount of the gift in the year the loan is made is determined over the entire term; there will be no further gifts considered made in later years of the term. In contrast, the amount of the gift for a demand loan is determined on a daily basis, so there is greater flexibility. If a child were to somehow come into a source of money with which to repay the loan, then in the case of a demand loan, its payment would stop the making of a daily gift of interest foregone, but in the case of a term loan, any repayment during the term would not alter the amount of the gift made when the loan was made.

Planning point:

Loans between family members can have the effect of shifting investment returns from a higher-bracket taxpayer who might be subject to the additional Medicare tax on investment income to an individual in a lower tax bracket who may not be subject to that new tax. If a **below-market-interest-rate loan** is made, the lender is deemed to have made the loan at a higher interest rate than that fixed by the loan agreement and the borrower is generally deemed to have paid this interest rate to the lender; the source of the "payment" depends on the particular circumstances. This has the effect of increasing the amount of interest, if any, the **donor** is considered to have received.

(i) A gift loan may be structured to take advantage of the exemption accorded loans not exceeding $10,000 in principal amount from the below-market loan rules.

(ii) Another limitation applies to a gift loan directly between individuals. The amount treated as retransferred by the borrower to the lender as of the close of any year shall not exceed the borrower's **net investment income** for such year where the aggregate of such loans between the borrower and lender does not exceed $100,000.[50]

- For these purposes, net investment income is defined not to include either qualifying dividends or net long-term capital gains unless and to the extent the taxpayer elects to treat them as such.
- If the net investment income from any borrower for any year does not exceed $1,000, the net investment income of such borrower for such year shall be treated as zero.

Planning point:

This should be distinguished from the $10,000 rule. On the one hand, if the child were to purchase a business interest that does not in fact pay dividends, the lender might not have any imputed income at all. The "might" arises from the fact that the $100,000 rule does not trace the net investment income solely to the asset purchased with the funds. If the child has an investment portfolio (even purchased with the child's own funds) that generates investment income, that income will be counted toward the limitation. If this portfolio is modest in the sense of producing no more than $1,000 annually, the income is not counted. Of course, if the business itself is paying dividends, such dividends and any qualifying dividends from the portfolio would not be counted toward the $1,000 limitation as long as the child does not need to make the election in order to take currently the investment interest expense deduction. Such expenses are not lost but may be deferred until such time as the taxpayer has sufficient net investment income to cover them.

[50] I.R.C. §7872(d)(1).

B. Take advantage of tax-favored dividends

1. Taking advantage of the tax rates on dividends

The tax rates are even more attractive for lower-income taxpayers.

Planning point:

Some middle-income business owners may be able to arrange their affairs to minimize other income so that, through deferral of compensation (really only available in a C corporation), they may be able to take advantage of the once-in-a-lifetime zero-percent tax rate. This could be particularly attractive where it appears, as it does, that the tax rates will not be extended, because in general, compensation will then be king again.

The change in the kiddie tax rules impedes the shifting of gains to children to take advantage of the zero-percent tax rate. The capital gains will generally be determined by attributing them to the parent for purposes of determining the correct rate. The child does not sell the stock while he or she continues to meet the extended age threshold for kiddie-tax application.

2. Redemptions

Section 302 deals with the question of how to treat a **redemption** of stock. Should the redemption be treated as a §301 distribution and therefore be a dividend to the extent of E&P, or should the redemption be treated as an exchange?

a. Section 302(a) states that a redemption will be treated as an exchange if it comes within one of the four statutory categories set forth in §302(b). If the redemption is treated as an exchange, the shareholder generally recognizes capital gain or loss equal to the difference between the amount realized and the basis in the redeemed stock. However, if the redemption does not fall within §302(b), §302(d) treats the redemption as a distribution to which §301 applies.

b. Regardless of whether the redemption is treated as an exchange or a distribution, the tax consequences to the distributing corporation are governed by §311. The distributing corporation will recognize gain upon the use of appreciated property to redeem stock but will not recognize loss.

Note:

It is impossible to determine the tax consequences of a redemption without first understanding and applying the **stock attribution rules**. There are four major categories of attribution rules: (i) family attribution; (ii) entity-to-beneficiary attribution; (iii) beneficiary-to-entity attribution; and (iv) option attribution. When comparing a shareholder's interest in the distributing corporation before and after a redemption, the attribution rules must be applied. For the present purposes, we will focus on family attribution.

- An individual is treated as owning all stock owned by the individual's spouse, children, grandchildren, and parents. There is no attribution between siblings or in-laws. According to the Service and most courts, the family attribution rules apply without regard to hostility. It does not matter if the individual has a history of conflict with the relative; any stock ownership is still attributed.
- In applying the attribution rules, while **chain attribution** is allowed (for example, parent to child to corporation in which the child owns more than 50 percent of the stock), there is no **double family attribution** (for example, parent to child to child's spouse).

c. A redemption qualifies for exchange treatment if the redemption is not essentially equivalent to a dividend.[51]

d. Exchange treatment applies to a redemption if the redemptive distribution is substantially disproportionate with respect to the shareholder.[52] Exchange treatment does not apply under this test unless immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote. Thus, the redemption must be substantially disproportionate and the less-than-50-percent test must be satisfied.

Note:

A redemption of only nonvoting stock from a shareholder can never satisfy this test because the percentage of voting stock owned remains unchanged. However, if there is a redemption of voting stock that qualifies under this test, a simultaneous redemption of nonvoting preferred stock (not §306 stock) is treated as an exchange. If there is a redemption of §306 stock and the redemption is concurrent with a redemption of voting stock, it may or may not be treated as an exchange depending on whether there is enough voting common stock redeemed to constitute a loss of control.[53]

In addition to the less-than-80-percent-of-voting test, the flush language in the statute mandates application of another less-than-80-percent test to the ownership of all common stock (whether voting or nonvoting). If there is more than one class of common stock, the test is applied on an aggregate basis by reference to fair market value, not on a class-by-class basis. Compare the percentage of common stock owned before, and ask: After the redemption, does the shareholder own less than 80 percent of the percentage the shareholder owned before?

Note:

The Service has ruled that a redemption of voting preferred stock from a shareholder that owns no common stock either directly or through attribution may pass the test regardless of the fact that the shareholder cannot satisfy the less-than-80-percent test relating to common stock. The second less-than-80-percent test must be satisfied only if the shareholder owns some common stock; in contrast, the less-than-80-percent-of-voting-stock test must always be satisfied.

Note:

Remember to apply the §318 attribution rules to determine ownership before and after the redemption.

e. For these purposes, the complete termination of interest is the most important. A redemption is treated as a sale or exchange if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.[54] The theory behind this provision is fairly obvious. If a shareholder completely terminates the shareholder's interest, the redemption is not essentially equivalent to a dividend -- the reduction in interest is most definitely meaningful (but for the attribution rules).

51 I.R.C. §302(b)(1).
52 I.R.C. §302(b)(2).
53 See I.R.C. §306(b)(4)(B).
54 I.R.C. §302(b)(3).

Note:

The attribution rules apply in determining whether there has been a complete redemption of a shareholder's entire interest. When the shareholders are not sufficiently related to each other, the common-sense notion of a termination of an interest will qualify as a sale or exchange. However, in a family corporation, while a shareholder may end all of the actual shareholder's stock interest, the shareholder will almost never be considered to have terminated the stock interest, because the shareholder is regarded as owning the stock owned by the other family members.

(i) The type of interest that must be terminated is the shareholder's proprietary interest in the corporation. The shareholder can retain an interest in the corporation as an officer or director. In addition, the shareholder can lease property to the corporation as long as the rent is not dependent on earnings or subordinated to the claims of general creditors. The shareholder cannot retain these types of interests in the corporation if the shareholder is relying on the waiver of family attribution (discussed below) in order to qualify as having terminated the entire interest.

Planning point:

In the absence of an attribution issue, complete terminations generally also qualify as substantially disproportionate redemptions. Usually, the complete-termination test is unnecessary. Its real significance lies in the application of the waiver of family attribution rules, which allow terminations that do not qualify as disproportionate distributions because of the family attribution rules to nevertheless qualify for exchange treatment.

(ii) The waiver of family attribution (which is the only major exception to application of the attribution rules) works as follows. A shareholder is allowed to waive family attribution only if:

- Immediately after the distribution, the distributee-shareholder has no interest in the corporation (including an interest as officer, director, or employee), other than an interest as a creditor;
- The distributee-shareholder does not acquire any such interest (other than stock acquired by bequest or inheritance) within 10 years from the date of such distribution; and
- The distributee-shareholder, at such time and in such manner as the Secretary prescribes by regulations, files an agreement to notify the Secretary of any such acquisition and to retain such records as may be necessary for the application of this rule.

Planning point:

Complete-termination cases where family attribution is the only impediment to qualifying as a sale or exchange is really elective. Dividend treatment can be used, if appropriate, merely by failing to file the agreement.[55] This may be desirable in the case of lower-bracket redeeming shareholders if the objective is to maximize the amount subject to tax.

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55 In addition to the above requirements, the waiver does not apply if any portion of the stock redeemed was acquired, directly or indirectly, within the 10-year period ending on the date of the distribution by the distributee from a person the ownership of whose stock would (at the time of distribution) be attributable to the distributee under §318(a); **or** any person owns (at the time of distribution) stock, the ownership of which is attributable to the distributee under §318(a) and such person acquired any stock in the corporation, directly or indirectly, from the distributee within the 10-year period ending on the date of the distribution, unless such stock so acquired from the distributee is redeemed in the same transaction. These

f. If the redemption is treated as an exchange, the shareholder generally recognizes capital gain or loss equal to the difference between the amount realized and the basis in the redeemed stock. However, if the redemption is not treated as an exchange, it is treated as a distribution to which §301 applies.

(i) Tier One: The distribution is taxed as a dividend to the extent of E&P;

(ii) Tier Two: Then as a return of capital to the extent of stock basis; and

(iii) Tier Three: Then as gain from the sale of stock.

Planning point:

Redemptions may be used as part of the program of removing trapped corporate income in a tax-favored manner without the same degree of trepidation or intimidation as before. Generally, the fear was that the hoped-for capital-gains tax rates would not be realized and the distribution would be subject to the high tax on dividends. Now that the latter tax rate has been brought low, redemptions will be used more frequently.

Even apart from use of children to redeem stock, ownership structure may now be modified by means of corporate stock redemptions. Shareholders may gradually withdraw their capital as low-taxed dividends going forward, generally without regard to whether or not capital-gains treatment is available. In addition, this may operate to make one of the big fights in the divorce tax area -- the taxation of corporate redemptions.

Although capital gains are currently taxed at the same rate as qualifying dividends, there are differences that must be considered in determining whether to recognize amounts as gains or as dividends. The rules are flexible enough that one can deliberately fail the sale or exchange treatment if this produces a better result. Capital gains, if deferred, will be taxed at a maximum 25 percent rate, while a dividend distribution, if deferred, will be taxed at a maximum 44.6 percent tax rate. There is more urgency to avoid future dividends than to apply the capital gains tax rate by structuring the redemption as a capital transaction.

g. A corporation distributing appreciated property in redemption of a shareholder's stock recognizes gain (but not loss).[56] The effect of a redemption on E&P depends on whether the redemption is treated as a sale or exchange or as a §301 distribution.

(i) If §301 applies, the effect on E&P is the same as it is for other nonliquidating distributions -- E&P is increased by the excess of fair market value over adjusted basis upon the distribution of appreciated property; E&P is decreased by the amount of cash distributed, by the principal amount of any obligations, and by the greater of fair market value or adjusted basis (reduced by any debt relief).

(ii) If the redemption is treated as an exchange, the effect on E&P is governed by §312(n)(7), which provides that the part of the redemption properly chargeable to E&P is an amount that does not exceed the ratable share of E&P attributable to the stock being redeemed. E&P is never reduced by more than the amount of the redemption.

Example 1: Corporation X is owned equally by two unrelated shareholders, A and B. X has $100,000 of current and accumulated E&P. If X redeems all of A's shares for $100,000, the redemption will qualify as an exchange because it is a complete redemption of A's interest. If there were no reduction in X's E&P account, the entire $100,000 would be left as a potential dividend to B. On the other hand, if the E&P account is reduced by the full amount of the payment for the stock, there

two additional rules do not apply if the acquisition or disposition by the distributee did not have as one of its principal purposes the avoidance of federal income tax.

56 I.R.C. §§311(a) and (b).

is no dividend potential. A's ratable share of the E&P is $50,000. Thus, there is a $50,000 reduction of E&P. Note that if X's E&P had been $250,000, the reduction would be limited to $100,000 (the amount of the redemption) even though A's ratable share is $125,000. (This would arise where the corporation had assets with depressed fair market values).

h. If the redemption is treated as an exchange, the shareholder generally recognizes capital gain or loss equal to the difference between the amount realized and the basis in the redeemed stock. However, if the redemption is not treated as an exchange, it is treated as a distribution to which §301 applies. The distribution is taxed as a dividend to the extent of E&P, then as a return of capital to the extent of stock basis, and then as gain from the sale of stock.

Example 2: The facts are the same as in **Example 1**, but assume that A and B are related (A is B's child [over 23]) and A's basis in the stock is $40,000 while B's basis is $20,000. B has two blocks of stock: the first, which he retains, was the original issue of stock; the second, which B transfers to A, was acquired later. X has $100,000 of current and accumulated E&P. If X redeems all of A's shares for $100,000, the redemption will qualify as an exchange because it is a complete redemption of A's interest. If A has capital losses, A will be more interested in receiving capital gains and by filing the waiver, A will recognize $60,000 of capital-gain income. The earnings-and-profits account is reduced by $50,000, leaving B in the position that the first $50,000 of corporate distributions will be taxed as a §301(c)(1) dividend. B has only the $20,000 basis available to shelter distributions in excess of the earnings and profits before having to recognize capital gain.

Instead, suppose that although the redemption could qualify as a complete termination of interest, because no agreement is filed, the family attribution rules apply to render the redemption a §301(c) corporate distribution. In that case, the entire $100,000 is taxed as a dividend out of X's earnings and profits to B. Now X's earnings-and-profits account is reduced by the full $100,000. Future distributions to B (assuming no current earnings and profits) can be made under §301(c)(2) return of capital and §301(c)(3) capital gain.

What happened to A's basis? According to a long-standing regulation, if a redemption results in a less-than-full recovery of basis, where the shareholder still owns some stock in the corporation, the basis in the redeemed stock is added to the basis in the retained stock. If the shareholder no longer owns any stock in the corporation, the basis in the redeemed stock is added to the stock basis of the related shareholder who caused the redemption to fail as an exchange.[57] Applying that regulation to these facts, A's $40,000 basis flips over to B's retained stock. Thus, B now has a $60,000 §301(c)(2) basis on which to take tax-free distributions in the future. This disgorgement of earnings and profits could have been accomplished at a zero-percent rate.

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57 Treas. Regs. §1.302-2(c), Examples 1, 2, and 3.

Planning point:

> Redemptions may be used as part of the program of removing trapped corporate income in a tax-favored manner without the same degree of trepidation or intimidation as before. Generally, the fear was that the hoped-for capital-gains tax rates would not be realized and the distribution would be subject to the high tax on dividends. Now that the latter tax rate has been brought low, redemptions will be used more frequently.
>
> Even apart from use of children to redeem stock, ownership structure may now be modified by means of corporate stock redemptions. Shareholders may gradually withdraw their capital at low-taxed dividends during a period when they are in a low tax rate on capital gains and income generally without regard to whether or not capital-gains treatment is available.

3. Eliminate current and future penalty taxes with low-tax dividends

Clients need to focus on the concern for the accumulated-earnings tax and the current cheap rates on dividend distributions from a C corporation. If the corporation sells its assets and has only interest income and gains, it looks like an enterprise without a trade or business but only investment income.

There are two separate penalty taxes that can be imposed on a corporation that improperly accumulates corporate income instead of distributing it to shareholders in an effort to avoid the higher marginal tax rate applicable to a shareholder's ordinary income versus capital gain. The two taxes are the accumulated-earnings tax (imposed by §531) and the personal-holding-company tax (imposed by §541).

a. The **accumulated-earnings tax** is imposed on any corporation (other than an S corporation) formed or used for the purpose of avoiding the income tax with respect to its shareholders by permitting earnings and profits to accumulate instead of being divided or distributed.[58] The tax rate had been decreased to 20 percent.[59] The tax is levied at a rate of 20 percent of accumulated taxable income, which is calculated by making certain prescribed adjustments to taxable income.

Note:

> Contrary to some clients' misconceptions, the §531 tax on accumulated earnings is not on the total of earnings and profits shown on the balance sheet. Rather, it is on that portion of current-year earnings that businesses allow to accumulate beyond their reasonable needs to avoid the shareholder tax on distributions.

(i) The tax is imposed if earnings are accumulated for the purpose of avoiding income tax on shareholders. It is not automatic even if a corporation has accumulated earnings and profits. Thus, the operative question is whether a corporation has **improperly** accumulated earnings (for a tax-avoidance purpose). Some accumulation of earnings is, in fact, reasonable. A corporation (other than a mere holding or investment company) is allowed to accumulate a minimum of $250,000 ($150,000 for certain service corporations) **in its lifetime** and a maximum equal to the amount needed to meet the reasonable needs of the business, which includes the reasonably anticipated needs of the business.[60]

(ii) If a corporation is a holding or investment company, this is considered prima facie evidence of a tax-avoidance purpose with respect to the accumulation of

[58] I.R.C. §532.
[59] JGTRRA §302(e)(5), amending I.R.C. §531.
[60] I.R.C. §537(a)(1).

earnings.[61] Once the Service establishes that a corporation is, in fact, a holding company or an investment company, it has proved its case for imposition of the accumulated-earnings tax without the need for any further evidence.

(iii) If a corporation is not a holding company or investment company, a showing by the Service that earnings have accumulated beyond the reasonable needs of the business is evidence of a tax-avoidance purpose that must be rebutted by a preponderance of evidence to avoid imposition of the penalty tax.[62]

Note:

The question of whether a corporation's earnings have been allowed to accumulate beyond the **reasonable needs of the business** is by far the most frequently litigated issue in the context of the accumulated-earnings tax. The answer depends in large part on the particular circumstances involved. The regulations list a few (nonexclusive) reasonable grounds for the accumulation of earnings:

- Bona fide expansion of business or replacement of plant;
- Acquisition of a business enterprise through the purchase of assets or stock;
- Provision for the retirement of bona fide debt created in connection with the trade or business;
- Provision of necessary working capital for the business;
- Provision for investments or loans to suppliers or customers if necessary to maintain the business; and
- Provision for the payment of reasonably anticipated product-liability losses.

The regulations also list several accumulation purposes, which may indicate an accumulation beyond the reasonable needs of the business:

- Loans to shareholders or the expenditure of funds for the personal benefit of shareholders;
- Loans having no reasonable relation to the business made to relatives or friends of shareholders, or to other persons;
- Loans to another corporation, the business of which is not that of the taxpayer corporation, if the capital stock of the other corporation is owned, directly or indirectly, by the shareholders of the taxpayer corporation and such common shareholders are in control of both corporations;
- Investments in properties or securities that are unrelated to the business; or
- Retention of earnings and profits to provide against unrealistic hazards.

Planning point:

The tax base for the accumulated-earnings tax (AET) is accumulated taxable income minus the sum of the **dividends-paid deduction** (under §561) and the **accumulated-earnings credit** (under §535(c)). Accumulated taxable income, despite its name, is computed by beginning with taxable income for the current year and making certain adjustments to more accurately reflect economic income. This is similar to, but not identical to, a computation of earnings and profits. Accumulated taxable income is not equal to current or accumulated E&P. Unlike the personal-holding-company tax, the accumulated-earnings tax has a cushion provided by the credit as well as the reasonable needs of the business. Access to the removal of this potential tax through the payment of dividends may be tempered by the fact that it is not necessary to zero out earnings and profits to avoid the tax. Nevertheless, both the AET and the PHC tax really give rise to a triple tax; the payment of either tax does not prevent the distribution of the after-corporate-income and after-penalty tax distribution from itself being subject to a shareholder to the tax on corporate distributions (at whatever the applicable rate). Although the use of the dividends-received deduction will avoid the triple tax, in cases where the stock will be held and the stock will get a stepped-up basis at death, the payment of the penalty tax rather than the tax on dividends could be beneficial.

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61 I.R.C. §533(b).

62 I.R.C. §533(a).

b. A corporation is considered a **personal holding company** (PHC) if:

- At least 60 percent of its adjusted gross income consists of personal-holding-company income, which includes dividends, interest, royalties, annuities, rents, minerals, oil and gas, copyright royalties, produced film rents, compensation for use of corporate property by shareholders, personal service contracts, and income from trusts and estates; and
- More than 50 percent of its stock is owned, at any time during the last half of the taxable year, directly or indirectly, by five or fewer individuals.

c. If a corporation is a personal holding company, it is subject to the **personal-holding-company tax**. The tax is imposed at a rate of 20 percent on undistributed personal-holding-company income. It is important to note that undistributed personal-holding-company income is not merely personal-holding-company income that has not, in fact, been distributed. Undistributed personal-holding-company income is equal to taxable income with certain adjustments minus the dividends-paid deduction.

Planning point:

One of the opportunities opened up for corporations subject either to the accumulated-earnings tax or the personal-holding-company tax is the elimination of the corporate penalty tax through the **payment of dividends**. Such dividends reduce the penalty-tax base. At least for the next several years, this means that corporations following the sale of its assets may not feel compelled to liquidate and accelerate a capital-gains tax. Although the sale of the assets will generate earnings and profits, those earnings and profits and those accumulated prior to the year of sale are not the problem. The problem in both cases is the potential suspect earnings on the proceeds of the sale. Without the immediate acquisition of a new trade or business, such corporations typically were subject to one penalty tax or the other because of the nature of the corporate income (PHC) or the absence of a business with respect to which a need could justify the accumulation of corporate earnings. Now they may **avoid the tax on a complete liquidation of the corporation** by the payment of more modest sums in the form of dividends and perhaps re-establish a trade or business in the future without the presence of any definite plans.

Both (accumulated-earnings and personal-holding company) tax bases are reduced by the dividends paid. However, this tends to increase the combined income and net investment income tax of the shareholder above the tax rate applicable to the retention in the corporation.

But the double tax may thwart efforts of shareholders to avoid net investment income tax by shifting such income to the corporation, which is not subject to the NII tax, if the corporation has no active trade or business.

C. Shifting income to the spouse

1. In general

Payments made to a spouse as an employee are subject to Social Security tax. Consequently, whatever H, a self-employed spouse, may save in reduced self-employment taxes will be offset by the burden of FICA that H must pay by hiring the spouse. However, this cost may be offset to a degree if, as noted above, such payments would qualify his wife, W, for certain Social Security benefits to which she might not otherwise be entitled. If W pays Social Security taxes for a sufficient period, W would be eligible for retirement and survivor benefits.

2. Social Security

Social Security benefit is based on the high 35 years of indexed wages times “break points” of 90%, 32%, and 15%. The higher average indexed monthly wages are, the lower the break point percentage. Without participation for at least 35 years, the wages for many years will be zero, reducing the benefit. But the wages, while generating new Social Security benefits, will be subject to a full FICA withholding at the full FICA rate, because this involves shifting wages from the taxpayer, presumably subject only to the 2.9-percent rate on wages above the taxable wage base. Thus, shifting compensation or earned income to a spouse generally entails an additional 12.4-percent Social Security charge, while if the compensation paid, if equal to the then-average indexed wages for the years of service, only increases the indexed average wages by benefit by 1/35 (about 2.857 percent), which is multiplied by the applicable break point percentage to get the increase in the benefit. The benefit calculation is done as a monthly amount by adding the 35 highest years of inflation-indexed compensation, dividing that by 420 months, and multiplying the amount times the break point percentage. If someone is in the middle break point percentage (many people are) the formula to determine the increase in benefit is: Additional compensation x 1/420 x 32%, or additional compensation x .07619%. The added benefit in some cases may be worth the cost of funding. In others, the hiring of the spouse may be justified in terms of other benefits.

Example: Jean had previously worked for 20 years and would be entitled to an annual Social Security benefit of $3,000. She is in the 32% break point. If Jean goes back to work and receives compensation of $16,000, her benefit will increase by $12.19 per month ($16,000 x .07619%) or $146.28 per year, while the additional cost to Jean and her husband Gene is $1,984 ($16,000 x 12.4%). Jean would have to draw benefits for 13.56 years to break even ($1,984/$146.28) not considering the time value of money. If Jean were paid the full amount of the taxable wage base, assume her annual benefit increases by $1,000 (estimate), while the additional Social Security tax rises to $20,906.40 ($168,600 x 12.4%).

Note:

The Social Security tax for the year purchases a life annuity in the amount of the added benefit. The cost must be compared to the actual benefit to the spouse. Remember that the spouse may already be entitled to an amount equal to 50 percent of the worker’s benefit; in some cases, this amount may still be larger than the recomputed benefit of the spouse as a worker, and thus, marginally no or a very small life annuity is being purchased by the investment of the additional Social Security benefits.

For example, if Gene was then entitled to an annual benefit of $7,000, Jean in her capacity as a spouse would already be entitled to an annual benefit of $3,500, so she accrues no additional benefit, as $3,500 is greater than $3,146. If she were paid the wage base, the economics are different because now her benefit as a worker ($4,000) would exceed her benefits as a spouse ($3,500); the issue then is whether a $500 life annuity ($4,000 - $3,500) justifies the additional investment in Social Security. But if Gene’s benefit were then $9,000, Jean would accrue no additional benefit even if she were paid the maximum wage base.

Related to this issue is the issue of whether the marginal increase in the worker’s benefit is more valuable than the increase in the spouse’s benefit (and the spouse is, after all, entitled to 50 percent of the additional benefit that accrues to the worker). Thus, if Gene’s benefit would increase by $200 by paying the $16,000 to him rather than her, doing so instead of hiring his spouse results in a $300 increase in benefits ($200 to Gene and $100 to Jean) and saves $1,984 in Social Security tax.

3. *Pension benefits*

Employing a spouse may also be used to provide a spouse with pension benefits.[63] This is particularly important if the owner has already topped out on compensation levels or annual addition contributions.

a. A spouse may be eligible to receive a $10,000 retirement annuity without regard to the spouse's compensation in a defined-benefit plan if the spouse has never participated in the employer's defined-contribution plan. Of course, the nondiscrimination rules will require that a similar offer be made to all other employees, but it may be well-suited in the case of a sole proprietor.

b. A spouse may have access to §401(k) elective deferrals that can be as much as $23,500, as much as doubling the amount the couple could defer.

Note:

> While the rule is generally that the employer contribution (for all employees) cannot exceed 25 percent of participants' compensation, employee contributions are not counted in this calculation; the operable limitation is that the annual addition (which includes both employer contributions and elective deferrals) for the participant cannot exceed 100 percent of compensation. Now, in a §401(k) plan with no employer match or other contributions, the spouse could be "paid" $23,500 (net of employment taxes) and defer the entire amount as an elective contribution. In that case, the spouse has no taxable income. As noted later in these materials, if the spouse is at least 50 years of age, an additional $8,000 catch-up contribution is available without regard to any of these limitations; in that case, the spouse could be "paid" $31,500 (net of employment taxes) and still not incur any income tax.

c. The spouse may have access to a profit-sharing plan, which could defer up to an additional $70,000 of income, the maximum contribution for 2025.

Note:

> The employer contribution to a profit-sharing plan cannot exceed the lesser of 100% of compensation or the dollar annual addition limitation for a participant ($70,000 in 2025); at the same time, except in certain age-weighted or cross-tested plans discussed later in these materials, the employer cannot deduct a contribution in excess of 25 percent of compensation. This means that the $70,000 would only be available if the spouse were making at least $280,000. For the very intensive employment of the spouse, the business owner should consider shifting duties and salary to the spouse. The compensation that can be taken into account for plan purposes cannot exceed $350,000; so in many cases, a business owner can reduce his or her own wages without suffering any reduction in his or her own retirement contribution while reducing the company's (or in the case of an S corporation shareholder/partner/member/proprietor, the individual's own) income tax by reason of the additional contribution. The couple's income otherwise remains the same.

Note:

> There is one major disparity between corporate plans and Keogh plans concerning employment taxes. While a self-employed person may deduct his or her retirement plan contribution, this deduction is on page one of the Form 1040, not on Schedule C. That contribution is subject to self-employment tax (which in turn is deductible in part). However, the contribution to the retirement plan for employees (including a spouse) is deductible on Schedule C and reduces the self-employment income of the proprietor/partner. Thus, for example, a self-employed person splitting income with a spouse may also benefit from a reduction of the self-employment tax.

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[63] The repeal of the family aggregation rules permits the usage of the compensation of all family members up to the maximum compensation that can be taken into account.

d. The spouse may have access to a SIMPLE plan that could defer up to an additional $33,000.

Note:

> The SIMPLE plan operates in a like manner to a §401(k) plan in that the employee makes an elective deferral of salary. The maximum elective deferral for a SIMPLE plan is $16,500 (an additional $3,500 for those at least 50 [net of employment taxes]), and the maximum employer contribution is three percent of compensation. The compensation that may be taken into account is not limited, but the maximum match is the amount of income deferred by the employee. Thus, only when the participant reaches compensation of $550,000 can the maximum $33,000 contribution ($3,500 more if the spouse has reached age 50) be realized.

Planning point:

> SIMPLE plans are not subject to the special ADP nondiscrimination rules that are applied to §401(k) arrangements, and thus, do not suffer from the potential loss of qualification that can happen to a §401(k) plan when non-highly compensated employees fail to participate in sufficient numbers and relative amounts.

Caution:

> The limitation on elective deferrals to a SIMPLE or §401(k) plan is applied by an aggregation of all of a participant's SIMPLE and §401(k) plans, regardless of whether the sponsors or employers are related. Thus, if a spouse already has a SIMPLE plan as an employee of an unrelated company to which the maximum deferral has been made, the spouse could only defer $7,000 ($23,500 §401(k) maximum contribution - $16,500 actual SIMPLE contribution) if hired as an employee. If the spouse were a participant in the §401(k) plan of an unrelated employer and had made the maximum $23,500 contribution, no deferral to the spouse's company SIMPLE plan could be made.

4. Long-term care

Long-term-care insurance contracts are taxed similarly to accident and health insurance contracts. Thus, certain benefits received under a long-term insurance contract provided by an employer may be received tax-free. As an insured medical plan, it is not tested for discrimination. If the long-term-care insurance contract is an indemnity policy (one that 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 that pays a set amount per day regardless of actual expenses), a taxpayer can exclude the greater of $420 per day or actual daily expenses.

a. A certain amount of the premiums paid on long-term-care insurance contracts qualify as medical expenses for purposes of the medical expense deduction. The qualifying amount in 2025 is limited on the basis of the insured's age, as follows (all ages refer to the insured's age as of the end of the taxable year).[64]

Age	Annual Limit
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

These amounts are indexed for inflation.

[64] Rev. Proc. 2014-61, 2014-47 I.R.B. 860, §3.25., 2019-44; 2021-45, 2022-38, 2023-34. 2024-40

Note:

> With respect to pass-through employers (S corporations, partnerships, and multimember LLCs), the Service has previously ruled that special rules apply. In the case of an S corporation, the payment of such (medical) insurance premiums (as limited by the annual dollar limit in the above table) is treated as taxable income to the more-than-two-percent shareholder and deductible by such shareholder as a medical insurance premium above-the-line (not in excess of the shareholder's share of the earned income of the business, including any wages paid to the shareholder), with any balance deductible below-the-line subject to the 7.5-percent-of-AGI threshold.

b. Unreimbursed long-term-care expenses qualify as medical expenses for purposes of the medical-expense deduction as long as the long-term-care services are not provided by a relative who is unlicensed to provide such services. Long-term-care expenses include:
   - Expenses for necessary diagnostic, preventative, therapeutic, curative, treatment, mitigative, and rehabilitative services required by a chronically ill individual; and
   - Expenses for maintenance or personal-care services required by a chronically ill individual.

c. For these purposes, a chronically ill insured person is one who has been certified within the previous 12 months by a licensed health-care practitioner as:
   - Being unable to perform, without substantial assistance, at least two activities of daily living for at least 90 days due to a loss of functional capacity;
   - Having a similar level of disability as determined by the Secretary of the Treasury in consultation with the Secretary of Health and Human Services; or
   - Requiring substantial supervision to protect from threats to health and safety due to severe cognitive impairment.

***Note*:**

> It is important to note that long-term-care insurance is not merely for the elderly; there are many younger people, unable to care for themselves, who would benefit from this type of insurance.
>
> 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.

Planning point:

> Employer contributions for long-term-care insurance are deductible as business expenses and are not included in the employee's income. However, if an employer provides long-term-care coverage under a cafeteria plan, benefits received are included in the employee's income. In addition, long-term-care coverage cannot be provided under a flexible spending account, although premiums can be paid through the use of Archer medical spending accounts (MSAs).

5. Miscellaneous

In addition to other benefits, hiring the spouse for the client's business can provide the following:

- Disability coverage for the spouse.
- Dependent care -- the credit depends on the earned income of the spouse with the lower amount. If a spouse with one dependent child is paid $3,000, or $6,000 in the case of more than one child, the couple may be able to max out the dependent-care credit. (Note

that an exclusion of $5,000 is also available, but no more than 25 percent of such benefits may be paid to a shareholder having more than a five-percent interest, so exclusion may be available if paid in respect of children as children of the spouse, but not in respect of children as children of the owner.)

- A second company car can be provided to the spouse as an employee.
- Group-term life insurance can be offered to the spouse as an employee on a tax-free basis to the extent of the premium paid attributable to the first $50,000 of coverage.

D. Shifting income to child

Planning point:

> Family income-shifting and C corporation income-splitting must be more seriously considered. Shifting earned income to a child serves the goal of reducing the compensation subject to **additional Medicare tax**, **spreading the AGI around** to reduce or eliminate the potential for excess MAGI for any member of the economic unit, and **reducing the overall tax burden by shifting income to a taxpayer in a lower tax bracket**. Since the kiddie tax applies only to **unearned income** of a young child, the shifting of **earned income** to the child by paying the child a salary through the family business is not affected by the kiddie tax. The increased standard deduction provided by the TCJA makes this planning tool even more valuable. Additionally, Net Investment Income Tax is assessed on a taxpayer-by-taxpayer basis, and as a result, a child will not be subject to the Net Investment Income Tax unless the child exceeds the single-filer threshold.
>
> However, this may have the effect of **increasing the Social Security tax burden** because the higher-income taxpayer may have already passed the taxable wage base and is only subject to the Medicare tax, while a child is likely to have the first dollar of wages subject to both Medicare and Old Age and Supplemental Disability Income tax. If the business is operated as a Schedule C sole proprietorship, or a partnership where the only partners are the mother and father, the child is exempt from Social Security until age 18.
>
> Compensation may permit an additional IRA/retirement plan participant.

1. Earned income

Since the kiddie tax applies only to **unearned income** of a young child, the shifting of **earned income** to the child by paying the child a salary through the family business is not affected by the kiddie tax.

a. The reasonable compensation standard has been a long-standing obstacle to this **income-shifting** technique. As a practical matter, however, the reasonable compensation standard may no longer be important in such cases. With much lower individual income-tax rates and increasing payroll taxes, generous salary payments from the family corporation to the children may no longer be attractive.

b. The maximum amount of savings can be achieved with salary payments of $15,000. This is the regular standard deduction amount for 2025; after the first $15,000 is paid ($22,000 if an IRA is set up), the income-tax savings to the family unit decline. Note that although substantial salary payments from the family corporation to the child (regardless of age) may not generate substantial income-tax savings, they do offer transfer-tax savings.

c. This suggests paying a $15,000 salary and shifting $2,700 of unearned income to the child under age 18. Under current rules, a dependent's standard deduction is limited to the greater of $1,350, or earned income plus $450 (with a maximum standard deduction for single taxpayers of $15,000).[65] Therefore, it is generally desirable for a dependent to

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[65] Rev. Proc. 2024-40.

have earned income of at least $15,000. The structure of the kiddie-tax rules makes it generally desirable for a dependent to have unearned income of at least $2,700.

Planning point:

> In some cases, the owner will be subject to both the Medicare tax (1.45 percent) and the additional Medicare tax (0.9 percent), and the employer's Medicare tax (1.45 percent), yet the shifting of earned income to the younger family member will trigger generally the full 15.3-percent OASDI/Medicare tax for both the employer and employee. But, this not only shifts the tax burden to a lower bracket but also reduces the owner's AGI, which could help the owner to avoid the additional Medicare tax on investment income. This is an example of spreading the AGI around to lower the overall taxes of the economic unit.

2. Unearned income

Section 501 of the SECURE Act eliminates the TCJA definition of "Kiddie Tax" on children's unearned income in excess of $2,700 at the highest trust and estate tax rates. Since the passage of TCJA in 2017, many have argued that low-income children, low-income scholarship recipients, and child survivors of military parents killed in action were the most affected by the Kiddie Tax. The SECURE Act restores pre-TCJA Kiddie Tax rules, in which the child's unearned income over the $2,700 income threshold is taxed at the parent's marginal tax rate. This change is effective for tax years beginning after December 31, 2019, but taxpayers could elect to apply it to tax years which begin in 2018 or 2019.

In addition, the TCJA unintentionally increased taxes on families of fallen soldiers. Referred to as "Gold Star Families," these families have suffered the loss of an immediate family member who died while serving in the military. After the family member passes, the family continues to receive survivor benefits in the form of regular paychecks paid to an eligible beneficiary. Under TCJA, if the beneficiary of survivor benefits is a child, they are subject to Kiddie Tax rules for unearned income over $2,700, taxed at the trust and estate tax rates. As a result, many of the Gold Star Families saw huge increases in their tax bill due to TCJA rules. The SECURE Act rectifies this issue by taxing the child's unearned income over $2,700 at the parent's marginal tax rate.

E. Alimony exclusion and deduction

1. For divorces executed before January 1, 2019

Alimony is taxable to the recipient and deductible by the payee.[66] These rules apply only to true alimony as defined by IRC §71. The parties can stipulate in the divorce decree that no payments will be considered alimony for tax purposes, thus electing out of the treatment.

2. For divorces executed after December 31, 2018

I.R.C. §§71 and 215 are repealed by the TCJA for any divorce or separation agreement executed after December 31, 2018. Therefore, alimony declared by an agreement executed after December 31, 2018, is not deductible by the payor and is excluded from the income of the recipient.

3. Modifications of agreements after December 31, 2018

If a divorce or separation agreement was executed before January 1, 2019, but modified after December 31, 2018, the new rules will apply only if the modification adds language specifically stating that the modified agreement is subject to the new law.[67]

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66 I.R.C. §§71 and 215.
67 Pub. L. 115-97, Title I, §11051(c).

Planning point:

> If the taxpayer is receiving alimony that is currently taxable, they may wish to seek a modification and add language to make the agreement subject to the new law. On the other hand, if the taxpayer is the payor, if the divorce is modified for any reason, they should examine the document closely to ensure that the modified document preserves its status of deductibility under the old law.

F. Exclusions and deferrals

1. Principal residence exclusion

As a lingering effect of the pandemic, more individuals than ever before are working remotely. Housing demand has skyrocketed in recent years, leading to high prices and low inventory. Many individuals have considered moving to:

- Live in their ideal location;
- Capitalize on their home equity; or
- Increase their living space due to remote working.

A taxpayer's principal residence need not be a single-family home in order to qualify for the exclusion. It may be a townhome, condominium, a cooperative apartment, a mobile home, or even a houseboat. Generally, the residence must have sleeping, cooking, and toilet facilities in order to qualify as a principal residence.

Section 121 provides that, under certain circumstances, gross income does not include gain realized on the sale or exchange of property that was owned (ownership test) and used (use test) by a taxpayer as the taxpayer's principal residence. Subject to other limitations and restrictions, a taxpayer may exclude gain only if, during the five-year period ending on the date of the sale or exchange, the taxpayer owned and used the property as the taxpayer's principal residence for periods aggregating two years or more.[68]

Note:

> The final regulations require this principal residence status to be determined on an annual basis; the taxpayer may have no more than one principal residence in one year. Be careful, because this means that one can use a dwelling for more than two years in a five-year period as a principal residence and not qualify for the exclusion. For example, suppose A and B own Home X in Philadelphia and Home Y in Miami. They split their time each year by spending November through March at Y and April through October at X. While A and B use Y as their residence 25 months (two years and one month) out of 60 months (five years), they never use Y as their principal residence in any year. A sale of Y at the end of the five-year period does not qualify.

a. However, the final regulations also provide other factors that may enable A and B to argue that Y was their principal residence in one or more of those years. The following are listed as factors to be taken into account:
   (i) The taxpayer's place of employment;
   (ii) The principal place of abode of the taxpayer's family members;
   (iii) The address listed on the taxpayer's federal and state tax returns, driver's license, automobile registration, and voter registration card;
   (iv) The mailing address for bills and correspondence;

68 Treas. Regs. §1.121-1(a).

(v) The location of the taxpayer's banks; and

(vi) The location of affiliated religious organizations and recreational clubs of the taxpayer.

b. The easiest way then for taxpayers to meet the two-residence test is simply to split their time between the two with an eye on the clock (and keep a log for substantiating use).

Example: Taxpayer L owns two residences, one in Virginia and one in Maine. During 2021 and 2022, L lives in the Virginia residence. During 2023 and 2024, L lives in the Maine residence. During 2025, L lives in the Virginia residence. L's principal residence during 2021, 2022, and 2025 is the Virginia residence. L's principal residence during 2023 and 2024 is the Maine residence. Either residence would be eligible for the §121 exclusion if it were sold during 2025.

Note:

Sometimes, it will not be clear which home clients will sell first, often because the exclusion is generally only available at two-year intervals with the thought that the "vacation" home can be qualified following the sale of the main home. This can produce undesirable results, as in the above example. Thus, it is important that the clients qualify both residences. However, remember that the facts-and-circumstances test can produce uncertainties. The majority of the time the general rule is not a safe harbor that clients can rely on, and it is conceivable that if A and B instead sold X at the end of the five-year period, the presence of these other factors with respect to Y could result in its being treated as the principal residence in four or more of the years; then X would not qualify as used as a principal residence for the minimum two-year period, even though it was used by A and B the majority of the time in each year.

The bottom line: These situations have to be managed and reviewed on an annual basis.

c. Another alternative is for spouses to separately use the residences so that each has a separate principal residence. The downside is that the maximum exclusion resulting from the sale of any one of the houses cannot exceed $250,000.

Example 1: H owns and lives in a home in Minneapolis in 2021 and 2022. W owns and lives in a chalet in Lake Wobegon in 2021 and 2022. Either H or W or both may sell their homes in 2025 and exclude up to $250,000 of gain on each.

However, if W had lived in the Minneapolis home in any two of the years 2020, 2021, and 2022, the sale of that home would be eligible for the full $500,000 exclusion. (Of course, then the sale of the Lake Wobegon home could not have the effect of allowing any more than a combined $500,000 exclusion.)

Example 2: The facts are the same as in **Example 1** above, except H and W sell the Minneapolis home for a $400,000 gain (where W had used that property as her principal residence in 2020 and 2021) and the Lake Wobegon home for a $100,000 gain. Because the Minneapolis home qualifies as H and W's principal residence, H may exclude up to $250,000 of the gain and W may use $150,000 of her exclusion on the Minneapolis home. W could also exclude up to $100,000 of the gain on the sale of the Lake Wobegon home because it qualifies as the principal residence.

Now W cannot avail herself of both exclusions because she cannot apply the exclusion twice within two years let alone one year as in this example. But she does have the choice. She probably would choose the Minneapolis home because she could shelter $150,000 rather than only $100,000 on the Lake Wobegon home.

If instead the Minneapolis home were sold for a $300,000 gain, W would probably choose to exclude the $100,000 gain on the Lake Wobegon home rather than the $50,000 gain on the sale of the Minneapolis home that is not covered by W's exclusion.

Note:

> What happens when the time is running out on the qualification for the use requirement? Since the issue is when the sale occurs, and not when the payments are received, and because there are **no related-party rules** (except on the sale of a remainder interest), parents can sell that home to one or more of their children on an installment basis and gift some or all of the payments to them over the years. The parents get the exclusion, and the children get a stepped-up basis (which might be helpful if the children are operating the property as rental real estate in enhanced depreciation deductions).

d. The law denies the **§121 exclusion** to as much of the gain from the sale of the principal residence (after December 31, 2008) as is allocated to periods of **nonqualified use**.[69] For these purposes, gain shall be allocated to periods of nonqualified use based on the **ratio** that: (i) the aggregate periods of nonqualified use during the period such property was owned by the taxpayer, bear to (ii) the period such property was owned by the taxpayer.[70] A period of nonqualified use means any period (**other than the portion of any period preceding January 1, 2009**) during which the property is not used as the principal residence of the taxpayer or the taxpayer's spouse or former spouse.[71] However, it does **not include**: (i) **any portion of the five-year period that is after the last date that such property is used as the principal residence of the taxpayer or the taxpayer's spouse**;[72] (ii) any period (not to exceed an aggregate period of 10 years) during which the taxpayer or the taxpayer's spouse is serving on qualified official extended duty;[73] or (iii) any other period of temporary absence (not to exceed an aggregate period of two years) due to change of employment, health conditions, or such other unforeseen circumstances as may be specified by the Service.[74] These rules apply after taking into account the depreciation that must be recaptured[75] and without regard to such gain.[76] Any gain from the sale of a principal residence that is not eligible for the §121 exclusion is subject to capital gain tax and/or NIIT depending on the taxpayer's AGI.

Note:

> The statute adopts an administratively convenient rule of proportionality that avoids appraising the value of the property when the use changes from qualified to nonqualified and vice versa. This precludes, however, a taxpayer from changing the use at opportune times, such as when the property has declined in value (to maximize qualified-use appreciation) or increased in value (to minimize nonqualified-use appreciation).

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69 I.R.C. §121(b)(4)(A).
70 I.R.C. §121(b)(4)(B).
71 I.R.C. §121(b)(4)(C)(i). The standard of property not being used as a principal residence is generally determined under a facts-and-circumstances test.[71] In addition, a period of nonqualified use would not include any period of temporary absence (not to exceed an aggregate period of two years) due to change of employment, health conditions, or any other unforeseen circumstance.
72 I.R.C. §121(b)(4)(C)(ii)(I).
73 I.R.C. §121(b)(4)(C)(ii)(II).
74 I.R.C. §121(b)(4)(C)(ii)(III).
75 I.R.C. §121(b)(4)(D)(i).
76 I.R.C. §121(b)(4)(D)(ii).

Planning point:

> Taxpayers currently in the nonqualified-use stage of ownership may consider changing to qualified use by the end of the year, thereby eliminating the inclusion of any gain beyond the statutory ($250,000/$500,000) maximums going forward.

Note:

> The exception noted in bold gives a taxpayer up to three years of rental or having the home on the market following the taxpayer's leaving the home before any nonqualified use accrues. On the other hand, if the taxpayer returns to the home as a principal residence after having vacated it, the entire period of absence would be nonqualified use. Thus, if taxpayer leaves the principal residence in January of 2023, rents it out, and sells the property in December 2025, none of the 36 months after leaving the house are treated as nonqualified use because they occur during the five-year period preceding the sale that are all after the home first became no longer used as a principal residence. On the other hand, if taxpayer returned in June and July of 2023 to use the home as a principal residence, all of the months from January 2023 through May of 2024 are nonqualified use, but those from August 2024 through December 2025 are not nonqualified because they occur after the last date the taxpayer used the home as the principal residence.

Example 1: Assume that a taxpayer buys property on January 1, 2020, for $500,000, and uses it as rental property for two years, claiming $25,000 of depreciation deductions and reducing the property's basis to $475,000. On January 1, 2022, the taxpayer converts the property to his principal residence. The taxpayer moves out on January 1, 2024, and sells the property for $750,000 on January 1, 2025. The total gain on the sale is $275,000 ($750,000 − $475,000). The $25,000 attributable to the depreciation deductions is included in income pursuant to §1250. The taxpayer allocates 40 percent of the remaining $250,000 gain, or $100,000, to nonqualified use (January 2020 to December 2021), which is ineligible for the exclusion. Because the remaining gain of $150,000 is less than the maximum gain of $250,000 that may be excluded by a taxpayer filing single, the $150,000 of gain is excluded from gross income.

Example 2: Assume that a taxpayer buys a principal residence on January 1, 2020, for $400,000, moves out on January 1, 2023, and begins renting the property. On December 1, 2024, the taxpayer sells the property for $600,000. The entire $200,000 gain is excluded from gross income because periods after the last qualified use do **not constitute nonqualified use**.

e. Ordinarily post-1997 depreciation to the extent it is recaptured on sale is not eligible for the exclusion (and ordinarily is subject to the maximum 25-percent tax rate on unrecaptured §1250 gain). The Service has issued an optional safe harbor method that individuals can use to determine the amount of deductible expenses attributable to a home office.[77] The safe harbor method is an alternative to calculating, allocating, and substantiating actual expenses for purposes of satisfying the requirements of §280A. Although the optional method simplifies the calculation of the home office deduction, it does not necessarily result in the maximum deduction each year. Calculating and substantiating home office expenses often results in a higher deduction than using the safe harbor method. Tax advisors should calculate the home office deduction using both methods to determine which method is more advantageous.

f. Under §121(c), a partial exclusion may be available if the taxpayer fails to meet the eligibility test due to a change in workplace location, a health-related issue, or an unforeseeable event.

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[77] Rev. Proc. 2013-13, 2013-6 I.R.B. 1.

(i) **Work-Related Move** – Taxpayers are eligible for a partial exclusion of gain due to a work-related move if:

- They took or were transferred to a new job location at least 50 miles farther from their home than their previous work location;
- The taxpayer had no previous work location and began a new job at least 50 miles from the home; or
- Either of the above statements is true for the taxpayer's spouse, co-owner of the home, or anyone else for whom the home was his or her residence.

(ii) **Health-Related Move** – Taxpayers are eligible for a partial exclusion of gain due to a health-related move if:

- The taxpayer moved to obtain, provide, or facilitate diagnosis, cure, mitigation, or treatment of disease, illness, or injury for themselves or a family member;
- The taxpayer moved to obtain or provide medical or personal care for a family member suffering from a disease, illness, or injury;
- The taxpayer's doctor recommended a change in residence due to a health problem experienced by the taxpayer; or
- Any of the above statements is true of the taxpayer's spouse, co-owner of the home, or anyone else for whom the home was his or her residence.

(iii) **Unforeseeable Events** – Taxpayers are eligible for a partial exclusion of gain due to a move related to an unforeseeable event if:

- The taxpayer's home was destroyed or condemned;
- The taxpayer, his or her spouse, or any co-owner of the home:
  - Died;
  - Became legally separated, or was issued a separate decree to pay support to the other spouse;
  - Gave birth to two or more children from the same pregnancy;
  - Became eligible for unemployment compensation;
  - Became unable, due to a change in employment status, to pay for basic household living expenses (food, clothing, housing, medication, transportation, taxes, court-ordered payments, other reasonable expense); or
  - Any other event determined to be unforeseeable in IRS published guidance or other facts and circumstances.

If a taxpayer is eligible for a partial exclusion, the exclusion limit is calculated as follows:

Step 1	Determine the shortest of the following 3 periods: 1. Your time of residence in the home during the 5-year period leading up to the sale	____________
	2. Your time of ownership of the home leading up to the sale	____________
	3. The time that has elapsed between the sale and the date you last sold a home for which you took the exclusion, if applicable	____________
Step 2	Take the smallest period from Step 1 (you may use days or months) and divide that number by 730 (if using days) or 24 (if using months)	____________
Step 3	Multiply the result from Step 2 by $250,000. Stop here if not married filing jointly	____________
Step 4	Repeat Steps 1–3 for your spouse and add the two results	____________
C) Your exclusion limit is $____________. Unless you have taxable gain from business or rental use (see *Business or Rental Use of Home*), only gain in excess of this amount is taxable.		

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Note:

As a lingering effect of the pandemic, millions of Americans work from home. Practitioners will likely hear a common question from clients… "*Can I deduct my home office expenses?"* It is important to emphasize that the home office deduction is generally only available to self-employed individuals and individual contractors, not employees.

Taxpayers may deduct expenses allocable to a home office used exclusively and regularly: (i) as the taxpayer's principal place of business for any trade or business; (ii) as a place to meet with patients, clients, or customers in the normal course of a trade or business; or (iii) for a separate structure not attached to the dwelling, in connection with the taxpayer's business. The principal place of business requirement will be satisfied if the taxpayer uses the home office for the administrative or management activities of his or her trade or business if there is no other fixed location where the taxpayer conducts a substantial amount of those activities. If an employee uses part of a dwelling exclusively and regularly as a principal place of business, the home office must be for the convenience of the employer. However, the home office deduction is part of unreimbursed employee business expense, which is a miscellaneous itemized deduction. Miscellaneous itemized deductions are suspended for 2018 through 2025. A home office deduction is also available for dwelling space used regularly for the storage of inventory or product samples held for use in a trade or business of selling products at retail or wholesale, and for the portion of a dwelling used regularly in the taxpayer's trade or business of providing day care in certain circumstances. The optional safe harbor method of calculating the home office deduction reduces the administrative burden on taxpayers claiming the deduction and satisfies the substantiation requirements. Taxpayers electing the safe harbor method are not required to allocate and substantiate home office expenses. Taxpayers electing the safe harbor method will not be required to complete Form 8829. However, the safe harbor method does not affect the qualification requirements.

g. The home office deduction is generally only available to self-employed individuals and individual contractors, not employees.

(i) Deductions for a home office are limited to gross income derived from the business reduced by deductions allocable to the use that are allowable regardless of whether the unit is used as a home office (for example, qualified residence interest, property taxes, and casualty losses) and allowable trade or business expenses not allocable to use of the dwelling (for example, normal business expenses such as supplies). Any amount disallowed because of the gross income limit is carried over and taken into account in determining the home office deduction in the next tax year.

78 IRS Publication 523.

(ii) Effective for tax years beginning on or after January 1, 2013, individual taxpayers can use an optional safe harbor method to calculate their home office deduction. Taxpayers calculate their deductible home office expenses by multiplying the allowable square footage (the portion of the home used as a qualified home office, not to exceed 300 square feet) by $5. The maximum home office deduction under the safe harbor method is $1,500. Except for otherwise allowable deductions such as home mortgage interest, property taxes, and casualty losses, a taxpayer electing the safe harbor cannot deduct any actual expenses for the business use of the home for that tax year.

Note:

This election is made year to year whether to use the safe harbor method or calculate and substantiate actual expenses allocable to the home office. The safe harbor election is made by using the method to compute the home office deduction on a timely filed income tax return. Once made, an election is irrevocable. A change from the safe harbor method to the actual expense method in a succeeding tax year, and vice versa, is not a change of accounting method and does not require IRS consent.

(iii) The home office deduction using the safe harbor method cannot exceed gross income derived from qualified business use of the home reduced by trade or business expenses unrelated to the home. Unlike the actual expense allocation method, any amount over the limit may not be carried over and claimed as a deduction in a succeeding tax year. Taxpayers can preserve the full amount of the home office deduction by using the actual expense method in years in which they have little or no income associated with the home office to avoid losing carryovers, but such carryovers may not be deducted in the years the safe harbor method is elected.

- A taxpayer with a qualified business use of a home for part of a tax year, or who changes the square footage for a qualified business use of a home during the tax year, must determine the average of the monthly allowable square footage for the year. In determining the average monthly allowable square footage, no more than 300 square feet may be taken into account for any one month, and the taxpayer will be treated only as having a qualified business use of a home in a month in which he or she had 14 or more days of business use.
- If otherwise eligible, taxpayers who share a home may each use the safe harbor method, but not for the same portion of the home. A husband and wife, for example, may each use the safe harbor method for a qualified business use of the same home for up to 300 square feet of different portions of the same home.
- A taxpayer who has more than one qualified business use of the same home and who elects the safe harbor method must use the safe harbor method for each qualified business use of the home. The taxpayer is limited to a maximum of 300 square feet that must be allocated among the qualified business uses of the home.

(iv) A taxpayer who uses the safe harbor method for a tax year and calculates and substantiates actual expenses for a subsequent tax year must calculate depreciation allowable in the subsequent year by using the appropriate optional depreciation table applicable for the property, regardless of whether the taxpayer used an optional depreciation table for the property in its placed-in-service year. In the subsequent year's depreciation calculation, the applicable year is the year that corresponds with the current tax year based on the year the property was placed in service.

(v) Planning issues:

- Electing the safe harbor method may also reduce the audit risk associated with claiming a home office deduction: calculating, allocating, and substantiating home office expenses aren't required under the safe harbor method.
- Because the maximum deduction under the safe harbor method is $1,500 without regard to direct expense such as painting and repair, the benefit of deducting direct expenses likely would be lost by electing the safe harbor method.
- Because gain must be recognized to the extent of depreciation allowed or allowable on the sale of a principal residence, and because the safe harbor provides that depreciation allowable for the portion of a home used as a home office is deemed to be zero for that tax year, **there is no gain recognition on subsequent sale of the home in contrast to not using the safe harbor**.
- The actual expense method is likely to provide a greater tax benefit than the safe harbor method if the home office is larger than 300 square feet or constitutes a relatively large percentage of the home. The larger the home office relative to the size of the home, and the higher the cost of operating the home, the more likely the actual expense method will result in a higher deduction. Taxpayers with a more expensive home will usually benefit from using the actual expense method because a relatively larger amount of depreciation and homeowners' insurance can be allocated to the home office.

Planning point:

> The size of the home office as a percentage of the total size of the home affects the amount of AGI and itemized deductions. Compared to the safe harbor method, the actual expense method increases AGI deductions, but because home mortgage interest and property taxes are fully deductible under the safe harbor method, decreases itemized deductions (for the portion of such deductions allocable to the business office). The decrease in AGI by using actual expense methodology is at least somewhat offset by the increase in itemized deductions. The larger the home office relative to the square footage of the home, the greater the likelihood that the actual expense method will provide more savings than the safe harbor method. The phase out of itemized deductions for high-income must be considered because taxpayers won't receive the full benefit from mortgage interest and taxes associated with a residence containing a home office. However, the effect may be an increased home office deduction that reduces AGI more than the safe harbor, which can also result in qualification of various credits and enhance potential medical expenses while reducing maximum charitable contributions.

2. Two principal residences at the same time

Since the taxpayer has three years after the residence change to sell the former residence and exclude the gain, some taxpayers may have two principal residences simultaneously. Taxpayers with vacation homes can shelter the gain on the personal residence and then also on the vacation home by selling the principal residence, excluding the gain and then moving to the vacation home. After two years, the vacation home will be considered the principal residence, thereby allowing the sheltering of gain on that home also.

Planning point:

> As a financial-planning strategy, it makes sense to own two dwellings. With the new nonqualified use rule, it may be required to preserve the maximum amount of exclusion. The exclusion applies to all of the gain realized on its sale, not just the gain attributable to the appreciation while the dwelling was the principal residence. Moreover, the qualification applies to each spouse in a couple. Each may qualify by separately meeting the ownership test and the use test.
>
> **One must use caution if periods of nonqualified use are involved.** In such, for sales or exchanges after December 31, 2008, the §121 exclusion amount may be apportioned.[79] Nonqualified use does not include any portion of the five-year period that is after the last date that such property is used as the principal residence of the taxpayer or the taxpayer's spouse;[80] and any period (not to exceed an aggregate period of 10 years) during which the taxpayer or the taxpayer's spouse is serving on qualified official extended duty;[81] or any other period of temporary absence (not to exceed an aggregate period of two years) due to change of employment, health conditions, or such other unforeseen circumstances as may be specified by the Service.[82]

Example: Bob and Sue were married on May 18, 2022. They had maintained separate residences prior to their marriage and each of them had lived in their residences for at least two years. On May 29, 2022, Sue moved to Bob's residence and began allowing her father to use her old residence rent-free. Sue now has two principal residences -- her former residence and Bob's residence. Bob and Sue file a joint return for 2022, using Bob's address on the return. Sue can sell her former residence for a $65,000 gain. By what date must she sell the residence to be able to exclude the gain? Presumably, if Sue sells the old residence by May 29, 2025, she will be able to exclude the $65,000 gain. Alternatively, after living in Bob's residence for two years, the couple could sell Bob's residence and exclude up to $500,000 of gain. Sue may have to establish that she moved on May 29, 2022. Perhaps a moving company receipt from that day would provide documentary evidence of the move. Simply updating her mailing address for her correspondence, checking account, voting registration, etc. would also provide documentation of the move.

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79 I.R.C. §121(b)(4)(A).
80 I.R.C. §121(b)(4)(C)(ii)(I).
81 I.R.C. §121(b)(4)(C)(ii)(II).
82 I.R.C. §121(b)(4)(C)(ii)(III).

Planning note:

As of April 1, 2023, upfront fees on certain high balance loans sold to Fannie Mae and Freddie Mac increased between 0.25% and 0.75%. Additionally, as of April 1, 2023, the upfront fees for mortgage loans on second homes increased between 1.125% and 3.875% depending on the loan-to-value ratio.

Planning point: The Augusta Rule

Taxpayers with multiple residences may want to take advantage of a tax planning strategy under IRC §280A, sometimes referred to as The Augusta Rule.

Taxpayers can exclude income derived from renting out their residence (including primary, secondary, and vacation homes), provided that:

- The residence is not the taxpayer's primary place of business;
- The residence is not rented for more than 14 days (the 14 days need not be consecutive); and
- The taxpayer charges a reasonable rental fee comparable to other rentals.

Since such income is excludable from income, the taxpayer cannot deduct any rental-related expenses.

Example: Tim owns a luxurious 3-bedroom high-rise condo in Times Square. He is traveling the week of New Year's Eve to stay with his family. Tim's friend informs him that he could easily rent his apartment for New Year's Eve. Tim decides to advertise his condo online for $2,500/night (market rate). Soon after, an individual booked the condo for 5 nights total. Tim spends $500 on cleaning services ($250 to clean the condo for guests and $250 to clean after the guests depart).

Tim received $12,500 of rental income ($2,500/night * 5 nights). Under IRC §280A, Tim may exclude the entire $12,500 of rental income from taxable income. However, he may not deduct the $500 he spent on cleaning services.

Business owners who do not use their home as a primary place of business may potentially consider utilizing the Augusta Rule.

Example: Bob is the owner of a small business, XYZ, LLC. Every December, XYZ, LLC holds a company retreat to discuss planning strategies for the upcoming year. Bob rents his vacation home in Naples, FL to XYZ, LLC for $5,000 for a weeklong stay, which is the market rent for the time of year. Bob does not rent his vacation home any other time during the year.

Provided all requirements are met, XYZ, LLC can deduct the rental expense as a business expense, and since Bob rented his vacation home for less than 14 days, he does not need to include $5,000 of rental income on his personal income tax return.

Business owners who utilize the Augusta rule should maintain adequate documentation to substantiate that the rental was for a legitimate business purpose and that the rental expense was reasonable based on market comparisons. No deduction is allowed if the rental was not used for a legitimate business purpose.

3. Related-party sales

Since the only limitation on the exclusion arising from the sale of the principal residence to a related person is with respect to the separate sale of a remainder interest in the residence, other related-party sales would appear to be viable planning options. For these purposes,[83] a related person is any person who bears a relationship to the taxpayer, which is described in §267(b) (relating to the disallowance of losses incurred in transactions between related persons) or §707(b).

Planning point:

A related-party sale may permit the taxpayer's economic unit to enjoy consecutive multiples of the maximum exclusion. A couple may consider the sale to a family member at a time when the couple will not recognize gain in excess of the maximum exclusion in conjunction with their estate-planning objectives.

Example 1: Mom and Pop have owned and used their residence as a principal residence for the required two-year period. Their basis is $150,000 and they sell the residence to Son for $650,000, taking back a note paying interest only for five years at an adequate interest rate with a balloon payment then due.

Mom and Pop realize a $500,000 gain, which they completely exclude by filing a joint return for the year of the sale. Several variations are possible.

In the first variation, Mom and Pop forgive the note in the year following the year of the sale, but only after they have received at least one interest payment. (The reason for deferring this forgiveness will be addressed shortly.) Now, if Mom and Pop are treated as making a gift of the note, they can completely exclude the transfer from gift tax by use of the exemption equivalent of the applicable credit amount. Son has a $650,000 basis in the property and may now exclude, once he meets the ownership and use requirements, any further gain. Suppose Son sells the property five years after the purchase for $900,000. He excludes the entire $250,000 gain ($900,000 - $650,000). Alternatively, Mom and Pop can keep the note alive and Son pays them $650,000 from the proceeds of his sale of the residence, keeping $250,000 (less any interest paid from his own resources). Within certain bounds, Mom and Pop could make annual-exclusion gifts to Son that could be used to fund the interest payments.

One should be careful and not get greedy by forgiving the interest payments annually, as this usually is used by the Service to show that the gift occurred in the year of the sale and that their subsequent cancellations were merely steps in an integrated plan.

As mentioned earlier, the cancellations of the interest or principal should not occur in the year of the sale. Once the Service establishes that the gift occurred in the year of the sale, it can argue that the gift was not of the note but of the residence. If Son acquires the property by gift and not by sale, Son does not take a cost basis in the property. The critical difference between these alternatives is that in this latter case, Son takes the gifted residence with a carryover basis (adjusted in some cases for the portion of any gift taxes paid attributable to the $500,000 appreciation in the property at the time of the gift). Thus, when Son sells the property five years later, Son must recognize the $500,000 gain that was not excluded by Mom and Pop ($900,000 amount realized - $150,000 basis - $250,000 exclusion).

[83] I.R.C. §121(d)(8)(B).

Note:

> What are the bounds of these sales to a related party? Consider the situation faced by many clients who own closely held corporate businesses. As with many clients holding stock in a closely held C corporation, they are very unlikely to have ever paid a dividend out of the company's annual profits. Yet, their salaries are making practitioners very nervous, for they are unreasonably high, while the accumulated-earnings penalty is becoming a distinct possibility. Would the following planning scenario make any sense from a tax standpoint?

Example 2: Your individual clients, owning several such interests in closely held C corporations, have listened intently to your warnings concerning the need to either justify the reasonable business needs, which should be documented if they are going to continue to accumulate such earnings in their businesses, or start to extract at least a small portion of the earnings each year as dividends. Aghast at the idea at having to pick up ordinary income on the payouts of these earnings as dividends (i.e., for which the company will receive no deduction), they ask whether they might "sell" their principal residence to their C corporation. They have approximately $500,000 of unrealized appreciation in their home (i.e., and a rollover basis of $150,000) and inquire as to whether they might extract $650,000 of cash from their company and use this previously mentioned exclusion to shelter the resulting gain. What do you tell them?

Arguably, since only "remainder interests" sold to related parties are not included in the types of sales that qualify for the §121 exclusion, it appears that the $650,000 can be taken out of their corporation without any tax consequences. Unfortunately, you do have to add that they still have a problem with the accumulated-earnings-tax penalty since you have essentially only substituted one type of asset (cash) for another (the house). However, since the house would now have a stepped-up basis (the fair-market-value purchase price), the corporation could sell the home six months later and realize little, if any, gain (especially after a six- or seven-percent real estate commission was paid).

Note:

> The sale could also be made to a flow-through entity such as an S corporation or an LLC. Although they would have been taxed on any profits being accumulated at the entity level, such a sale to a "related party" would still be possible. With the S corporation, it might be a way to take distributions (i.e., in reality, these would be sales proceeds instead) without a corresponding reduction in their stock basis. Or, with an LLC, the payment of these sales proceeds would again have no effect on the basis of their ownership interests. Of course, with the sale of one's home to any of these various entities, it is not envisioned that the home would be owned for any significant period of time. It would probably be sold within three to six months from the original purchase date. Care should be taken to collect the appropriate rents in the interim. As discussed above, it is hardly within a C corporation's "reasonable business needs" to accumulate funds to buy the personal residences of its owners. So there would still be the AET penalty tax exposure regardless of how they held these excess funds (i.e., as cash, investments, real estate, etc.). However, the payment of sales proceeds to the owners on the purchase of their homes would at least allow for monies to be coming out of the corporation without having them be subject to employment-tax or income-tax withholding at ordinary rates, and without their "salary deduction" on Page 1 of Form 1120, *U.S. Corporation Income Tax Return*, being even more bloated.

4. Election out of the exclusion

The taxpayer can elect out of the exclusion otherwise applying to the sale. This is important in identifying which of two sales within two years that would otherwise apply should not apply, namely the sale of the residence with the smaller gain.

Planning point:

> Even if a client were to have a large capital loss carryover, an election on the exclusion on the gain from the sale of one's home should not be made simply to produce the necessary capital gain to use these excess capital losses. First of all, the election out of using the home-sale exclusion is an "all or nothing" deal. Therefore, would there be any unexcluded gain that would not be sheltered by the capital loss carryover? Since capital loss carryovers can be carried over indefinitely, they should probably be saved for those situations where the capital gain resulting from a sale could not otherwise be excluded. This same argument could be made for electing out of the home-sale exclusion in order to create capital gain that could then be treated as "net investment income" to be offset by excess investment interest expense on Form 4952, *Investment Interest Expense Deduction*. Once again, since excess investment interest expense can be carried over indefinitely, one should wait to use it to shelter investment income that otherwise would be included in gross income.

5. *Renting a home prior to a sale*

In periods when the real estate market is soft or depressed, it may take a considerable time for a home listed for sale to actually go to settlement. Similarly, homeowners may be tempted to keep a home in lieu of selling it if it is located in a hot rental market. Perhaps the owners may already have moved for business or personal reasons, leaving the home vacant. In such situations, rental of the home pending its sale may be an economically viable strategy for the owners. The cost of maintaining two residences may be prohibitive. In addition, the insurance carrier may refuse to maintain coverage on a vacant property. The income-tax treatment of income and expenses resulting from such a rental depends on a number of factors and may become complicated. Restrictions may apply under the vacation-home rules of §280A, the passive-loss limitations of §469, and even the hobby-loss limitations of §183.[84] Generally, some current tax benefits may be obtained annually by renting a residence prior to its sale. Remember, however, that such rental activity will disqualify the owners from the home-sale exclusion when the home is later sold if the property was not used as a principal residence for at least two of the five years ending on the date of its sale. What should taxpayers do in such situations?

a. If the owner expects the property to eventually be sold at a substantial gain, the availability of the home-sale exclusion is obviously significant for income-tax purposes. In such cases, preservation of the property as a residence under the two-out-of-five-year rule may be the most important tax objective. For example, if the taxpayer will have to recognize $250,000 of gain at a 20-percent tax rate if the property is either vacant or rented for the last four out of five years before its sale, the tax on that sale will be $50,000. This amount may be greater than the combination of both the rental income and net tax benefits generated by the property during its rental. However, if the choice is between rental and a vacancy, the rental situation will be better because vacancy does not count as qualified use for purposes of the exclusion anyway.

Planning point:

> If at all possible, the best strategy may be to move back in for enough time before the home is sold **to qualify** for the two-out-of-five-year-use requirement for the exclusion, but not, as noted earlier, if the taxpayer otherwise qualifies. If the taxpayers' new home is within a reasonable distance, it may be possible to rent that home until the old home is sold. Note that under the new exclusion rules, there is no requirement that the old home be sold within any time period before or after the purchase of a new home, or even that a new home be purchased at all.

[84] For an interesting discussion of the tax treatment of homes rented prior to sale, see "Difficult Home Sales Raise Various Tax Scenarios," *Taxation for Accountants*, September 1997, by Peter J. Westort, CPA.

Note:

> In some cases, clients may wish to put the house on the market for sale upon moving out, although a sale might not be immediate. If the property is not offered for rent, case law indicates that the property has not been converted from personal to nonbusiness investment property.[85] One important exception occurs if the sales price asked at the outset is above the current market value of the property: in this case the property is then held for income production in the form of post-offer-for-sale appreciation of the property (if this is a reasonable expectation).[86] The significance lies in the ability to deduct maintenance and other related expenses incurred with respect to the property between time of moving out and the sale (which might be considerably later).

b. **If the selling situation is somehow bad enough that the owners do not expect to sell the home for as much as they paid for it**, then the availability of the exclusion loses its importance. In such cases, it may be immaterial whether the owners qualify for the exclusion, and the rental of the residence pending its sale will present no tax risk. In fact, if the property is firmly established as a rental property, a loss upon its sale could potentially be treated as a deductible loss pursuant to §165 (i.e., given the decline in value is established as occurring once the home was converted to a rental). However, the treatment of the sale of a personal residence converted to rental property is not entirely clear, particularly with regard to whether the loss is a capital loss, or an ordinary loss under §1231.[87] Arguably, though, given that the rental is not temporary and the house is taken off the market, then a §1231 ordinary loss to the extent of the decline in value while it was rented could be claimed.

Planning point:

> If a client wants to take a loss on the sale of the residence, keep two points in mind. The first is the basis for loss purposes -- the client's basis in the property as of the time of conversion is the lesser of the client's adjusted basis or fair market value at the time the property is converted to rental use. Second, in order to convert, it is generally necessary for the client to preclude during the term of the lease use of the portion of the dwelling rented by the client as a residence. Taxpayers should consider obtaining a home appraisal to determine the residence's value as of the date of conversion.

6. Other opportunities

An even better opportunity is available to taxpayers with residences in certain favored locations. The tax law provides that as long as the residence is not rented for more than 14 days during the year, all of the rental income is received tax-free. This is actually a double-edged sword. No deductions (i.e., other than the normal mortgage interest and taxes on Schedule A) are allowable as well. This can be positive in that any depreciation would have been recaptured as "unrecaptured §1250 gain" taxable at a maximum 25-percent rate. While the depreciation may increase by additional rental use, much of it, and sometimes all of it, is wasted because it duplicates the exclusion of income. It also reduces the basis in the property unnecessarily. As an example, at the New Jersey shore, some homeowners are taking in as much as $6,000 per week for use of their beachfront property, creating tax-free income of $12,000.

7. Limited personal use of a dwelling

Many taxpayers hold dwelling units primarily for the production of current rental income, but also use the properties occasionally for personal purposes. The Service has provided a safe harbor for taxpayers who

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85 *Newcombe v. Commissioner*, 54 TC 1298 (1970).

86 *Lowry v. Commissioner*, 34 AFTR 2d 74-6206 (D. N.H. 1974).

87 See *Rechnitzer v. Commissioner*, T.C. Memo. 1967-55; *Hazard v. Commissioner*, 7 T.C. 372 (1946); TAM 8350008; Treas. Regs. §1.165-9(b)(1).

exchange a residence in a purported tax-free exchange.[88] In the case of a dwelling unit, an issue could be raised as to whether it is held for productive use in a trade or business given its use for personal purposes.[89] A personal residence does not qualify for the tax-free exchange.

a. Effective for exchanges of dwelling units occurring after March 9, 2008, the Service will not challenge the exchange on the basis that the relinquished property did not have the required holding purpose if two requirements are met:
   (i) The taxpayer owns both properties for the qualifying use period (for the relinquished property, at least 24 months immediately before the exchange;[90] for the replacement property, at least 24 months immediately after the exchange[91]); and
   (ii) Within the **qualifying use period**, in each of the two 12-month periods immediately preceding the exchange: (i) the taxpayer **rents the dwelling unit to another person(s) at a fair rental for 14 days or more**; and (ii) the period of the taxpayer's **personal use[92] of the dwelling unit** doesn't exceed the greater of 14 days or 10 percent of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

b. A taxpayer is treated as using a dwelling unit for personal purposes for a day if the unit is used for personal purposes by: (1) the taxpayer or any other person who has an interest in the dwelling unit or by a member of the family of the taxpayer or the other person; (2) any individual who uses the unit under a reciprocal use arrangement (other than use by a person having an equity interest in the property under a shared-equity financing agreement); or (3) by any individual unless for that day the dwelling unit is rented for a **fair rental**.[93]

c. A taxpayer is not treated as using a dwelling unit for personal reasons if the unit is rented out or held for rental at a fair rental to any person for use as a personal residence.[94]

d. Personal use days don't include days the taxpayer used a dwelling unit as his or her principal residence:
   (i) Before or after a rental (or attempted rental) period of 12 or more consecutive months beginning or ending in the tax year; or
   (ii) Before a consecutive rental (or attempted rental) period of less than 12 months beginning in the tax year, at the end of which the residence is sold or exchanged.[95]

Note:

The safe harbor applies only to the determination of whether a dwelling unit is held for productive use in a trade or business or for investment; it does not qualify the exchange per se if all the other requirements for a like-kind exchange are not satisfied.

88 Rev. Proc. 2008-16, 2008-10 I.R.B. 1.
89 Treas. Regs. §1.1031(a)-1(a)(1)
90 For the relinquished property, the first 12-month period immediately preceding the exchange ends on the day before the exchange takes place (and begins 12 months before that day) and the second 12-month period ends on the day before the first 12-month period begins (and begins 12 months before that day).
91 For the replacement property, the first 12-month period immediately after the exchange begins on the day after the exchange takes place and the second 12-month period begins on the day after the first 12-month period ends.
92 Personal use occurs on any day on which a taxpayer is treated as having used the dwelling unit for personal purposes. I.R.C. §280A(d)(2) (taking into account §280A(d)(3), but not §280A(d)(4)).
93 I.R.C. §280A(d)(2). Whether a dwelling unit is rented at a fair rental is determined based on all of the facts and circumstances that exist when the rental agreement is entered into. All rights and obligations of the parties to the rental agreement are taken into account.
94 I.R.C. §280A(d)(3).
95 I.R.C. §280A(d)(4).

8. Modification of exclusion of gain on sale of a principal residence

Surviving single spouses may qualify for the up-to-$500,000 exclusion (applicable to married couples) if the sale occurs not later than two years after their spouse's death and the requirements for the $500,000 exclusion (at least one spouse meets the ownership requirements, both meet the use requirements, and neither is ineligible for the exclusion benefits by reason of the once-in-two-years rule) were met immediately before the spouse's death.[96]

Example: Nicholas died on March 31, 2023, owning a principal residence as tenants-by-the-entireties with his spouse, Alexandra. The property was purchased in 1982 for $100,000. It was worth $900,000 at his death. Alexandra sells the property on April 1, 2026, for $1,000,000. Because one-half of the residence is included in his estate, that half of the property will receive a step-up in basis from $50,000 to $450,000. Alexandra has a total basis of $500,000 in the property. When she sells it, she realizes a gain of $500,000. As her maximum exclusion is only $250,000, the remaining $250,000 of realized gain is recognized.

Now, if Alexandra sold the property on March 30, 2025, her maximum exclusion would increase to $500,000, and none of the realized gain would be recognized.

9. Sale of vacant land in different year than dwelling sale[97]

It is the sale of the dwelling unit itself which triggers the $250,000 ($500,000 MFJ) gain exclusion. If the dwelling unit is sold first, the gain is excluded in the year sold. If the vacant land is sold within two years after, any additional exclusion up to the maximum will be reported in the later year.

If vacant land is sold in one tax year and the dwelling unit is sold in the next year before the return due date (including extensions) for the return which includes the land sale, exclude the gain (within the maximum limits) on sale of the vacant land when the return is filed.

If vacant land is sold in one tax year and the dwelling unit is not sold before the return is filed, report the gain on vacant land as taxable income when the return is originally filed. If the dwelling unit is subsequently sold within the statutory time period (and the gain thereon does not exceed the maximum exclusion amount), file an amended return and exclude the gain on sale of the vacant land.

Example 1: In 1993 Charlotte buys a house and 10 acres that she uses as her principal residence.

In May 2023 Charlotte sells eight acres of the land and realizes a gain of $110,000.

She does not sell the dwelling unit before the due date for filing her 2023 return; therefore, she may not exclude the $110,000 gain on her return.

In March 2025 Charlotte sells the house and remaining two acres realizing a gain of $180,000.

Charlotte may exclude the $180,000 of gain on the sale of the residence and two acres in 2025.

Because the sale of the eight acres occurred within two years from the date of the sale of the dwelling unit, the sale of the eight acres is treated as a sale of the taxpayer's principal residence.

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96 I.R.C. §121(b)(4).

97 Treas. Reg. §1.121-1(b)(3)(ii)(C).

Charlotte may file an amended return for 2023 to claim an exclusion for $70,000 ($250,000 maximum exclusion less $180,000 gain previously excluded on the house sale) of the $110,000 gain from the sale of the eight acres.

Example 2: In 2002 Danny buys a house and one acre that he uses as his principal residence. In 2003 he buys 29 acres adjacent to his house and uses the vacant land as part of his principal residence.

In 2025 Danny sells the house and one acre for a loss of $25,000 and the 29 acres for $270,000 gain in two separate transactions.

Danny may exclude the net $245,000 gain from the two sales in 2025. Both sales are considered part of one transaction.

G. Qualified small-business stock

1. A 100-percent exclusion for some stock

Individuals have a limited time in which to avail themselves of a most valuable tax benefit. Perhaps the greatest advantage that C corporations have in contrast to other forms of business organizations lies in the special capital-gains tax rate that applies to certain dispositions of qualified small business stock. Only stock in a C corporation can be qualified small business stock. This is especially important in choice-of-entity decisions in the last year the 100-percent exclusion applies to stock issued in that year. Creating a C corporation in that year produces a more favorable tax result than other qualifying small business stock that was acquired in other years.

The percentage exclusion for qualified small business stock acquired after September 27, 2010, and before January 1, 2011, was increased to 100 percent and the minimum tax preference does not apply.[98] After a series of extensions for stock issued in later years, the 100-percent exclusion was made permanent by the PATH Act of 2015. The §1202 provisions are preserved by the TCJA.

Note:

Currently, the exclusion for gain from the qualifying disposition of such qualified stock for investments made in 2010 and later years is 100 percent. Because net investment income only includes so much of such gains included in taxable income, the gain is subject to a reduced (0 percent) effective additional net investment income tax rate, since at most none of the gain will be taxed (assuming applicable limitations are not exceeded); likewise, none of the gain will add to the taxpayer's AGI.

Such stock is also eligible for a tax-free rollover. It is particularly useful for locking in gain when the taxpayer would have sold the stock before the end of the qualifying five-year holding period for a qualified disposition. In the case of any sale of qualified small business stock held by a taxpayer other than a corporation for more than six months and with respect to which such taxpayer elects the application of this section, gain from such sale shall be recognized only to the extent that the amount realized on such sale exceeds: (1) the cost of any qualified small business stock purchased by the taxpayer during the 60-day period beginning on the date of such sale; reduced by (2) any portion of such cost previously taken into account by this provision.[99] Thus, one can sell (one does not need a reorganization exchange) the stock outright with only a six-month holding period and recognize none of the gain if the taxpayer buys up from the sale new qualified small business stock. As with the reorganization provisions, the taxpayer's basis in the stock of the new corporation will be its cost basis reduced by the unrecognized gain on the sale of the stock of the old qualified small business stock. If need be, rollovers may be repeated. This

98 I.R.C. §1202(a)(4)(A) and (C).
99 I.R.C. §1045(a).

can defer the impact of the gain on the regular tax, the investment income tax base, and the taxpayer's AGI. Because the new qualified small business stock must qualify as qualified small business stock, the ultimate sale of stock in the rollover chain without a qualifying rollover will qualify for the exclusion so long as the five-year holding period is met. One cannot, however, tack the holding period of old stock to determine whether the new stock has met the six-month holding period requirements of a rollover.[100]

The Service has not issued guidance on the tacking of the holding periods of individual qualified small business stock for purposes of the five-year holding period for purposes of the exclusion. Likewise, it has not issued guidance on the effect of different exclusion rates that apply dependent on the date of acquisition (100 percent, 75 percent, 50 percent). If such stock is sold, does one look at the date of disposition or the date of acquisition to determine which exclusion rate applies to recognized gain? The Code states that it is the date of acquisition. This may be why the Service has not issued any guidance with respect to the tacking of holding periods for purposes of gain recognition at the end of a rollover chain.

Because the rollover is triggered by an election, control is retained to "recognize" the 100-percent excluded gain and make an investment in qualified small business stock within 60 days and not have it treated as a rollover and retain a cost basis in the new qualified business stock.

Example: L owns qualified small business stock that was issued on January 1, 2015, with respect to which it has built-in gain of $10,000 on January 2, 2019. L projects AGI of $240,000, including $50,000 of net investment income. If L sells the stock and does not roll over the gain, an additional $10,000 of income is added to AGI and net investment income. Since there is no excess AGI, L is not subject to the net investment income tax but does pay current tax on the additional $10,000 of gain recognized.

If instead L rolled over the gain into another qualified small business stock, L would not be taxed on the $10,000 of includable gain. However, the new stock would be taxed on its disposition and it would have an additional $10,000 of gain that corresponds to a $10,000 basis reduction in the replacement stock. Of such gain, would some or all of the gain benefit from the five-year holding period of the original qualified small business stock in the event that the replacement stock was sold less than five years from the time the replacement stock is acquired?

One must be aware, however, that not all stock or all dispositions qualify for this treatment, and excess levels of gain do not qualify for the exclusion even if a portion of the gain does, but such levels of gain are not likely to be realized. In addition, the exclusion only applies to a disposition if the stock was held by the taxpayer for more than five years. In order to understand if a corporate business could qualify for the exclusion and if the gain recognized exceeds the amount eligible for the exclusion, two terms must be kept in mind.

a. The first is qualified small business stock. Qualified small business stock refers to stock in a **C corporation**, which was originally issued after August 10, 1993, which, as of the date of its issuance, was a **qualified small business**;[101] such stock was acquired by the taxpayer at its **original issue** (directly or through an underwriter) either in exchange for money or other property (not including stock),[102] or as compensation for services provided to such corporation (other than services performed as an underwriter of such stock);[103] and during substantially all of the taxpayer's holding period for such stock, such

100 I.R.C. §1045(b)(4).
101 I.R.C. §1202(c)(1)(A).
102 I.R.C. §1202(c)(1)(B)(i).
103 I.R.C. §1202(c)(1)(B)(ii).

corporation meets the **active business requirements** and such corporation is a C corporation.[104]

(i) A **qualified small business** means any domestic corporation that is a C corporation if:

- The aggregate gross assets of such corporation (or any predecessor thereof) at all times on or after 1993, and before the issuance did not exceed $50,000,000;[105] and
- The aggregate gross assets of such corporation immediately after the issuance (determined by taking into account amounts received in the issuance) does not exceed $50,000,000.[106]

Note:

In general, all corporations that are members of the same **parent-subsidiary controlled group** shall be treated as one corporation for these purposes.[107] For these purposes, the term "parent-subsidiary controlled group" means any controlled group of corporations as defined in §1563(a)(1), except that "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears in §1563(a)(1),[108] and §1563(a)(4) shall not apply.[109]

(ii) The active business requirements are met by a corporation for any period if during such period at least 80 percent (by value) of the assets of such corporation are used by such corporation in the active conduct of one or more **qualified trades or businesses**,[110] and such corporation is an **eligible corporation**.[111]

- If, in connection with any **future qualified trade or business**, a corporation is engaged in **start-up activities**,[112] activities resulting in the payment or incurring of expenditures that may be treated as **research and experimental expenditures**,[113] or activities with respect to **in-house research expenses**,[114] assets used in such activities are **treated as used in the active conduct of a qualified trade or business**. Any determination is made without regard to whether a corporation has any gross income from such activities at the time of the determination.
- A **qualified trade or business** means any trade or business **other than**:
  - ○ Any trade or business involving the **performance of services** in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any other trade or business where the

104 I.R.C. §1202(c)(2)(A). A corporation shall be treated as meeting the active business requirements for any period during which such corporation qualifies as a **specialized small business investment company**. I.R.C. §1202(c)(2)(B)(i). A "specialized small business investment company" means any eligible corporation which is licensed to operate under section 301(d) of the Small Business Investment Act of 1958 (as in effect on May 13, 1993). I.R.C. §1202(c)(2)(B)(ii).

105 I.R.C. §1202(d)(1)(A).

106 I.R.C. §1202(d)(1)(B).

107 I.R.C. §1202(d)(3)(A).

108 I.R.C. §1202(d)(3)(B)(i).

109 I.R.C. §1202(d)(3)(B)(ii).

110 I.R.C. §1202(e)(1)(A).

111 I.R.C. §1202(e)(1)(B). An "eligible corporation" means any domestic corporation; except that such term does not include a DISC or former DISC, a corporation with respect to which an election under §936 is in effect or which has a direct or indirect subsidiary with respect to which such an election is in effect, a regulated investment company, real estate investment trust, or REMIC, and a cooperative. I.R.C. §1202(e)(4).

112 I.R.C. §1202(e)(2)(A).

113 I.R.C. §1202(e)(2)(B).

114 I.R.C. §1202(e)(2)(C).

principal asset of such trade or business is the reputation or skill of one or more of its employees;[115]

  - Any **banking, insurance, financing, leasing, investing**, or similar business;[116]
  - Any farming business (including the business of raising or harvesting trees);[117]
  - Any business involving the production or extraction of products of a character with respect to which a deduction is allowable under §613 or §613A;[118] or
  - Any business of **operating a hotel, motel, restaurant, or similar business**.[119]

- For these purposes, stock and debt in any subsidiary corporation shall be disregarded and the parent corporation shall be deemed to own its ratable share of the subsidiary's assets, and to conduct its ratable share of the subsidiary's activities.[120] A corporation shall be treated as failing to meet the active business requirements for any period during which more than 10 percent of the value of its assets (in excess of liabilities) consists of stock or securities in other corporations, which are not **subsidiaries** of such corporation (other than working capital assets).[121] For these purposes, a corporation shall be considered a subsidiary if the parent owns more than 50 percent of the combined voting power of all classes of stock entitled to vote, or more than 50 percent in value of all outstanding stock, of such corporation.[122]

Note:

A corporation is not treated as meeting the active business requirements for any period during which more than 10 percent of the total value of its assets consists of real property that is not used in the active conduct of a qualified trade or business. The ownership of, dealing in, or renting of real property is not treated as the active conduct of a qualified trade or business.[123]

b. Although for general holding period purposes, stock acquired in exchange for property tacks the holding period of the contributed property (other than money or stock), for purposes of the exclusion holding period, such stock shall be treated as having been acquired by the taxpayer on the date of such exchange.[124] In addition, while for general gain purposes, the basis of the stock is generally the basis of the property contributed, the basis of such stock in the hands of the taxpayer shall in no event be less than the fair market value of the property exchanged.[125] If the adjusted basis of any qualified small business stock is adjusted by reason of any contribution to capital after the date on which such stock was originally issued, in determining the amount of the adjustment by reason

115 I.R.C. §1202(e)(3)(A).
116 I.R.C. §1202(e)(3)(B).
117 I.R.C. §1202(e)(3)(C).
118 I.R.C. §1202(e)(3)(D).
119 I.R.C. §1202(e)(3)(E).
120 I.R.C. §1202(e)(5)(A).
121 I.R.C. §1202(e)(5)(B).
122 I.R.C. §1202(e)(5)(C).
123 I.R.C. §1202(e)(7).
124 I.R.C. §1202(i)(1)(A).
125 I.R.C. §1202(i)(1)(B).

of such contribution, the basis of the contributed property shall in no event be treated as less than its fair market value on the date of the contribution.[126]

c. If the taxpayer has **eligible gain** for the taxable year from one or more dispositions of stock issued by any corporation, the aggregate amount of such gain from dispositions of stock issued by such corporation, which may be taken into account for the taxable year shall not exceed the **greater of** $10,000,000 reduced by the aggregate amount of eligible gain taken into account for prior taxable years and attributable to dispositions of stock issued by such corporation,[127] or 10 times the aggregate adjusted bases (determined without regard to any addition to basis after the date on which such stock was originally issued) of qualified small business stock issued by such corporation and disposed of by the taxpayer during the taxable year.[128] In the case of any joint return, the amount of gain taken into account is allocated equally between the spouses to subsequent taxable years.[129] For these purposes, eligible gain means any gain from the sale or exchange of qualified small business stock held for more than five years.[130]

d. Rule in other years: The Internal Revenue Code has provided a partial exclusion on certain capital gains from certain stock. In general, in the case of a **taxpayer other than a corporation**, gross income shall not include 50 percent of any gain from the sale or exchange of **qualified small business stock** held for more than five years.[131] Special rules apply to certain empowerment-zone businesses.[132] The portion of the gain includable in taxable income is taxed at a maximum rate of 28 percent under the regular tax.[133] Seven percent of the excluded gain is an alternative-minimum tax preference;[134] the portion of the gain includable in alternative-minimum taxable income is taxed at a maximum rate of 28 percent under the alternative-minimum tax. Gain from the sale of qualified small business stock generally is taxed at effective rates of 0 percent under the regular tax.[135] The percentage exclusion for qualified small business stock acquired after February 17, 2009, and on or before September 27, 2010, was increased to 75 percent.

Caution:

This can produce a perverse result for a taxpayer in the 1-percent or 15-percent bracket, because the 14-percent effective tax rate on the entire gain exceeds the zero-percent rate that applies to other capital gains recognized by such taxpayers. Since the definition of net capital gains specifically backs out the gain from the sale of qualified small business stock, such taxpayers cannot opt out of the 14-percent tax rate in favor of the zero-percent tax rate. Fortunately, for taxpayers acquiring their interests in the latter part of 2010 or all of 2011, 2012, and 2013, the entire gain is excluded, permitting a zero-percent tax rate. But because of the five-year rule, taxpayers currently disposing of such stock are subject to this anomaly.

Example: On April 1, 2019, John acquires for $50,000 originally issued stock in Startup Corporation that qualifies as small business stock and remains so at all relevant times. On September 1, 2025, John sells his stock in Startup Corporation for $650,000. On the sale in 2025, John realizes a long-term capital gain of $600,000 ($650,000 - $50,000), but none of the gain is recognized. Unlike other

126 I.R.C. §1202(i)(2).
127 I.R.C. §1202(b)(1)(A). In the case of a separate return by a married individual, this is applied by substituting "$5,000,000" for "$10,000,000". I.R.C. §1202(b)(3)(A).
128 I.R.C. §1202(b)(1)(B).
129 I.R.C. §1202(b)(3).
130 I.R.C. §1202(b)(2).
131 I.R.C. §1202(a)(1).
132 I.R.C. §1202(a)(2).
133 I.R.C. §1(h).
134 I.R.C. §57(a)(7).
135 The 50 percent of gain included in taxable income is taxed at a maximum rate of 28 percent.

nonrecognition provisions, such as reorganizations where the gain is merely deferred, the gain realized is excluded and John pays no tax in respect of the Startup stock at any time. Had he purchased the stock in April 2013, he would only exclude 75 percent of the gain and recognize and pay capital gains tax on the $150,000 (.25 x $600,000) capital gain realized and not excluded.

The alternative minimum tax can be affected by the inclusion of capital gains in alternative minimum taxable income, but the preference item is limited. For qualified small business stock acquired after September 28, 2010, there is no preference, thus eliminating a potential source of an AMT liability attributable to the gain; some portion of the gain on the sale of stock arising from any other time frame will be included in the AMT base.

Example: In the prior **Example**, not only is the entire $600,000 gain excluded for income tax purposes, this exclusion is not treated as a preference item for AMT purposes. If on the other hand, Ted purchased the stock in April 2010, not only would he have to pay tax on $150,000, but the $450,000 exclusion would be included in the determination of alternative minimum taxable income.

Note:

The provision applies not to when the stock is sold but to **when the stock is purchased**. Given the prospect of higher capital-gains tax rates in later years, taxpayers may wish to make new investments in such start-up businesses or newly issued stock to obtain the benefits of an exclusion of some degree.

2. Planning implications

For taxpayers planning to start up a new business, the C corporation can produce a huge tax advantage, but of course the small business stock needs to increase in value over the next five years or longer in order to take advantage of the capital gains exclusion.

Planning point:

One can be certain that the IRS will press taxpayers in audit or in court to present detailed evidence of qualification of the sale for this treatment. Those participating in the management of the corporation should generate adequate documentation and record keeping to track the value of the corporate assets. In theory, the Code requires that one show that at each instance up to the disposition the value of the assets did not exceed the upper threshold level; but in practice, unless the assets are wildly fluctuating and anywhere close to the $50,000,000 level, an annual written valuation of assets should suffice.

Planning point:

Creation of a business in this form will also prove effective in controlling AGI and reducing net investment income in the post-2012 period (when the net investment income tax nominally applies). Such an investment could fit well in an effort to avoid the net investment income taxes. Because some or all of the gain is excluded, it does not impact the taxpayer’s AGI at all or as fully as gain from other investments, thus perhaps avoiding or reducing the tax on unearned income in that year. The sale of qualified small business stock after the requisite five-year holding period will generally result in a gain that is to a limited extent included in gross income (and consequently, MAGI) and in net investment income.

H. Choice of Entity

1. Impact of the TCJA on choice of entity

The repeal of §199 and the creation of §199A give us new dynamics for pass-throughs. Some planning points to consider under TCJA:

a. Section 199A gives the taxpayer a deduction not available to C corporations. For 2018 through 2025, an S corporation, entity taxed as a partnership, or even a sole proprietorship not only has the advantage of a single layer of tax but has a possible 20% deduction from taxable income. The new corporate tax rate under TCJA is a flat 21%.[136] So, although the top bracket is reduced to 21%, the 15% bracket is eliminated. The strategy of leaving income in a C corporation to take advantage of the 15% bracket has been upended by the flat tax rate. Also, C corporations have lost the domestic production activities deduction of §199. Small businesses operating in C corporation form should consider conversion to a pass-through entity to take advantage of the §199A deduction.

b. Section 199A applies to the pass-through income of an entity. Wages received by an owner and guaranteed payments received by a partner do not qualify. However, a sole proprietor can apply §199A to 100% of the income from a sole proprietorship. This means that a 100% owner of an S corporation should evaluate converting to a sole proprietorship to take full advantage of the §199A deduction. However, you have to do the math carefully. The §199A deduction goes up, but the self-employment tax does also.

Caution:

> This strategy is better for someone starting a new business than for an existing S corporation. To convert from an existing entity to a sole proprietorship is a ***taxable transaction.*** The cost of conversion must be considered.

Planning point:

> All of the variables must be considered for each taxpayer. A younger taxpayer may think they will never draw Social Security, and therefore wish to minimize self-employment tax. The wage limitations and personal services limitations must also be considered. For instance, if the taxpayer is NOT in one of the specified personal services but is over the taxable income threshold, she may need to operate as an S corporation so that the wages she pays herself will count towards the wage limit. Also, partners in a partnership with low wages to non-owner employees may wish to elect Subchapter S status for the same reason.

2. The impact of §1202 on entity choice

Before advising an abandonment of a C corporation for any entity type, the tax advisor must consider §1202. Does the owner's stock qualify? What is the likelihood that a future sale would be structured as a stock sale? The prudent tax advisor will educate the client so that the client can make an informed decision. The client needs to be fully aware that the desire for current tax savings may be in conflict with the desire for even greater savings if the company is sold.

I. Investment property and like-kind exchanges

1. Converting taxable investment property into a principal residence

Caution:

> While the service provided guidance (following) regarding conversion of taxable investment property into a principal residence, one must use caution due to the subsequent release of the

[136] I.R.C. §11(b).

nonqualified use regulations. In such, for sales or exchanges after December 31, 2008, the §121 exclusion amount is apportioned.[137]

Many taxpayers have investment real estate that is not eligible for the exclusion because it is not, and could not be, a principal residence such as a warehouse or a raw land. Despite the gain inherent in the property, tax can be first deferred and then excluded as follows.

a. Under §1031, real property can qualify as like-kind even though there is difference in grade. Thus, the property could be exchanged tax-free for a condominium if other conditions are met.

   (i) The most important condition is that the replacement property (the condominium in this case) be held for productive use in a trade or business or for investment. A personal residence does not meet this criterion, but rental property does. Thus, it is important that the taxpayer establish the requisite intent at the time of the exchange: (a) by continuing to hold the property; and (b) for the required purpose, and evidence of that intent can be shown by holding the property that could be a principal residence out for rental.

Note:

The Service could try to apply the step-transaction doctrine or sham-transaction doctrine in this case to show that at the time of the exchange the intent was always to hold the property as a residence. The greater the bona fides of the effort to rent and the rental value obtained, the more difficult this would be for the Service.

   (ii) The exchange is technically tax-deferred because the basis mechanism for §1031 exchanges preserves the gain realized on the exchange by carrying over the basis in the exchanged property to the replacement property.

b. After rental for a short period of time (but at least one year, as this may also help to deflect objections to the exchange), the taxpayer moves into the condominium and uses it as a principal residence for a period of at least two years. After five years following the exchange, the taxpayer sells the condominium for cash. As long as the gain then recognized is less than the maximum allowable exclusion, the taxpayer has eliminated the entire tax on the gain on the investment property.

Example: J owns a warehouse on which straight-line depreciation has been taken so that on January 1, 2020, it has a value of $500,000 and an adjusted basis of $300,000. If J sold the warehouse for its fair market value, J would recognize a $200,000 gain, and a maximum capital gains tax of $50,000 (0.25 rate for unrecaptured §1250 gain x $200,000 realized gain).

Instead, Accountant recommends and arranges for a three-party exchange whereby J receives a $500,000 condominium. J rents the condo until February 2022 (and takes depreciation of $16,000), at which time he moves in and uses it as a principal residence until March 2025, when it is sold for $550,000. J’s basis is $284,000 ($300,000 carryover basis - $16,000 depreciation deduction) so the recognized gain is $266,000, consisting of $16,000 of depreciation deductions and $250,000 of other gain. J excludes the $250,000 under §121, $200,000 of which represents the gain that would have been taxed had the warehouse been sold instead of exchanged. Thus, J saves $50,000 of capital-gains tax.

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137 I.R.C. §121(b)(4)(A).

Caution:

> As stated above, the Service may try to attack the original exchange. But beyond that, there is also the possibility that the depreciation that had been taken on the warehouse after August 5, 1997, would be treated as depreciation taken with respect to the condominium even though it was taken before the principal residence is sold. None of the regulations address this issue, but this argument could eliminate some or all of the tax savings depending on the amount of the depreciation taken in relation to the realized gain on the exchange.

c. The American Jobs Creation Act of 2004 limited the use of §1031 in conjunction with §121 exclusions.

(i) A taxpayer may exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years prior to the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change in place of employment, health, or, to the extent provided under regulations, unforeseen circumstances is able to exclude an amount equal to the fraction of the $250,000 ($500,000 if married filing a joint return) that is equal to the fraction of the two years that the ownership and use requirements are met. There were no special rules relating to the sale or exchange of a principal residence that was acquired in a like-kind exchange within the prior five years.

(ii) Effective for sales or exchanges of principal residences after October 22, 2004, the exclusion for gain on the sale or exchange of a principal residence does not apply if the principal residence was acquired in a like-kind exchange in which any gain was not recognized within the prior five years.

Note:

> This prevents a tax-free disposition of investment or business real property through a three-step plan under which: (i) the property is exchanged for residential real property, tax-free under §1031; followed by (ii) a conversion to personal use; and finally (iii) a tax-free sale under §121.

2. Like-kind exchanges only available for real property

Clients should be advised that the TCJA repealed §1031 like-kind exchange treatment for property other than real property. The trade of property other than real property is a taxable transaction for exchanges initiated after December 31, 2017.[138]

J. Incentive stock options

1. In general

Stock options provide an employee with 'the option to purchase shares' in the corporation at a specified price rather than representing compensation to the employee taxpayer. For stock option programs, the treatment to the taxpayer depends on the classification of the options as either incentive stock options, non-qualified stock options, stock appreciation rights, or phantom rights as well as whether the stock was disposed of in a qualified or disqualified transaction. If an employer qualifies a plan and the option it issues to an employee, the arrangement may be a statutory stock option called an **incentive stock option (ISO)**. In general, like a nonstatutory stock option, the employee is not taxed on the grant of an

[138] I.R.C. §179(a)(1).

ISO. ISOs provide the taxpayer with a chance to participate in the company's stock plan by purchasing stock at a specified/strike price, which will usually be below market value for the shares. Unlike nonstatutory stock options, the exercise of the ISO is not a taxable event to the employee for regular income-tax purposes,[139] but the excess, if any of the stock's fair market value and the option price is an "item of adjustment" for alternative-minimum-tax purposes. The excess of the stock's fair market value and the exercise/purchase price is often called the "bargain element." To the extent a taxpayer is not subject to AMT, there is no tax consequence for exercising incentive stock options.

Planning point:

> If a taxpayer is holding ISOs, there could be AMT consequences to manage. When a taxpayer is forecasting increased taxable income in future periods, it may be worth exercising ISOs earlier rather than later to trigger current year AMT and generate AMT credits for future periods.
>
> With such strategies, there can be opportunities to positively impact cash flow in future periods and manage total taxes across multiple periods.

When ISOs are later sold, there are different tax treatments depending on the transaction being treated as a "qualified disposition" or a "disqualified disposition."

a. **Qualified Dispositions**: For qualified dispositions, the taxpayer will treat the transaction and determine their taxable gain/loss as though they had purchased the shares on the open market and the transaction will be treated as a long-term capital transaction.
   (i) Dispositions are qualified transactions if the taxpayer has held the shares for more than one year from the date exercised and at least two years from the date that the ISOs were offered to the employee.
   (ii) The employee recognizes gain only at the later sale or distribution of the option stock, using the original option price as the employee's basis for determining gain. The employer cannot deduct any amount in connection with the ISO.

b. **Disqualified Dispositions**: If the taxpayer fails to meet either of the waiting periods required to have a qualified disposition, the transaction will be considered disqualified and split between short-term and long-term based on the holding period of the stock by the employee taxpayer.
   (i) If the employee engages in a disqualifying disposition of the option stock, the employee will recognize as income at that time the bargain-purchase element of the option and the employer may deduct that amount as compensation expense.[140]

Note:

> What makes the ISO particularly attractive at this juncture is the apparent recovery of the market. Although the difference in the value of the stock over the option price is included in AMTI, it is not included in gross income until sale of the stock, which is generally within the control of the taxpayer, so the ISO does not bring with it the inclusion into income (AGI and MAGI) that the vesting of a §83 property does (assuming no §83(b) election was made).

Planning point:

> One of the problems many taxpayers have faced over the past couple of years is the exercise of ISOs only to see the price tumble from dot-com highs to dot-gone lows. While the exercise of the options does not trigger regular income tax, the spread (the excess of the option stock's fair

139 I.R.C. §421(a).
140 I.R.C. §421(b).

market value on the date of exercise of the option over the option price paid by the employee) is treated as an adjustment for alternative-minimum-tax purposes. For many, the AMT liability has exceeded the fair market value of the stock acquired by the exercise. While the AMT liability may generate a credit, it may take years before the AMT can be recovered, if at all. However, if the taxpayer disposes of the stock within the same calendar year as the exercise, the Code limits the amount of the adjustment to the excess of the amount realized on the disposition of the stock over the amount paid for the stock. Therefore, accountants should generally recommend exercise of any ISO as close to January 1 as possible to give the maximum amount of time to determine, through monitoring of the valuation direction, whether a disqualifying disposition should be undertaken.

c. As with other special tax benefits, the ISO must meet a number of restrictive requirements at the time of the grant[141] and at all times through exercise, which include the following:[142]

(i) The grantee must be an employee of the corporation granting the option, or of its parent or subsidiary, at all times between the grant and the exercise of the ISO.[143]

Planning point:

Conspicuously absent from the litany of restrictions and limitations are any nondiscrimination or coverage rules. Unlike other qualified plans, an ISO may be limited to whatever class of employees the employer chooses, including only highly compensated employees.

- The employee, however, is given an additional three months following the termination of employment (the "extended employment") to exercise the option.[144] This extended employment period increases to one year in the case of an employee whose termination of employment is due to disability.[145]
- Military leaves of absence, sick leave, and any other bona fide leaves of absence (such as a leave for government service) are not considered to sever the employment relationship during the term of the ISO as long as such leave does not extend beyond 90 days.

(ii) The option property is limited to the stock[146] of the employer, any parent, or any subsidiary.[147]

(iii) The ISO plan can only last up to 10 years from the date the plan is adopted or the date the plan received shareholder approval, whichever is earlier.[148]

(iv) The employee must exercise the ISO, by its terms, if at all, no later than 10 years from the date of its grant.[149]

(v) Except with respect to an ISO granted to an owner of 10 percent or more of the total combined voting power of the stock of the employer corporation or its parent or subsidiary, the option exercise price must be no less than the fair market value of the underlying ISO stock at the time the option is granted.[150]

141 Prop. Regs. §1.422A-2(a)(1)(ii).
142 Prop. Regs. §1.422A-2(a)(1)(iii).
143 I.R.C. §422(a)(2).
144 I.R.C. §422(a)(2).
145 I.R.C. §422(c)(6). For these purposes, disability is defined in I.R.C. §22(e)(3).
146 Stock can be voting or nonvoting, common or preferred stock. Treas. Regs. §1.421-7(d).
147 I.R.C. §422(b).
148 I.R.C. §422(b)(3); Temp. Regs. §14a.422A-1, Q & A-2(c)(2).
149 I.R.C. §422(b)(3); Temp. Regs. §14a.422A-1, Q & A-2(c)(3).
150 I.R.C. §422(b)(4); Temp. Regs. §14a.422A-1, Q & A-2(c)(4).

(vi) The ISO by its terms cannot be transferred by the option holder **other than by will** or by the laws of descent, and the option cannot be exercised by anyone other than the option holder during the option holder's lifetime.[151] The option holder may be able to specifically designate the beneficiary, without this causing the option to fail to be an ISO.[152] The ISO holder's estate may exercise the ISO.[153]

Planning point:

Because the option is not assignable, the option cannot be part of a gifting program. If estate-freezing strategies are indicated, it is necessary to exercise the option during life and then transfer **the stock** in a value-freezing transaction. If preservation of the capital-gains treatment is important, the stock must be held for at least one year after exercise and two years after the grant of the option. An alternative solution is to transfer **the stock** to an intentionally defective grantor trust (IDGT), since the transfer of the stock does not constitute a disposition, let alone a disqualifying disposition for income-tax purposes, even though it may constitute a completed gift for both gift- and estate-tax purposes.

(vii) The employee cannot exercise more than a certain number of ISOs in a taxable year. That number corresponds to the number of shares of employer stock whose value, at the date of grant, did not exceed $100,000. That number of shares acquired by exercise can exceed $100,000 of employer stock.[154]

Caution:

If the grantee-employee at the time of the grant owns stock that has more than 10 percent of the voting power of all classes of stock of the employer corporation or any parent or subsidiary corporation, the ISO must, at the time the ISO is granted, have an option price of at least 110 percent of the fair market value of the stock subject to the option and the option must state that it is not exercisable after the expiration of five years from the date of its grant.[155] For these purposes, special rules of attribution apply. An employee is considered as owning stock owned directly or indirectly by or for the employee's brothers and sisters (whether by half or full blood), spouse, ancestors (parents, grandparents, other ancestors), and lineal decedents (children and grandchildren, but not nieces and nephews).[156] The employee is also deemed to own stock held by a corporation (domestic or foreign), partnership, trust, or estate for which the individual is a shareholder, partner, or beneficiary proportionately to the employee's interest in the corporation, partnership, trust, or estate as a shareholder, partner, or beneficiary.[157]

2. *Tax consequences to employee*

a. As discussed elsewhere, §83 does not apply to the grant of an option, as there is no transfer of property; consequently, the employee does not recognize income at the time of the grant.[158] Since the employee has not paid anything, the basis of the ISO is zero.

b. Unlike a nonstatutory stock option, the employee recognizes no income on the **exercise** of the ISO.[159] However, if the ISO is exercised more than three months after the employee has terminated employment with the granting corporation, the failure to exercise within the extended employment period converts the ISO into a nonqualified stock option.[160]

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151 I.R.C. §422(b)(5); Temp. Regs. §14a.422A-1, Q & A-2(c)(5). See also Prop. Regs. §1.422A-2(g).
152 Prop. Regs. §1.422A-2(g); Treas. Regs. §1.421-7(b)(2).
153 Rev. Rul. 62-182, 1962-2 C.B. 136.
154 I.R.C. §422(d).
155 I.R.C. §422(c)(5).
156 I.R.C. §422(d)(1).
157 I.R.C. §422(d)(2).
158 Treas. Regs. §1.83-3(a)(2).
159 I.R.C. §§422(a) and 421(a)(1).
160 I.R.C. §422(a)(2).

Accordingly, the employee will recognize taxable income on exercise in the amount of the excess of the amount of the fair market value of the stock over the sum of the employee's basis in the option (if any), plus any consideration paid by the employee upon option exercise.[161]

Planning point:

While the employee recognizes no regular taxable income on the exercise of an ISO, the bargain element at that time is treated as an item of adjustment that is included in alternative-minimum-taxable income.[162] For alternative-minimum-tax purposes, the employee has a basis equal to the sum of the exercise price and the item of adjustment.[163] If, however, a **disqualifying disposition** of the ISO stock occurs in the same taxable year of the employee, the maximum item of adjustment is the gain on the disposition of the ISO stock.

(i) As stated previously, an ISO, by its terms, cannot be transferred except upon the death of an employee. If the employee attempts a lifetime transfer, the option ceases to be an ISO and, as a nonstatutory stock option, the employee recognizes taxable income equal to the amount the employee received on the arm's-length transfer.[164] A similar result occurs by a transfer of the ISO back to the employer by cancellation. If an ISO lapses at the end of its term or otherwise without having been exercised and the employee never acquires any basis in the ISO, the employee will not be permitted to recognize any loss due to the lapse, even if the FMV of the ISO stock exceeds the ISO exercise price at the time of the lapse.

Note:

The employee who received an ISO cannot place **the option** in a funded revocable inter vivos trust or an intentionally defective grantor trust without violating the terms and conditions of the grant, since it would have been transferred other than by will or the laws of descent and distribution. Further, even if the gift to a revocable trust were deemed an incomplete transfer that does not violate this requirement, the transfer of the option at the death of the employee would not be by will or by the laws of descent and distribution, and would probably cause the option to violate the ISO rules.

(ii) The basis of the stock acquired by the exercise of the option is the amount the employee pays to exercise the ISO. However, if the employee disposes of the stock before expiration of the statutory holding period, the stock's basis is further increased by the amount included in the employee's gross income as compensation from the disqualifying disposition.[165]

c. One of the additional requirements for the employee to obtain all of the favored tax benefits is that the stock not be disposed of for a statutory holding period.[166] This period extends until the later of two years from the date of the granting of the ISO to the employee or one year from the date that the shares were transferred to the employee upon exercise. If an employee disposes of ISO stock before the expiration of the statutory holding period, the disposition will be considered a "disqualifying disposition." For these

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161 Treas. Regs. §1.83-7(a).
162 I.R.C. §56(b)(3).
163 I.R.C. §56(b)(3).
164 PLR 7809072.
165 Prop. Regs. §1.422A-1(b)(3), Ex. (3).
166 I.R.C. §422(a)(1). See also Prop. Regs. §1.422A-1(a)(1)(i)(A).

purposes, the Service has ruled that the transfer occurs on the date that the employer receives the notice of exercise by the employee, as long as the employee also complies with the payment requirements of the plan.[167]

Not all sales, exchanges, gifts, or other transfers of legal title of the stock are treated as disposition.[168] Excluded are the following.

(i) A transfer from a decedent who held ISO stock to an estate or a transfer by bequest or inheritance.[169]

(ii) An exchange of the ISO stock in a corporate reorganization or any stock-for-stock swap accorded nonrecognition treatment under §1036.[170]

(iii) The mere pledge or hypothecation of the ISO stock.[171]

(iv) Any transfer of ISO stock between spouses or incident to a divorce under §1041(a).[172]

(v) The acquisition of option stock in joint ownership with right of survivorship or the subsequent transfer of ISO stock into such joint ownership.[173] However, a change in joint owners, including a termination of joint ownership occurring other than upon the death of one of the joint tenants, is considered the disposition of ISO stock except to the extent it results in the reacquisition of ISO stock by the employee.[174] Note that the transfer of ownership resulting from the death of one of the joint owners of the stock is not considered the transfer of ownership of the ISO stock.

(vi) A transfer of ISO stock by an insolvent individual to a trustee in bankruptcy, a receiver or any other similar fiduciary in any proceeding under the Bankruptcy Code or any other similar insolvency proceeding, and any subsequent transfer of that stock for the benefit of that individual's creditors.[175]

d. ISO stock held by employee for statutory holding period -- If the employee holds the ISO stock for the statutory holding period (i.e., not a disqualifying disposition), the employee recognizes capital gain in the amount of the excess of the amount realized over the basis in the option stock.

Planning point:

> The major advantage of an ISO is that by not disposing of the stock in a disqualifying disposition the employee avoids any ordinary compensatory income.

e. ISO stock not held by employee for statutory holding period -- In contrast, if the employee does not hold the ISO stock for the statutory holding period (i.e., a disqualifying disposition) by exercise of an ISO, the employee must recognize as compensation income in the year of the disqualifying disposition the difference between the option's exercise price and the stock's fair market value **at the time of option exercise**.[176] The

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167 Rev. Rul. 70-335, 1970-1 C.B. 111. But see *Becker v. Commissioner*, 378 F.2d 767 (3d Cir. 1967), rev'g 46 T.C. 613 (1966) (date of transfer when notice and payment placed in the mail).
168 I.R.C. §424(c)(1).
169 I.R.C. §424(c)(1)(A).
170 I.R.C. §424(c)(1)(B).
171 I.R.C. §424(c)(1)(C) and Treas. Regs. §1.425-1(c)(1).
172 I.R.C. §424(c)(4). The spouse who receives such stock will receive the same tax treatment on the subsequent disposition of the stock as that to which the employee would have been entitled.
173 I.R.C. §424(c)(2).
174 Treas. Regs. §1.425-1(c)(2).
175 I.R.C. §422(c)(3).
176 I.R.C. §421(b).

employee may offset the gain realized on disposition by adjusting the basis in the stock by the amount of the compensation inclusion; however, if the adjustment would thereby trigger a tax loss on the disposition, the compensation cannot exceed the excess of the amount realized over the stock's basis.[177]

Example 1: On June 1, 2023, X Corporation granted to E, an employee, an ISO to buy 100 shares of X Corporation stock at $10 a share, its fair market value at the time. E exercised the option on December 1, 2023, when the stock was selling on the open market for $12 a share. On June 5, 2025, E sold the stock for $15 a share. Since E disposed of the stock after completion of the statutory holding period (i.e., after the stock has been held more than two years after the date the option was granted and more than one year after the date the option was exercised), in 2024 E will report on Schedule D a long-term capital gain on the disposition of the stock as follows.

Selling price ($15 x 100 shares)	$ 1,500
Purchase price ($10 x 100 shares)	-1,000
Gain	$ 500
Amount reported as capital gain	**$ 500**

Example 2: Assume the same facts as in **Example 1**, except that on May 23, 2025, E sold the stock. Although E held the stock for more than a year, less than two years had passed from the time E was granted the option. In 2024, E must report the difference between the option price ($10) and the value of the stock when E exercised the option ($12) as compensation on line 1 of Form 1040. The rest of E's gain is long-term capital gain reported on Schedule D as follows.

Selling price ($15 x 100 shares)	$ 1,500
Purchase price ($10 x 100 shares)	-1,000
Gain	$ 500
Amount reported as wages	
[$1200 ($12 (FMV of stock on exercise date) x 100 shares) - $1,000 ($10 (option price) x 100 shares]	**$ 200**
Amount reported as capital gain	**$ 300**

Example 3: Assume the same facts as in **Example 2,** except that on May 23, 2025 E sold the stock for $11 per share. In 2025, E would be required to recognize as compensation income $100 ($1100 ($11 selling price/share x 100 shares) - $1,000 ($10 (option price/share) x 100 shares). Since the selling price is less than the fair market value of the stock on the exercise date and the disposition in a transaction in which loss, if sustained, would otherwise be recognizable under the Code, then the amount of ordinary income that E recognizes is limited to $100, which is the excess of the amount realized in the sale over the basis of the ISO stock.

Selling price ($11 x 100 shares)	$ 1,100
Purchase price ($10 x 100 shares)	-1,000
Gain	$ 100
Amount reported as wages	**$ 100**

[177] I.R.C. §422(c)(2).

Note:

> The ISO plan **may** allow the ISO to be exercised by the estate of the employee or by anyone who has acquired the ISO due to a bequest or inheritance from the employee.[178] The estate or heir succeeds to the same tax treatment on exercise of the option that the employee would have had if the employee had remained alive. Since the ISO lapses after the expiration of the extended employment, the deceased employee must have been an employee within three months of death. If the deceased was employed at death, the three-month period does not begin to run against the estate or heir with regard to exercise.

The transfer of ISO stock to the estate, the heir of the employee, and the transfer of ISO stock by the estate to a beneficiary are all excluded from being considered a disposition of an ISO.[179] However, if either the estate or the heir transfers the stock in a disqualifying disposition, the estate or the heir will recognize income on the disposition.[180]

K. Employee Stock Purchase Plans

Another form of employee equity-based compensation comes in the form of **employee stock purchase plans (ESPPs)**. ESPPs allow employees to purchase an employer's stock at a discount without vesting restrictions. However, when selling the stock there are some complexities. When stock purchased through an ESPP is later sold, the ultimate treatment also depends on whether the disposition is a qualifying disposition or a disqualified disposition.

- **Qualified Disposition**: After purchasing the stock through a qualified ESPP and later selling the stock, the employee taxpayer will receive preferential tax treatment if the following two requirements are met: (1) the employee taxpayer held the shares for at least one year from the purchase date; and (2) the employee taxpayer has held the shares for at least two years from the offering period of the ESPP plan. If those two requirements are met, there is both an ordinary income component and capital income component. The ordinary income component is the lesser of: (1) the bargain element as of the exercise date; and (2) the gain between the actual purchase price and the final sales price. The remaining proceeds will have long-term capital treatment subject to preferential tax rates. Essentially, the bargain element is taxed as ordinary income, limited to the total gain. Any remaining gain would be subject to capital treatment.

Example: As part of a qualified ESPP, an employee acquired 100 shares in ABC Inc. for $20 per share. The market price on the offering date is $25, representing a 20% discount to the taxpayer. In a qualified disposition, the taxpayer sells all 100 shares in ABC Inc. for $32. The sale incurred total transaction fees of $100. The ordinary and capital gains would be calculated as follows:

Ordinary Income – Lesser of (1) and (2)

Step 1: $3,200 sales price (100 * $32) – $2,000 purchase price (100 * $20) - $100 commissions = $1,100 Total Gain

Step 2: Discount on Exercise = $500 (100 * ($25 - $20))

The taxpayer recognizes $500 of "ESPP Ordinary Income" on line 8 of the Form 1040 to the extent it is not reflected in the employee's Form W-2.

178 Treas. Regs. §1.421-8(c)(1).
179 I.R.C. §424(c)(1)(A).
180 Treas. Regs. §1.421-8(c)(2).

Capital Gain/Loss

Proceeds	$3,100 ($3,200 sales price - $100 of commissions)
Less: Adjusted Basis	$2,500 (100 * $20 + $500 ordinary income reported on Form1040)
LT Capital Gain	$600 Reported on Part 2 of Schedule D of Form 1040

Thus, the total gain of $1,100 is bifurcated between ordinary income of $500 and $600 of capital gain.

- **Disqualified Dispositions:** For disqualified dispositions, the employee taxpayer has not met the holding period requirements for a qualified transaction and the ordinary income component should be reported in Box 1 of Form W-2 as compensation. If the employer has not included the amount on the 1040, the employee taxpayer is still required to calculate and include the income in their return on line 8 of the Form 1040. Isolating the amount on the W-2 may be difficult, but a clue as to whether or not the income has been included is to compare Box 1 wages with the wages of Box 3. The amount would be included in Box 1 as compensation but not in Box 3 as FICA taxes do not apply for ESPP plans. If there is uncertainty regarding ESPP compensation having been included in the W-2, the employee should contact their payroll department for clarification. Additionally, because the disposition is disqualified, the capital treatment described above could result in capital income split between short-term and long-term based on the holding period of the stock by the employee taxpayer.

***Example**:* As part of an ESPP plan arranged in compliance with §423, an employee was offered shares as part of the plan in June 2022. The market price at the time of the offering was $30. The employee exercised/purchased 100 ESPP shares in January 2023 for $21 when the market price was $25. The taxpayer later sells all 100 shares in January 2024 at a market price of $45, paying a commission of $100 for the sales of the shares.

Ordinary Income: Lesser of Step 1 and Step 2

Step 1: $4,500 sales price (100 * $45) – $2,100 basis (100 * $21) - $100 commissions = $2,300 Total Gain

Step 2: Discount on Exercise = (100 * ($25 - $21)) = $400

The taxpayer recognizes $400 of "ESPP Ordinary Income" on line 8 of the Form 1040 to the extent it is not reflected in the employee taxpayer's Form W-2.

Capital Gain (Loss)

Proceeds	$4,400 (100 total shares sold * $45 sales price - $100 commissions)
Less: Adjusted Basis	$2,500 (100 total shares sold * $21 + $400 reported on line 8 of Form 1040)
Tax Gain (Loss)	$1,900 Reported on Part 2 of Schedule D of Form 1040

Thus, the total gain of $2,300 is bifurcated between ordinary income of $400 and $1,900 of capital gain.

Note in both examples provided, the adjusted basis of the shares for purposes of calculating capital gain (loss) results in the basis had the taxpayer bought the shares at market price on the exercise date. Also note that though this is a disqualified disposition, the taxpayer held the shares for more than one year, and thus, the disposition qualifies for long-term capital gain treatment.

L. Restricted property

Planning point:

> Now may be the time to set up a deferred compensation plan. For Social Security tax purposes, deferred compensation is taxable at the earlier of payment or vesting. Deferred compensation arrangements are now subject to several limitations that can cause an acceleration of the compensation, so in some cases, if available, a deliberate failure to meet these requirements may be the most tax-efficient course of action.

When an employer transfers property to an employee in connection with the performance of services, the employee includes a like amount when the property is actually or constructively received. This produces harsh results where the employer imposes restrictions on the property that may limit the usefulness to the employee as an economic asset, and, if in fact the restrictions apply so as to cause the employee to forfeit the property, it seems that the employee would be taxed on an amount over which the employee lacked any power of disposition.

1. Section 83

The Code provides an overall structure for determining, **if a transfer of property has occurred**, the timing and amounts of the inclusion by the employee performing the services, and the deduction by the employer for whom the services were performed, which override the traditional notions of tax accounting for both parties. Although serving functions similar to deferred-compensation programs, a present transfer of property is not deferred compensation, and the tax-accounting rules for transfers of restricted property differ from those applicable in arrangements in which the transfer of cash is deferred. These rules apply to an independent contractor as well, as long as the transfer was in connection with the performance of services.[181]

2. Section 83 operation

When the employer, in connection with the performance of services, transfers property to any person other than the person for whom such services are performed, the person who performed such services must include in gross income in the first taxable year in which the rights of the person having the beneficial interest in such property are **substantially vested** the excess of the fair market value of such property (determined without regard to any restriction other than a nonlapsing restriction) at the first time the rights of the person having the beneficial interest in such property become substantially vested, whichever occurs earlier, over the amount (if any) paid for such property.[182]

a. The income event is only deferred when the property is **substantially nonvested**. The "amount paid" is defined generally as the value of any money or property paid for the transfer of property to which §83 applies.[183] It does not refer to any amount paid for the right to use such property or to receive the income therefrom.

b. Until such property becomes substantially vested, the employer is regarded as the owner of such property, and any income from such property received by the employee (or beneficiary thereof) or the right to the use of such property by the employee constitutes

181 Treas. Regs. §1.61-2(d)(6) provides that §83 applies to all transfers of property in connection with the performance of services made after June 30, 1969.

182 I.R.C. §83(a).

183 Treas. Regs. §1.83-3(g).

additional compensation and shall be included in the gross income of such employee or independent contractor for the taxable year in which such income is received or such use is made available.[184]

Planning point:

During the time the property is owned for tax purposes by the employer, any of the income paid to the employee is treated as compensation. In the case of stock, this would apply both to taxable cash dividends and otherwise nontaxable stock dividends. This applies even if the employer issues a Form 1099-DIV to the employee.[185] By contrast, when the employee makes a §83(b) election, the property is deemed owned by the employee, so dividends paid with respect to the stock are taxed as dividends.

The compensation may be subject to ordinary income rates and the .9 percent Medicare tax in 2017 and later years, but dividends are taxed at potentially special tax rates and may be subject to an additional Medicare tax at a 3.8 percent tax rate.

c. If an employee is taxable under §83(a) when the property transferred becomes substantially vested and thereafter the person's beneficial interest in such property is nevertheless forfeited pursuant to a lapse restriction, any loss incurred by such person (but not by a beneficiary of such person) upon such forfeiture is an ordinary loss to the extent the basis in such property has been increased as a result of the recognition of income by the employee under §83(a) with respect to such property.[186]

Example 1: On November 1, 2023, X Corporation sells to E, an employee, 100 shares of X corporation stock at $10 per share. At the time of such sale, the fair market value of the X Corporation stock is $100 per share. Under the terms of the sale, each share of stock is subject to a substantial risk of forfeiture, which will not lapse until November 1, 2033. Evidence of this restriction is stamped on the face of E's stock certificates, which are therefore nontransferable. Since in 2023 E's stock is substantially nonvested, E does not include any of such amount in his gross income as compensation in 2023. On November 1, 2033, the fair market value of the X Corporation stock is $250 per share. Since the X Corporation stock becomes substantially vested in 2033, E must include $24,000 (100 shares of X Corporation stock x $250 fair market value per share less $10 price paid by E for each share) as compensation for 2033. Dividends paid by X to E on E's stock after it was transferred to E on November 1, 2023, are taxable to E as additional compensation during the period E's stock is substantially nonvested and are deductible as such by X.

Example 2: Assume the facts are the same as in **Example 1**, except that on November 1, 2030 each share of stock of X Corporation in E's hands could as a matter of law be transferred to a bona fide purchaser who would not be required to forfeit the stock if the risk of forfeiture materialized. In the event, however, that the risk materializes, E would be liable in damages to X. On November 1, 2030, the fair market value of the X Corporation stock is $230 per share. Since E's stock is transferable in 2030, the stock is substantially vested and E must include $22,000 (100 shares of X Corporation stock x $230 fair market value per share less $10 price paid by E for each share) as compensation.

Example 3: Assume the facts are the same as in **Example 1**, except that in 2028 E sells his 100 shares of X Corporation stock in an arm's length sale to I, an investment company, for $120 per share. At the time of this sale each share of X corporation's stock has a fair market value of $200. E must include $11,000 (100

184 Treas. Regs. §1.83-1(a)(1).
185 Rev. Proc. 80-11, 1980-1 C.B. 616.
186 Treas. Regs. §1.83-1(e).

shares of X Corporation stock x $120 amount realized per share less $10 price paid by E per share) as compensation for 2028 notwithstanding that the stock remains nontransferable and is still subject to a substantial risk of forfeiture at the time of such sale.

d. The employee obtains basis in the property in two stages.
   (i) While the property is still substantially nonvested, the basis for the property reflects any amount paid for such property.
   (ii) It also reflects on or after the time any amount is includable in the gross income of the employee (including any amount so includable as a result of a disposition by the person who acquired such property) the amount of such income.[187] It also reflects such adjustments as are authorized under §§1015 and 1016.

e. The employee's holding period in the property generally begins only after the property becomes substantially vested.[188] Property is substantially vested when it is first either transferable or not subject to a substantial risk of forfeiture.[189] However, the holding period begins with the date of the transfer of the substantially nonvested property if the employee makes the §83(b) election to treat the transfer as complete for income tax purposes.[190]

3. Components of nonvested property

a. One of the key concepts underlying the transfer of restricted property is the notion of a **substantial risk of forfeiture**. If the property is not subject to a substantial risk of forfeiture, the employee will be immediately taxed on the receipt of the property as ordinary income to the extent of the fair market value, taking into account other nonlapsing restrictions. Restrictions that, by their terms, never lapse, do not postpone the timing of the income, but only affect the amount. In contrast, if the property is subject to a restriction that would cause the employee to forfeit it, both the timing of inclusion and the determination of the amount of the inclusion is generally deferred. Property is not transferred subject to a substantial risk of forfeiture to the extent that the employer is required to pay the fair market value of a portion of such property to the employee upon the return of such property. The risk that the value of property will decline during a certain period of time does not constitute a substantial risk of forfeiture.[191]
   (i) The most basic substantial risk of forfeiture is one in which the forfeiture is avoided only upon the performance (or nonperformance) of substantial future services. Whether a risk of forfeiture is substantial or not depends upon the facts and circumstances.[192]
   (ii) The forfeiture provisions must be real in the sense that the employer will actually enforce them. This places in doubt transfers to employees who have sufficient voting power to influence the employer's actions.

b. Since the purpose of §83 is to postpone while the employee cannot realize any of the economic value of the property, the employee must not be able to transfer property for a consideration to the extent of a substantial portion of the value; if a purchaser of the

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187 Treas. Regs. §1.83-4(b)(1). See, e.g., PLR 9421013.
188 I.R.C. §83(f).
189 Treas. Regs. §1.83-3(b).
190 Treas. Regs. §1.83-4(a).
191 Treas. Regs. §1.83-3(c)(1).
192 Treas. Regs. §1.83-3(c)(1). See PLR 9046030 (substantial risk of forfeiture found if, under shareholder's agreement, terminated employees **could** receive nonmarket-based amount that is substantially less than the stock's fair market value; employee's rights to full enjoyment of the property are conditioned upon the future performance of substantial services).

property from the employee takes the property free from the risk of forfeiture, the property is transferable. In contrast, if a purchaser takes the property subject to the risk of forfeiture, the employee does not have a cash equivalent as the discount from value will be significant compared to the time-value of money.[193]

Note:

> For purposes of §83, property is **substantially nonvested** when it is subject to a substantial risk of forfeiture **and** is nontransferable. Property is **substantially vested** for such purposes when it is either transferable **or** not subject to a substantial risk of forfeiture.

c. For purposes of §83, in the case of property subject to a nonlapsing restriction, the price determined under the formula price will be considered to be the fair market value of the property.[194] For these purposes, a restriction that, by its terms, will never lapse (also referred to as a "nonlapsing restriction") is a permanent limitation on the transferability of property, which will require the transferee of the property to sell, or offer to sell, such property at a price determined under a formula, and which will continue to apply to and be enforced against the transferee or any subsequent holder (other than the transferor).[195]

4. Section 83(b) election

The employee may elect to treat the transfer of the substantially nonvested property as complete for tax purposes as of the time of the transfer. This has the effect of accelerating the ordinary compensation event and making the employee (or beneficiary) the owner of the property for tax purposes.[196]

a. If the employee elects to treat the property as vested even though it is substantially nonvested, the employee includes in gross income the excess (if any) of the fair market value of the property at the time of transfer (determined without regard to any lapse restriction) over the amount (if any) paid for such property, as compensation for services.[197]

Planning point:

> The tax stakes in making the election involve a calculation of the cost of deferring ordinary compensation income against the value of treating all post-transfer appreciation in the property as capital gain income when the property is disposed of. If the employee waits until the property becomes substantially vested, all of the post-transfer appreciation in the property (to that point in time) will be taxed at that time as ordinary compensation income.

Caution:

> Although the employee premises the §83(b) election on significant growth in the value of the property before it becomes substantially vested, the property could depreciate in value. Had no election been made, the income event would have been deferred and quantified at the lower value; the election causes the employee to accelerate the ordinary income at the higher value at transfer with the recovery on disposition of the property of the decline as a capital loss.

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193 *Cowden v. Commissioner*, 289 F.2d 20 (5th Cir. 1961), on remand, 20 T.C.M. 1134 (1961) (defining the cash equivalence of a promise to pay if the obligor is solvent, the promise is unconditional and assignable, not subject to set-offs, and of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money).

194 Treas. Regs. §1.83-5(a).

195 Treas. Regs. §1.83-3(h).

196 I.R.C. §83(b).

197 Treas. Regs. §1.83-2(a).

Planning point:

> The ordinary income is compensation, so in the year it is included, it may trigger an increase in the compensation level above the threshold to trigger the Medicare tax on excess compensation or increase the taxpayer's AGI and MAGI above the threshold causing the taxpayer's unearned income to a potential Medicare tax.
>
> In some cases, the inclusion is essentially free because the value of the underlying property is worth zero (such as stock appreciation rights).

(i) The fact that the transferee has paid full value for the property transferred, realizing no bargain element in the transaction, does not preclude the use of the election. In fact, an employee should make a protective election in those circumstances rather than find the post-transfer appreciation accruing up to the point of substantial vesting taxed as ordinary income.

(ii) The employee must generally file a written statement no later than 30 days after the transfer of the property.[198] The election is made by filing a copy of a written statement with the Internal Revenue office with which the employee files the return. The Service no longer requires that a copy of that statement be submitted with the income tax return for the taxable year in which the property was transferred.[199]

b. In computing the gain or loss from the subsequent sale or exchange of the property, its basis is the amount paid for the property increased by the amount included in gross income under the §83(b) election.[200] The holding period of such property is to begin just after the date such property is transferred.[201]

Caution:

> An employee must consider that the property may still be **forfeited** after the election is made. The employee is entitled to a loss in that event only to the extent of any amount paid for the property, but for these purposes, the tax cost of the inclusion, which generates basis, is not an amount paid. A forfeiture means that the employee will have had phantom income in respect of the property transfer. The loss the employee may recognize with respect to any amounts actually paid for the property is deemed to arise from a sale or exchange and is thus capital in nature, subject to the limitations on individuals for deducting currently such losses.

5. Election under §83(i)

The TCJA added a new §83 election governed by §83(i). The election allows a recipient of a "qualified equity interest" to defer income for up to five years with a §83(i) election. A qualified equity interest is received in the form of stock that is obtained by exercising a stock option or settling a restricted stock unit (RSU). When either of these events happen, the general rule is that the employee has taxable income, including income tax, Social Security tax, and Medicare tax. The requirements to make the election are:

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198 Treas. Regs. §1.83-2(b). The one exception is for an employee who purchases property at fair market value from the employer in connection with the employee's performance of services, who may file the election at any time. §556 of the Tax Reform Act of 1984, P.L. 98-369. This provision specifically overrides the result of the taxpayer in *Alves v. Commissioner*, 79 T.C. 864 (1982), aff'd, 734 F.2d 478 (9th Cir. 1984) (employee taxed on post-transfer growth in employer restricted stock purchased at fair market value).

199 But see PLR 8833015 (inadvertent failure by employee to submit a §83(b) election with the income tax return did not invalidate the election, where the employee did file the election with the IRS within 30 days of the transfer and sent copies of the election to the employer).

200 Treas. Regs. §1.83-2(a).

201 Treas. Regs. §1.83-4(a).

a. In the year of the grant of the options or RSUs, the employer must have granted options or RSUs to at least 80% of its full-time U.S. employees under a written plan that have the same rights and privileges.
b. The employee may not be an excluded employee, i.e., a current CEO or CFO; current and former highly compensated employees; and employees who have an ownership interest of more than 1% in the company.
c. The employee may not be able to sell the stock back to the company or take cash in lieu of stock at the time that the stock becomes transferable.
d. The company must be a private equity firm. Publicly traded companies do not qualify.
e. Any repurchase of stock in the prior calendar year by the company disqualifies the company unless 25% or more of the repurchased stock is former deferral stock and a reasonable method was used to determine from whom the stock would be repurchased.

The §83(i) election must be made no later than 30 days after the first date the rights of the employee in such are transferable or are not subject to a substantial risk of forfeiture.

Planning Point:

> The tax practitioner should educate all clients who issue such equity interests on the availability of the §83(i) election. The provision has limited application because of the strict eligibility requirements, but could be a great benefit to employees of companies that meet the requirements.

M. Cashing in on a loss

1. In general

Some taxpayers have significant gains but are reluctant to recognize them because of the tax that would be created. However, a capital loss will offset capital gains, thereby reducing the amount subject to tax. If, as, and when interest rates increase, corporate bonds and bond mutual funds are investments that will be declining in value, and some may decline below the cost basis the investor has in them. In addition to serving a need to rebalance the portfolio, taking such losses can serve a tax purpose as well. The proceeds of the sales (gains and losses) can be reinvested in either stocks, bonds, or any other investment that may seem prudent. Within certain limits, the new investment can be in a similar investment vehicle.

Note:

> Beginning in 2011, a broker must report the basis and long-term/short-term nature of its gain or loss with respect to corporate stock in connection with its sale if the stock was acquired through a transaction in the account in which the security was held or by a transfer to that account from a broker accompanied by a reporting statement. A similar rule applies with respect to mutual funds. A similar rule for debt instruments is to apply for such items acquired and disposed of after December 31, 2014.

2. Wash sales

A wash sale is a term used in connection with a sale of property at a tax loss closely preceded or followed by the acquisition of identical property, leaving the seller in the same position as if the sale had not taken place. Has the investor suffered a true economic loss for tax purposes, or should the loss be disregarded and accounted for in the continuation replacement investment? The Code defines a wash sale with respect to which the loss, although realized, is **disregarded** for tax purposes. Conversely, if the transaction does not come within the statutory definition of a wash sale, the loss will generally be allowed.

The Code disallows any loss deduction for any loss claimed from the sale or other disposition of shares of stock or securities if, within a 61-day period, the investor acquires substantially identical stock or securities by purchase or taxable exchange. This 61-day period begins 30 days before such sale or disposition and ends 30 days afterward. For these purposes, a contract or option to acquire such **substantially identical** stock or securities is treated as though the underlying stock or securities were acquired when the option or contract is acquired rather than when the substantially identical stock or securities are acquired by exercise of that option or contract rights. These rules do not apply to certain "straddle" positions.

a. The term "stock or securities" for purposes of the wash-sale rules includes contracts or options to acquire or sell stock or securities except as limited by regulations (none as yet issued), but does not embrace commodity futures or foreign currency. Note this does not address the question of whether such contracts or options are substantially identical. One difficulty in trying to apply the statute to an option and the underlying stock or security is a ruling that held that a taxpayer who sold a stock warrant at a loss and within the 61-day period acquired shares of stock to which the warrant related was entitled to deduct the loss, since the warrant was not "substantially identical" to the stock. The ruling suggested that if the relative values and price changes in the warrant and stock are so similar as to make the warrants fully convertible securities, the warrants could possibly be considered substantially identical with the shares of stock.

b. The acquisition of substantially identical stock or securities is treated as an acquisition by purchase when the stock or securities are received as compensation or in accordance with a stock subscription. Even the granting of a compensatory stock option within the 61-day period will trigger the rule by "purchase."

Note:

The wash sale rules do not apply to real estate. Thus, a sale of real estate at a loss can be followed by a purchase of substantially identical real estate without triggering the loss disallowance rule. However, if the sale and purchase is viewed as an exchange for tax purposes, §1031, which provides for a non-elective deferral of gain or loss, will produce a similar tax result by not recognizing currently the loss.

The Service has ruled that an exchange took place when the sale and subsequent purchase involved the same two parties and took place within a short period of time of each other and were mutually dependent, i.e., the sale would not have occurred but for the purchase to be made.[202] In contrast, the Tax Court has held that intent governs and no exchange takes place where the parties did not intend an exchange at the time of the transactions.[203]

Note:

Similarly, the wash sale rules do not apply to cryptocurrency as it is classified as property rather than a security. Prior legislation proposed extending the wash sale rules to include cryptocurrency, but ultimatel was not passed by Congress. It is possible that future legislation will once again target the cryptocurrency wash sale loophole.

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202 Rev. Rul. 61-119, 196-1 C.B. 395.

203 *Mars v. Commissioner*, T.C. Memo. 1987-481.

Planning point:

> If a taxpayer waits long enough before acquiring a new position (i.e., 31 days after the date of the sale), the tax loss from the sale is permitted. This means, however, that the taxpayer is cut off from any appreciation in the stock or bond during this waiting period. "Doubling up," meaning purchasing an identical amount of the stock or bond first, will enable the taxpayer to wait 30 days and then sell the depreciated stock while retaining the appreciation on the newly acquired lot; note, however, that starts the clock running anew for holding-period purposes.

Example: J owns 100 shares of Biotech Pharmaceuticals which he purchased at $20 per share; it is now trading for $15 a share. J still likes the stock but could use a capital loss to offset some other gain positions he is cashing out. J sells the stock on March 1. On April 1, he purchases the shares but now at $17 a share. J may take the $500 loss on the sale but now pays $1,700 to purchase the block of 100 new shares.

Instead, on March 1, J purchase 100 shares at $15 a share, and on April 1, he sells 100 shares at $17 a share. In this case, J can recognize a $300 loss (if J sells the old shares) and has 100 shares with a $1,500 basis worth $1,700. J has traded off an additional $200 of current recognized loss for an additional $200 of appreciation.

3. Substantially identical

In one case, an investor disposed of bonds and acquired from the issuer bonds with the same principal amount and coupon rate but with a maturity rate six months later than the original bonds. This resulted in a slightly lower yield on the new bonds (.0007 percent). The court found the difference in maturity date and yield to be insignificant and ignorable for purposes of the wash-sale rules. It likewise found the difference between a 20-year six-month maturity date and a 23-year maturity date to be insignificant given that either bond was callable by the corporate issuer after the same fixed date. The court looked to whether an investor holding the securities sold would or would not, from the standpoint of his investment objectives, be indifferent to their replacement by the securities purchased. That same case, however, found that the investor's economic position had changed when the bonds were from different issuers because of the inherent risk differential in different issuers, even though principal amount, coupon rate, and call date were identical.

Note:

> In an age when many investors turn to mutual funds, some narrow, sector-specific, or index funds, the case for substantial identity gets murkier. In a sector-managed fund, although the individual stocks in the portfolio are likely to be near identical, the managers may weigh the fund differently or use different hold, sell, and buy philosophies to attain substantial identity. An indexed fund is not so much managed as set by at least a broadly general formula as to the composition and relative proportions of investments. Yet Vanguard has had better net yields at least in part due to the fee structures of the index funds. Is this enough to, say, permit a taxpayer to sell out at a loss on the Fidelity index fund and simultaneously buy the Vanguard index? How indifferent would the investor be given a general strategy of tracking the market? Suppose instead the one index fund is the Dow 30 and the other the Russell 2000?

4. Holding period and basis adjustments

The wash-sale rule requires adjustments to the holding period and basis in the substantially identical property. Otherwise, the investor could convert long-term losses into short-term ones or lose the loss entirely. Consequently, the holding period of the sold security is tacked onto that of the purchased security. If the security is purchased triggering the wash-sale rule, the basis of the property acquired (new property) is the basis of the property sold (old property) plus or minus (as the case may be) the difference between the cost of the new property and the price at which the old property was sold.

Example: There is a wash sale of stock having a basis of $100 for $90, followed by the purchase of substantially identical stock for $100. Accordingly, the basis of the new stock is $110.

5. Matching rules

a. If the amount of stock or securities acquired (or covered by contract or option) differs from the amount sold or otherwise disposed of, the two transactions must be matched on the basis of the order of acquisition.

Example: Investor sells 100 shares of stock each with a basis of $100 for $90 each, generating a $10 loss per share. If Investor purchases 30 shares of the stock within the 61-day period, only 30 percent ($300) of the loss ($1,000) is disallowed.

b. A similar problem occurs when the investor holds different blocks of stock or securities with different bases. If the order of sale can be identified, that order will be followed in disallowing losses with matching purchases of substantially identical stock or securities; if the order cannot be established, the FIFO rule will be applied. If the replacement property acquisitions can be identified, that order will be respected in performing the matching.

Caution:

Shareholders of an open-end mutual fund realize a gain or loss on their shares at the time of redemption. Thus, the period of concern regarding the wash-sale rules begins 30 days prior to, and ends 30 days following, the redemption of shares in a fund at a loss. The loss-disallowance rule can be triggered either by the purchase of additional fund shares during this period or by an ordinary or capital-gain dividend and subsequent reinvestment in additional shares of the fund. For example, suppose the investor participates in an automatic savings plan with the fund by monthly purchases. Any loss realized on a redemption of shares is offset by the monthly investments at the beginning of the straddling months. Alternatively, as is common, the fund declares its ordinary and capital-gain dividends at the end of the year, but the investor has opted for the automatic reinvestment plan. Any loss realized on the redemption is offset by the reinvestment, which occurs within the 30-days of the redemption.

Planning point:

The cost basis relative to net asset value at the time of the redemption determines the gain or loss on the shares. Only if this results in a loss are the wash-sale rules implicated. Therefore, the use of the appropriate method -- FIFO, specific identification, average-basis -- can in some cases be chosen to prevent a loss on the redemption.

6. Options

A wash sale also occurs when the taxpayer has entered into a contract or option so to acquire substantially identical stock or securities sold at a loss. When replacing the stock with an option position rather than a stock position, the taxpayer’s risk of loss on the option is limited to the premium rather than the cost of the stock. However, it does not matter whether the option is in-the-money or out-of-the-money.

Example: M sells 1,000 shares of Beef Steak Copper Mines stock (the “loss lot”) for $50 on November 1, realizing a loss of $50,000. On the following day, M acquires out-of-the-money call options, entitling him to buy 1,000 shares for $60 on a date 40 days later. The premium is $1 per share, or $1,000. On the day following the purchase of such options, Taxpayer buys 1,000 shares of Beefsteak Copper Mines stock for the then-current market price, which is assumed still to be $50 per share (the "new lot").

Because the option is purchased first, it both triggers the wash sale but also becomes the repository of the basis adjustment. Hence the $50,000 loss that is disallowed on the sale the day before is added to the basis of the option rather than the new lot of Beefsteak Copper Mines. M's basis in the option is $51,000. When the option expires unexercised M has a loss of $51,000.

This loss should not be a wash sale because the new lot was purchased more than 30 days before the deemed sale on expiration. In this example, if M is willing to pay the sum of the two transaction costs on purchase and sale of the stock and the premium paid for the option, the loss will be recognized.

7. Related parties

One of the primary Code provisions that the Service can use in connection with transactions involving related parties is §267, which disallows losses in sales "directly or indirectly" to related parties. The argument the Service can raise here is whether there has been an indirect sale when the taxpayer sells the stock or security at a loss and a related person purchases, within the 61-day window period, substantially the same stock or securities sold.

a. Most commonly, one spouse sells stock at a loss, and the other purchases it the same day. While case law supports the alter ego theory of loss, which is to say that when the second spouse buys it is the same as the selling spouse buying, this alter ego arises only in contexts where the selling spouse in essence was pulling all the strings, providing all the money, even if the purchase was titled in the nominally buying spouse's account (which it could just as easily wound up had the selling spouse purchased the stock or securities and then transferred them to the spouse in a marital deduction transfer).

(i) A husband, having an account with brokers in his name, arranged for an account to be opened in the name of his wife. Thereafter he ordered the brokers to make purchases and sales for the account of his wife. The only stocks purchased for the wife's account were those ordered sold by the husband on the same day and the stocks sold for the account of the wife were purchased on the same day for the account of the husband. He furnished the funds to pay for the securities acquired for the wife's account. The stocks in the name of the wife were kept in the husband's safety deposit box with stocks in his name. She never saw them until after his death. The predecessor to the Tax Court held that the evidence failed to show that husband relinquished dominion and control of stocks, or that the account in the name of his wife was not in reality his account.[204]

Example: Husband sells 1,000 shares for a loss of $10 per share. On the same day, husband transfers money to wife's brokerage account and makes arrangements for wife to use this money to purchase 100 identical shares. Wife has very little knowledge of the transaction. Wife does not regularly engage in trading. Under the *Mitchell* case, husband should be treated as having executed a wash sale because the wife is a mere alter ego of husband who has retained "dominion and control" over the shares nominally purchased by his wife.

(ii) In another case decided by that same court, the loss was **not** disallowed. It did not matter that the husband arranged the sale so that he could realize the

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204 *Estate of Mitchell*, 37 B.T.A. 161 (1938).

diminution in value as a loss for tax purposes, nor did it matter that he persuaded his wife to purchase similar shares because he believed that they would "come back." The Board of Tax Appeals regarded the conception that a wife's ownership may be regarded as dominion or control by the husband as "erroneous." There was nothing in the record to support this view. The wife had substantial wealth of her own, far more than was necessary to enable her to buy the shares. Her property was kept and accounted for separately from that of her husband. All of the shares here involved were kept among her separate properties, and she had since sold some of them.[205]

Note:

> Some of the shares had been purchased by an intermediary because the husband apparently was concerned that the wash sale rule could apply. There was an understanding that the wife would purchase the intermediary's shares somewhat later. Thus, even this "guilty" conscience was not enough to destroy the genuineness of the husband's complete disposition of these shares.
>
> The court also noted that none of the proceeds of the wife's sales of the stock went back to him, nor did he subsequently acquire any of those shares, nor did he use such shares as collateral security for his personal loans.

b. Courts have expressed less skepticism when non-spouses are involved and are reluctant in this case to apply an alter ego theory to the relationship between parent and child or brother and sister.

(i) Where a father sold stock at a loss, loaned money from the proceeds to his son to finance a purchase of the same securities the next day, the loss was allowed. The father had the right to sell the stock for the purpose of establishing a loss for income tax purposes. Viewed in its real light, the son simply borrowed from his father money to purchase that stock and executed his note for it, pledging as security the stock which he had bought and paid for.[206]

Note:

> The facts also included the fact that the son defaulted on the note and the father exercised his rights by claiming the stock, which had further declined in value during the Depression. The father did not want the son to incur the loss on the note.

(ii) A brother was allowed to claim a loss from selling securities, even though he gifted the proceeds of the sale to his sister who then at his advice, but not direction, purchased the same securities for her own account.[207]

c. A recent revenue ruling applied the alter-ego rule in a situation involving a closer relationship than that of a spouse.[208]

(i) A, an individual, owns 100 shares of X Company stock with a basis of $1,000. A sells the 100 shares of X Company stock for $600. The following day, A causes an individual retirement account or a Roth IRA, established for the exclusive

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205 *Young*, 34 B.T.A. 648 (1936). See also *Behan*, 32 B.T.A. 1088(1935) where prior to paying the brokers for her purchases, the proceeds received by the husband from the sale of his securities were by him "given" to her and deposited in her bank account, and immediately thereafter payment for the securities purchased by her was made by checks drawn on such account, and it further appeared that the husband did not thereafter reacquire the securities sold by him, and the wife in all cases received new certificates in her own name and received all the income from the securities purchased by her.

206 *Cole v. Helborn*, 4 F. Supp. 230 (W.D. Ky. 1933).

207 *Commissioner. v. Johnston*, 107 F.2d 883 (6th Cir. 1939).

208 Rev. Rul. 2008-5, 2008-3 I.R.B. 1.

benefit of A or A's beneficiaries, to purchase 100 shares of X Company stock for its then fair market value. The Service ruled that this should be disallowed because in a 75-year old case a court found that a rule of strict construction should not be unduly pressed to permit easy evasion of a taxing statute.[209] The taxpayer sold bonds (at a market price) to a corporation of which the taxpayer was the sole shareholder. On the same day, in exchange for land, the corporation transferred the same bonds at the same price to the trust. A mere difference between an acquisition by the seller personally and an acquisition by a trust over which the taxpayer had absolute dominion and control amounted only to a refinement of title that may be disregarded.[210] Otherwise, "a trust like this one could be used deliberately to accomplish the very thing which Congress intended to frustrate." Although title to the bonds was acquired by the trust, actual command over the property was still in the taxpayer.

(ii) Applying the reasoning of that case to the facts of this ruling, even though an individual retirement account is a tax-exempt trust, A was deemed to have acquired, for purposes of §1091(a), 100 shares of X Company stock by virtue of the purchase.[211] Thus, the loss on the sale of stock was disallowed. The Court further determined that A's basis in the IRA was not increased by virtue of §1091(d).

Planning point:

It is important to note that one's dominion and control is not problematic in the case where the second party is one's own IRA. But **it does not follow that the ruling applies in a case where the purchase is made by, say the taxpayer's wife's IRA**. This would bring back the distinction drawn in cases discussed in paragraph a., above.

8. Bond premium

Because the wash-sale rules apply only to losses, not to gains, one can sell a bond that, by virtue of a higher interest rate than current market, at a recognized gain to offset losses and immediately buy back the same premium-priced bonds. In this case, one is taking gains this year that will be offset by already realized losses (or capital loss carryover).

a. The second tax-saving opportunity this move allows is that over the coming years, one can take an interest expense deduction by electing to amortize the premium on the bond. Therefore, in matching up gains and losses, consider bond holdings as well as equity positions.

b. True, the sale of the bond results in a 20 percent capital gains tax, but the investor decreases the taxable interest from the bond by amortizing the premium on the "new" bond. Thus, while the cash flow is the same (since the bond makes the same interest payments as before) the amount taxable at 40.8 percent (37 percent + 3.8 percent) going forward has been reduced.

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209 *Carbon Steel Co. v. Lewellyn*, 251 U.S. 501,(3 AFTR 3046 (U.S. 1925).
210 *Security First National Bank of Los Angeles*, 28 B.T.A. 289 (1933).
211 See also *Shoenberg v. Commissioner*, 77 F. 2d 446, 16 AFTR 95 (8th Cir. 1935).

Example: Investor Q purchased a $100 10-percent corporate bond at face and it is now two years before maturity and trades at $108. If held for two years, the bond will pay Q $20 ($10 + $10) that will generate an $8.16 tax over the two years. If Q sells the bond and recognizes an $8 capital gain, the generated tax in the current year is $1.60. Repurchasing the bond at $108 and electing to amortize premium results in a net interest income of $6 ($10 - $4 annual amortization), which causes Q to have a tax liability of $2.45 in each year.

Strategy	Ordinary Income Tax	Capital Gains Tax	Total
Hold			
Year 1	$4.08		$4.08
Year 2	$4.08		$4.08
Total	$8.16		$8.16
Sell/repurchase			
Year 1	$2.45	$1.60	$4.05
Year 2	$2.45		$2.45
Total	$4.90	$1.60	$6.50

Taxes go from $8.08 to $6.50 (not taking into account time-value-of-money effects) and the after-tax cash flow goes from $11.84 to $13.50.

Planning point:

The technique is particularly attractive to investors with capital losses, who can use those losses to offset the capital gains tax triggered by the bond sale. The longer the maturity on the bond, the less the after-tax return. If the bond is callable, and at a price below its current price, it probably will be called. This could result in different tax consequences than those outlined above.

9. Capital losses

The presence of capital loss carryover presents two problems. At the very least, such losses, limited as they are annually by the amount of capital gain (+ $3,000), if substantial, may take a significant number of years in the absence of capital gains to provide tax benefits. When the projected period is significant, the losses will be eliminated and no further tax benefit is usable when the taxpayer dies. Older taxpayers with large capital losses face the real prospect of losing tax benefits.

Note:

Obviously one tactic is to recognize gains to the extent of such losses; the stock or security may be repurchased, assuming the sale is dictated by the tax rather than investment necessities, since there is no wash-sale disallowance for gains.

A related problem that many taxpayers do not recognize is that joint filers, while aggregating their separate gains and losses, do not thereby transform a loss of one of the taxpayers into a “marital” loss that continues after the death of the taxpayer who suffered it.

But such losses should cause the taxpayer to consider harvesting gains to a like extent where possible to reduce later potential NII tax that would be generated in the recognition of category 3 gain. The gains offset by the losses will generate no current liability for income or NII tax purposes; and the increased cost basis in the repurchased security will reduce the gain on disposition later.

a. A decedent died, but prior to his death, the decedent sold all his stock at a loss. In the absence of any express statutory language, only the taxpayer who sustains a loss is entitled to take the deduction.[212] Therefore, the capital loss sustained by the decedent for

212 See *Calvin v. United States*, 354 F. 2d 202 (10th Cir. 1965).

the period ending with the date of his death is deductible only on his final income tax return. Thus, no part of such capital loss is deductible by the decedent's estate or carried over to subsequent years.[213] The same principles would apply to the spouse. The Service has also held that the segregation of a married couple's losses is required and if, in a year succeeding the year of death of one spouse, the survivor sustains a net operating loss, the loss may be carried back only to that portion of the income reported in a joint return previously filed with the decedent, which vested in the survivor.[214] The Service has also privately ruled[215] that no part of the loss incurred on the sale of property owned by the decedent is deductible by the survivor and that loss may not be carried over on the survivor's individual income tax returns.

b. The regulations provide that if a husband and wife making separate returns for any taxable year made a joint return for the preceding taxable year, any capital loss carryovers are allocated to the spouses on the basis of their individual capital losses for the preceding taxable year which gave rise to such capital loss carryovers, and the portions of the capital loss carryovers so allocated to each spouse may be carried forward by such spouse to the taxable year.[216] Thereafter, when a spouse files a separate return, only those carryovers allocated to the spouse may be used by the spouse. Clearly, the surviving spouse files a separate return in years following the year of death.

Planning point:

The same problems attend the ownership of loss investments where the loss has not been recognized. Such property's excess of basis over fair market value will disappear at the death of the owner by reason of the basis adjustment at death. Such property could be sold before death to create the capital loss, but as noted above, this is subject to limitations that may preclude full benefit of the loss in the year of sale or in the short number of years following the sale before the taxpayer's death. If the property is transferred to the spouse before death, death will not eliminate the built-in loss and may permit the surviving spouse to realize the tax benefits of the loss over the presumably longer lifetime.

10. Stock market gains or losses

a. If the taxpayer has already taken capital losses, consideration should be given to selling gain securities to offset those losses. State law may deny any deduction for capital losses not offset in the current year by capital gains, and while federal law allows a carryover, it only permits $3,000 of such excess losses to offset ordinary income each year.

(i) Capital losses offset any capital gains, but long-term capital losses are used to offset long-term capital gains before they are used to offset short-term capital gains. Similarly, short-term capital losses must be used to offset short-term capital gains before they are used to offset long-term capital gains. Because short-term gains are taxed at ordinary-income tax rates, a capital loss can offset it at a higher marginal rate than when it offsets a long-term gain taxed at a lower, preferential tax rate. If a short-term gain has already been recognized, it is better to avoid selling property that would generate a short-term loss than one that will produce a long-term loss. To do this requires making sure that the long-term capital losses are not taken in the same year as the long-term capital gains are taken. Of course, deferral of the recognition of gain (or loss) until the following

[213] Rev. Rul. 74-175, 1974-1 C.B. 52.
[214] Rev. Rul. 65-140, 1965-1 C.B. 127.
[215] PLR 8510053.
[216] Treas. Regs. §1.1212-1(c)(1)(iv).

year should not be entertained where the risk is high that the value of the property will decline before it can be sold. Similarly, a taxpayer will not want to risk increasing the loss on property that he or she expects will continue to decline in value by deferring the sale of that property until the following year.

(ii) Taking such losses on stock or securities implicates the wash-sale rule. If the stock is otherwise desirable because of its strong possibility of a quick or robust turnaround in market value, the need to recognize the loss limits what the taxpayer can do:

- Buy more stock, but outside the 61-day window; or
- Buy stock in a different, but similar company if the attractiveness lies in the sector more generally.

b. **Deferring capital losses**. Rather than taking certain capital losses to offset current lower-taxed long-term capital gains, take capital losses later to offset higher-taxed gains in future years. **Taxpayers without current year long-term capital gains may choose to take them currently**.

Planning point:

Capital losses: Many taxpayers have built-in capital losses in investments that must be carefully timed. Individuals cannot carry capital losses back, so recognition of gains is not available as an offset to future losses. Here the wash-sale rules will apply to a sale of a stock or security: no loss is recognized if the taxpayer purchases substantially within a 61-day window centered around the sale date,[217] so one must cut off any investment in the loser for at least 31 days to recognize the loss. Note that the Service has held that the purchase by the taxpayer's IRA (and presumably other alter egos) will be treated as a purchase by the taxpayer triggering the wash-sale rules.[218] However, the wash-sale rules do not apply to property that is not a stock or security.

But, investors must also take into account that if a current capital loss only offsets 15-percent income a future capital loss may offset a higher 20-percent capital gain. Thus, an investor with a portfolio having winners and losers may decide to defer the recognition of gains to higher capital-gains rates years if they have offsetting capital losses that: (a) will be taken before such gains; and (b) will not be disallowed by a purchase within the 61-day window.

The good news is that current capital losses that should be taken for investment purposes may offset $3,000 of ordinary income in a year the investor has no gains and offset any higher taxed capital gains recognized in a later year. The key is to recognize losses first; they have a future. Do not recognize them after gains; they have no past.

As with all of these ideas, tax professionals must temper these federal income tax concepts with the constraints of state law. For example, certain states do not allow an individual to carry over capital losses. Taking a capital loss in a year in which the taxpayer did not recognize at least an equal amount of gains would result in a permanent loss of that loss for state tax purposes, and perhaps increase state taxes in a later year where there are sufficient capital loss carryovers for federal tax purposes but not for state tax purposes.

11. The investment-expense trap

Investment-management fees are a common expense for many high-net-worth clients with substantial investment portfolios. Yet clients who do too well or not well at all may find potential tax problems.

a. Investment expenses are not deductible for tax years 2018 through 2025.[219]

217 I.R.C. §1091(a).
218 Notice 2008-5.
219 I.R.C. §67(g).

b. Partnerships are required to report expenses separately as a separately stated item. Thus, it does not reduce other pass-through items and it is not capitalized into the property of the partnership.[220]

Note:

Apparently, some brokerage firms have taken such expenses and allocated them to the investment assets held in the account as an "accommodation" for some of its investors, while other firms do not. Thus, as will be described below, there may be tax reasons to shop the portfolio among investment houses.

Example: Client has a $1,500,000 portfolio that is subject to an annual asset-management fee of 1.2 percent ($18,000). In 2024, Client has a total of $1,000,000 of income. As a result, although Client pays $18,000 to help produce $1,000,000 of taxable income, none of the payment is deductible.

Planning point:

This ordinarily does not occur in a mutual fund, which nets its fees against distributions. From a tax standpoint, this is more efficient than the typical arrangements for an asset-management model. Thus, investing in a mutual fund rather than venture capital or finding the "right" brokerage house (which, if it allocates costs to portfolio items, would be reflected in reducing capital gains or increasing capital losses) may produce better results for the client in this profile.

Again, this is an idea that only applies to a targeted group of individuals who find themselves either in full phase out or AMT ranges of income.

N. Terminations as a sale or exchange

1. Sale or exchange requirement

In order for an investor to recognize capital gain from a transaction in property there must be a sale or exchange.[221] Courts have been called upon to determine whether there has been a sale or exchange in a variety of contexts.[222] However, the Code contains provisions that deem certain transactions to be a sale or exchange and, therefore, any resulting gain or loss is to be treated as a capital gain or loss to the extent the underlying property is treated as a capital asset. In particular, gains and losses attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to **property** are treated as gains or losses from the sale of a capital asset, even though a sale or exchange may otherwise be lacking.[223]

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220 I.R.C. §702(a).

221 *Helvering v. William Flaccus Oak Leather Co.*, 313 U.S. 247 (1941).

222 See *Douglass Fairbanks v. U.S.*, 306 U.S. 436 (1939) (pre-OID rules: gain realized on the redemption of bonds before their maturity not a "sale or exchange"); *Commissioner v. Pittston Co.*, 252 F. 2d 344 (2d Cir), *cert. denied*, 357 U.S. 919 (1958), (a payment received in lieu of subsequent profits and not a sale or exchange); *Commissioner v. Starr Brothers*, 205 F. 2d 673 (2d Cir. 1953) (payment received by a retail distributor from a manufacturer in exchange for waiving a contract provision prohibiting the manufacturer from selling to the distributor's competition not a sale or exchange); *General Artists Corp. v. Commissioner*, 205 F.2d 360, cert. denied 346 U.S. 866 (2d Cir. 1953) (amounts received by a booking agent for cancellation of a contract to be the exclusive agent of a singer not from a sale or exchange); *National-Standard Company v. Commissioner*, 749 F.2d 369 (6th Cir. 1985) (loss incurred on the transfer of foreign currency to discharge the taxpayer's liability not a "sale or exchange"); *Stoller v. Commissioner*, 994 F.2d 855 (D.C. Cir.1993) (pre-§1234A: losses incurred on the cancellation of forward contracts to buy and sell short-term government securities that formed a straddle not a "sale or exchange"); *Freeland v. Commissioner*, 74 T.C. 970 (1980), *Middleton v. Commissioner*, 77 T.C. 310 (1981), aff'd per curiam 693 F.2d 124 (11th Cir. 1982) and *Yarbro v. Commissioner*, 45 T.C.M. 170, aff'd. 737 F.2d 479 (5th Cir. 1984), cert. denied, 469 U.S. 1189 (1985) (abandonment of property subject to nonrecourse indebtedness a "sale").

223 I.R.C. §1234A.

Note:

> Some transactions, such as settlements of contracts to deliver a capital asset, are economically equivalent to a sale or exchange of such contracts since the value of any asset is the present value of the future income that such asset will produce. In addition, to the extent that the Code treated modifications of property rights as not being a sale or exchange, it effectively provided taxpayers with an election to treat a transaction as giving rise to capital gain, subject to more favorable rates than ordinary income, or an ordinary loss that could offset higher-taxed ordinary income and not be subject to limitations on use of capital losses. The effect of an election could be achieved by selling the property right if the resulting transaction resulted in a gain or by providing for the extinguishment of the property right if the resulting transaction resulted in a loss.

2. Sale or exchange treatment

Accordingly, the cancellation, lapse, expiration, or other termination of a right or obligation with respect to **any type of property** that is (or on acquisition would be) a capital asset in the hands of the taxpayer is treated as a "sale or exchange."[224] The major effect is to remove the effective ability of a taxpayer to elect the character of gains and losses from certain transactions.

3. Lease terminations

A Supreme Court decision had held that the **amounts received by a lessor from a lessee as consideration for the lessor's consent to the early termination of a lease** are taxable as ordinary income rather than capital gain. The Court stated that "basically the payment was merely a substitute for the rent reserved in the lease."[225]

Now, such a payment received "for the cancellation, lapse, expiration, or other termination of a right or obligation with respect to property" is treated as capital gain as long as the underlying property is a **capital asset**. In the context of a lease cancellation payment, the lease is the right or obligation being cancelled or terminated, and the leased property is the property with respect to which the cancellation or termination applies.

a. A capital asset is defined as property held by the taxpayer (whether or not connected with his or her trade or business). However, excluded from the definition is property, used in his or her trade or business, of a character which is subject to the allowance for depreciation, or real property used in his or her trade or business. Real estate under this definition will be a capital asset in the hands of a lessor unless it is property used in a trade or business.

b. Real property held for rental either automatically will be considered as property used in a trade or business (under the Seventh Circuit standard) or possibly, depending on the level of the lessor's activity (under the standards applied by the Second and Sixth Circuit, the Court of Claims, the Tax Court, and the IRS), but property subject to a net lease under the case law (and the IRS's ruling stance) apparently will be considered a capital asset.

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[224] I.R.C. §1234A(1).

[225] *Hort v. Commissioner*, 313 US 28, (1941), 25 AFTR 1207.

4. *Litigation proceeds*

Speaking of converting ordinary income into capital gain, which would be the next best result on litigation proceeds that do not qualify for an exclusion (under §104), it is possible that as a result of a change in the law a few years ago this is now a real, albeit aggressive, possibility. The primary stumbling block is establishing a sale or exchange for tax purposes. Some courts have found capital gains in some lawsuit settlements, by either deeming a sale or exchange or just not discussing the requirement.[226] For example, the Tax Court found a recovery in an intellectual-property dispute to be capital in nature and simply did not mention whether there was (or needed to be) a sale or exchange.

a. Section 1234A generally applies to terminations of contract rights, most often an unexercised option; the purpose of deeming a sale or exchange to occur by reason of the expiration is to prevent the option cost being treated as a deductible, ordinary loss. However, by its terms, it extends to the cancellation, lapse, expiration, or other termination of a right or obligation (other than a securities futures contract or a debt instrument) with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer.

b. Some litigation arises in the context of the status of contracts that are often terminated, either explicitly or implicitly, often by the litigation or its settlement.[227] Remember that the underlying lawsuit (or the right to sue) must be a capital asset in the hands of the taxpayer.

Note:

> If asked for advice, the tax professional could suggest that the parties in a settlement agreement refer to the underlying contract under which the events took place and to agree that the contract was being canceled or terminated.

O. Inflation-oriented debt

1. *Inflation-indexed debt instrument*

An inflation-indexed debt instrument is a debt-instrument that satisfies three conditions.

a. The debt instrument is issued for U.S. dollars, and all payments on the instrument are denominated in U.S. dollars.

b. Except for a **minimum guarantee payment**, each payment on the debt instrument is indexed for inflation and deflation. A payment is indexed for inflation and deflation if the amount of the payment is equal to:

   (i) The amount that would be payable if there were no inflation or deflation over the term of the debt instrument, multiplied by

   (ii) A ratio, the numerator of which is the value of the **reference index** for the date of the payment and the denominator of which is the value of the reference index for the issue date.

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226 See *Inco Electroenergy Corp. v. Commissioner*, T.C. Memo. 1987-437.

227 See PLR 9631010, where the IRS ruled that income recognized by a regulated public utility corporation from the termination of a natural gas purchase contract is gain from the sale of a capital asset.

Note:

> The reference index is an index used to measure inflation and deflation over the term of a debt instrument. To qualify as a reference index, an index must satisfy three conditions:[228]
>
> - The value of the index is reset once a month to a current value of a single **qualified inflation index**. For this purpose, a value of a qualified inflation index is current if the value has been updated and published within the preceding six-month period. A qualified inflation index is a general price or wage index that is updated and published at least monthly by an agency of the United States government (for example, the non-seasonally adjusted U.S. City Average All Items Consumer Price Index for All Urban Consumers (CPI-U), which is published by the Bureau of Labor Statistics of the Department of Labor).[229]
> - The reset occurs on the same day of each month (the reset date).
> - The value of the index for any date between reset dates is determined through straight-line interpolation.

c. No payment on the debt instrument is subject to a contingency other than the inflation contingency or the following contingencies:

(i) A minimum guarantee payment; or

(ii) Payments under one or more alternate payment schedules if the payments under each payment schedule are indexed for inflation and deflation and a payment schedule for the debt instrument can be determined under §1.1272-1(c). (For purposes of this section, the rules of §1.1272-1(c) are applied to the debt instrument by assuming that no inflation or deflation will occur over the term of the instrument.)

Note:

> In general, a minimum guarantee payment is an additional payment made at maturity on a debt instrument if the total amount of inflation-adjusted principal paid on the instrument is less than the instrument's stated principal amount. The amount of the additional payment must be no more than the excess, if any, of the debt instrument's stated principal amount over the total amount of inflation-adjusted principal paid on the instrument. An additional payment is not a minimum guarantee payment unless the qualified inflation index used to determine the reference index is either the CPI-U or an index designated for this purpose by the commissioner in the Federal Register or the Internal Revenue Bulletin.[230]

2. Inflation-adjusted principal amount

For any date, the **inflation-adjusted principal amount** of an inflation-indexed debt instrument is an amount equal to the product of: (i) the outstanding principal amount of the debt instrument (determined as if there were no inflation or deflation over the term of the instrument), multiplied by (ii) a ratio, the numerator of which is the value of the reference index for the date and the denominator of which is the value of the reference index for the issue date.[231]

3. General tax effect

If a debt instrument is an inflation-indexed debt instrument, one of two methods applies to the instrument: the **coupon bond method** or the **discount bond method**. Both methods determine the amount of OID that is taken into account each year by a holder or an issuer of an inflation-indexed debt instrument.[232]

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228 Treas. Regs. §1.1275-7(c)(2).
229 Treas. Regs. §1.1275-7(c)(3).
230 Treas. Regs. §1.1275-7(c)(5).
231 Treas. Regs. §1.1275-7(c)(4).
232 Treas. Regs. §1.1275-7(a).

Note:

> The tax rules that generally apply to an inflation-indexed debt instrument do not apply to a debt instrument issued by qualified tuition programs nor to certain debt instruments between natural persons, those that are short-term taxable obligations, and those that are U.S. savings bonds.[233]

4. Deflation adjustments

When the inflation adjustment is negative, the deflation adjustment reduces the amount of interest (OID, qualified stated interest, and/or market discount) otherwise includable in income by a holder with respect to the debt instrument for the taxable year. If the amount of the deflation adjustment exceeds the interest otherwise includable in income by the holder with respect to the debt instrument for the taxable year, the excess is treated as an ordinary loss by the holder for the taxable year.

a. However, the amount treated as an ordinary loss is limited to the amount by which the holder's total interest inclusions on the debt instrument in prior taxable years exceed the total amount treated by the holder as an ordinary loss on the debt instrument in prior taxable years.

b. If the deflation adjustment exceeds the interest otherwise includable in income by the holder with respect to the debt instrument for the taxable year and the amount treated as an ordinary loss for the taxable year, this excess is carried forward to reduce the amount of interest otherwise includable in income by the holder with respect to the debt instrument for subsequent taxable years.[234]

Note:

> In the less likely event of deflation, the principal investment may be protected at maturity, with guarantee payments increasing the indexed amount to the face value of the securities. For each year prior to maturity, a deflationary scenario results in a **downward adjustment of the principal** base used to determine the annual interest payments. Thus, annual cash flow may be less than the investor anticipated, although it can never be negative under deflation. In fact, the investor may realize an overall **tax savings** if the annual decrease in principal exceeds the annual interest payments. Such a net decrease, up to the interest reported as income in all years to date, is treated as a tax loss and results in a tax savings/increased cash flow for the investor.
>
> Over the life of the investment, however, the return is less than a nonindexed instrument because the stream of interest payments is less than for a nonindexed security. Further, under deflationary conditions, the tax limitation on the deduction of losses may result in a portion of losses being deferred until the holder disposes of the bonds; this is inconsistent with the treatment of inflationary principal increases that are taxed in the year they arise.

c. A holder's adjusted basis in an inflation-indexed debt instrument is determined using the principles applicable to OID. However, a holder's adjusted basis in the debt instrument is decreased by the amount of any deflation adjustment the holder takes into account to reduce the amount of interest otherwise includable in income or treats as an ordinary loss with respect to the instrument during the taxable year. The decrease occurs when the deflation adjustment is taken into account.[235]

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233 Treas. Regs. §1.1275-7(b)(2).
234 Treas. Regs. §1.1275-7(f)(1)(i).
235 Treas. Regs. §1.1275-7(f)(2).

P. Capital investment in 2025

1. Section 179 expensing

A taxpayer that satisfies limitations on annual investment may elect under §179 to deduct (or "expense") the cost of qualifying property, rather than to recover such costs through depreciation deductions. The TCJA increased the maximum deduction to $1,000,000 for years beginning after 2017.[236] The $1,000,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $2.5 million.[237] The $1,000,000 amount and the $2,500,000 threshold are indexed for inflation for tax years after 2018. The indexed amounts for 2025 are $1,250,000 for the annual limit and $3,130,000 for the phaseout.[238]

Note:

> Section 179 and the repair regulations both apply to materials and supplies and property covered by the de minimis safe-harbor election. The repair regulations permit a taxpayer to deduct materials and supplies for items costing up to $200; as to such items, without an election to capitalize, the expensing rules apply. This expensing of materials and supplies provides a tax deduction which may be in excess of amounts expensed under §179. Thus, the dollar limitation of §179 is not allocable to this property and can be used against property for which a materials and supplies deduction is otherwise unavailable, potentially providing a larger overall deduction than either §179 or the repair regulations would allow separately.
>
> In addition, the regulations provide a safe-harbor election with respect to qualifying property that is $2,500 or $5,000, depending on whether the taxpayer has an applicable financial statement. Amounts that qualify for such expensing are not amounts spent for §179 property and thus:
> (i) may exceed the $1,000,000 limitation; and (ii) not be counted as §179 property placed in service for purposes of determining the phase out of the §179 limitation for the taxable year.

a. Since amounts paid for materials and supplies or covered by a de minimis election are not §179 property, those amounts do not operate as a cost of §179 property that may cause the maximum limitation on expense to be reduced. Section 179 property is tangible property (and some computer software) that is subject to §168, i.e., subject to cost recovery through depreciation; since such items are written off they are not subject to cost recovery (or put another way, such items are not categorized as capital).

b. Since §179 is elective property-by-property but the de minimis election applies to all such eligible property, ordinarily the §179 election will be reserved solely to items with cost above the applicable $2,500/$5,000 threshold. Thus, the de minimis safe harbor of $2,500 (for taxpayers without applicable financial statements) or $5,000 (for taxpayers with applicable financial statements) per item in the repair regulations also will preserve the §179 dollar limitation, but at the cost of a net income charge on the taxpayer's financial statements. The de minimis safe harbor requires book/tax conformity, while §179 does not, and §179 may be better than a written procedure and de minimis election for businesses that need better financial statements.

c. The business can over-purchase assets and lose the benefits of the expense. Thus, some businesses should take care in timing their capital equipment. The amount of expense wasted does not carry over to later years. It is better to spend up to the limit and defer further capital expenditures that are not eligible for safe harbor expensing or repair to a later year.

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236 I.R.C. §179(b)(1).
237 I.R.C. §179(b)(2).
238 Rev. Proc. 2024-40.

(i) The limitations apply at both the entity level and the owner level, a concept often overlooked in a pass-through entity situation.

(ii) Another possibility is to defer the placing in service of such property until the following year.

d. The second area where one can go off is the taxable income limitation: the aggregate cost of §179 property elected to be expensed under §179 that may be deducted for any taxable year may not exceed the aggregate amount of **taxable income of the taxpayer** for such taxable year that is derived from the **active conduct by the taxpayer of any trade or business** during the taxable year.

(i) For these purposes, the aggregate amount of taxable income derived from the active conduct by an individual, a partnership, or an S corporation of any trade or business is computed by aggregating the net income (or loss) from all of the trades or businesses actively conducted by the individual, partnership, or S corporation during the taxable year. Items of income that are derived from the active conduct of a trade or business include §1231 gains (or losses) from the **trade or business** and **interest from working capital** of the trade or business.

Note:

Property that is placed in service of an activity that is not an active trade or business is not eligible §179 property but may still be eligible for the safe harbor rules that apply to de minimis expenditures.

Planning point:

Here the use of a single member LLC may be helpful to an individual who might be denied the expense by reason of the taxable income limitation. Since such entity is not a separate entity, only the individual's taxable income limitation would apply, and such taxable income from an active trade or business also includes any compensation from the entity business.

(ii) Taxable income derived from the active conduct of a trade or business is computed without regard to the deduction allowable under §179, any §164(f) deduction (for self-employment taxes), any net operating loss carryback or carryforward, and deductions suspended under any section of the Code.[239]

(iii) The amount not currently expensable by reason of the taxable income limitation does carry over. So the lack of taxable income should not be an impediment to its current use.

(iv) A limited partner, for as long as he or she is a limited partner, cannot have any taxable income derived from the active conduct of the trade or business of the partnership. However, absent a special allocation of §179 expense, LP will still be allocated his or her share of §179 expense that he or she will remain unable to use by reason of the taxable income limitation. Furthermore, he or she will continue to reduce his or her basis in the partnership by the full amount of the §179 expense. The LP may have some options. (These may be negated by passive-loss limitations, if applicable.)

- First, if he or she operates a sole proprietorship that generates taxable income derived from the active conduct of a trade or business in the

239 Treas. Regs. §1.179-2(c)(1).

current or later year, he or she may be able to apply the §179 expense from the partnership.

- Second, if he or she ever becomes a general partner, he or she may be able to enjoy a catch-up through the generation of taxable income derived from the active conduct of a trade or business, but this may take several years, and, if the partnership makes additional §179 expenses, LP may find this use further deferred because the maximum amount that a partner may take will be limited by the excess of the dollar limitation in that year over the actual elected §179 expenses for that year.
- Alternatively, the partnership can simply allocate the §179 expense to the general partners. However, in many limited partnerships, the general partners may have a low basis and capital account because the deal is structured as one in which the general partner provides minimal capital but takes a large profits interest or a guaranteed payment. The consequence is that the general partner may run out of basis to take the current loss.

(v) However, depreciation is not subject to the taxable income limitation. Accordingly, in some cases where the taxable income limitation may be in effect for several years, the ability to take depreciation deductions may produce a higher tax benefit than a deferred §179 expense.

f. The amount expensed is not taken into account as a purchase for purposes of the mid-quarter convention. This means that taking an expense on property purchased in the fourth quarter may avoid the application of the mid-quarter convention, while taking the expense on property purchased in any other quarter may make the mid-quarter convention more likely.

g. The expense gives more bang for the buck if made with respect to property having longer recovery periods under MACRS. This could be in conflict with the mid-quarter convention avoidance rule above.

h. The §179 expense is not subject to adjustment in the AMT system.

2. TCJA changes to bonus depreciation

TCJA increases the first-year expensing percentage (bonus depreciation) from 50% to 100% for property acquired and placed in service after September 27, 2017. Property acquired prior to September 28, 2017, but placed into service after September 27, 2017 is still subject to the phase out of the PATH Act of 2015.

a. Bonus depreciation increased from 50% to 100% for property acquired and placed in service after September 27, 2017 and before January 1, 2023. For property acquired after December 31, 2022, the bonus percentage is phased out as follows:[240]

[240] I.R.C. §168(k)(1)(A), §168(k)(6)(A).

Placed in Service Year	Bonus Depreciation %	Bonus Depreciation % for Longer Production Period Assets and Airplanes
9/28/2017-12/31/2022	100%	100%
2023	80%	100%
2024	60%	80%
2025	40%	60%
2026	20%	40%
2027	None	20%
2028 and thereafter	None	None

b. For property placed in service after September 27, 2017 and before January 1, 2018, the taxpayer could elect out of the 100% additional first-year depreciation and take 50% instead. As under old law, the taxpayer can elect completely out of bonus depreciation for all years for which they are eligible.

c. Unlike the §179 deduction, a taxpayer is not required to have net income to take bonus depreciation and bonus is not limited to smaller businesses or capped at a certain dollar level. Bonus depreciation is not available for used property, property used outside of the United States, tax-exempt use property, or tax-exempt financed property. A taxpayer can elect out of additional first-year depreciation for any class of property for any taxable year.

d. For property placed in service after December 31, 2015 and before September 28, 2017, bonus depreciation is available for qualified property that meets the following requirements:

 (i) Property must be MACRS property with a recovery period of 20 years or less, computer software, and water utility property, and **qualified improvement property**;

 (ii) Original use must begin with the taxpayer; and

 (iii) Property must be placed in service before January 1, 2020.

e. Beginning in 2016, "qualified improvement property" rather than qualified leasehold improvement property was bonus-eligible property, although all property that would be characterized as qualified leasehold improvement property continues to qualify. Qualified improvement property is any improvement to an interior portion of a building that is nonresidential real property if the improvement is placed in service after the date the building was first placed in service, excluding: (1) enlargements; (2) elevators/escalators; and (3) internal structural framework. The improvements do not need to be made pursuant to a lease. Perhaps as the result of a drafting mistake, the *TCJA* statutory language did not reflect the intended 15-year recovery period for qualified improvement property (QIP). This meant that QIP was not eligible for bonus depreciation because it was not 15-year property. The CARES Act reclassifies QIP as 15-year property (20-year ADS life) and allows businesses to immediately write off costs associated with QIP instead of depreciating the improvements over a 39-year life.[241] The CARES Act QIP fix is effective for property placed in service after December 31, 2017.

 On September 21, 2020, the IRS and Department of Treasury released the second round of final bonus depreciation regulations, making further clarifications and addressing the

[241] CARES Act §2307.

CARES Act QIP fix.[242] The CARES Act reclassified QIP as 15-year property (20-year ADS life) and allowed businesses to immediately write off costs associated with QIP instead of depreciating the improvements over a 39-year life, but it stated that the improvement must be "made by the taxpayer." The final regulations clarify this terminology and state that an improvement is made by a taxpayer if the taxpayer makes, manufactures, constructs, or produces the improvement for itself, or if the improvement is made, manufactured, constructed, or produced for the taxpayer by another person under a written contract. On the other hand, the final regulations clarify that if a taxpayer acquired nonresidential property in a taxable transaction and such property had an existing improvement placed in service by the seller of such property, the existing improvement is not considered to have been made by the taxpayer. Property with preexisting QIP transferred in a nonrecognition event does not qualify for bonus depreciation, since the basis of the QIP is dependent upon the transferor's basis.

f. The requirement that property be new is repealed by TCJA. The new requirement is that additional-first-year depreciation can be taken in the first year that the property is placed in service by the taxpayer, regardless of whether it is new or used.[243]

g. The $8,000 bonus applicable to luxury automobiles is preserved by TCJA, and the limitation on the amount of depreciation deductions allowed is increased.[244] 2025, the new amount for all passenger automobiles, including trucks and vans, is:

Tax Year	Amount
1st year	$12,200
2nd year	$19,600
3rd year	$11,800
Succeeding years	$7,060

Therefore in 2025, a taxpayer may deduct $12,200 depreciation plus $8,000 bonus depreciation in the first year a passenger automobile subject to the limitations is placed in service for a total deduction of $20,200.

h. The TCJA added an anti-abuse provision that disallows bonus depreciation on property purchased from a related party.[245]

Note:

> One way to avoid the limitations on passenger automobiles was for a taxpayer to purchase a vehicle that was not a passenger automobile. Vehicles having a gross weight of over 6,000 pounds are not passenger automobiles and not subject to the limitations applied to them. The SUV became the vehicle of choice for the tax-savvy, permitting annual depreciation deductions far in excess of the annual dollar limitations on passenger automobiles. Then, Congress finally took action on the SUV by limiting the amount of the §179 expense to $25,000 (annually indexed for inflation). Businesses purchasing new vehicles can now take the §179 deduction first and depreciate the remaining cost basis. Taxpayers may be expected to browse the showrooms of their local Cadillac Escalade, Porsche Cayenne, Land Rover LR4, and BMW X5 M dealers.

242 T.D. 9916.
243 I.R.C. §168(k)(2)(A)(ii).
244 I.R.C. §168(k)(2)(F)(i), §280F(a)(1)(A).
245 I.R.C. §168(k)(2)(E)(ii).

Note:

> Arguments can be made on both sides of the issue, but it appears that the reduction of business use of an SUV below 50 percent will trigger a recapture of prior depreciation deductions.

Note:

> Unlike §179, there is no dollar limit on the bonus depreciation (or regular depreciation) that can be deducted in one year.

V. Qualified plans and retirement

A. Why it still makes sense to make contributions

In an era where the return on stock investments has become volatile, many participants have cut back on or eliminated their §401(k) elective deferrals. This has also surfaced as an issue in SIMPLE plans, which likewise is largely premised on employer-based contributions. However, the relative value of qualified plan investments vis a vis other options largely remains advantageous due to:

- Immediate tax benefit in the deduction or exclusion of income;
- Deferral of taxation on investment returns; and
- Employer contribution not subject to Social Security tax when contributed or distributed.

Note:

> As noted earlier, reduction of income will prove advantageous as tax rates rise and the deferral of return taxation permits investments that return dividends and interest to enjoy a tax benefit similar to that of unrealized gains. Increases in the employment taxes on wages and investment income summon taxpayers to find portfolio strategies that avoid such charges.

B. IRAs

1. Capital losses

Some IRAs have realized and unrealized losses. Can there be any tax play here?

a. First, the bad news. An IRA itself is tax-exempt, so its losses are irrelevant to its taxation. Those losses reduce the amount that could be distributed to the owner so indirectly and only over the period of distributions is this "benefit" realized. One exception: If the IRA has been funded largely with **nontaxable contributions**, the owner has an "investment in the contract" for §72 purposes. The distributee from an IRA is not taxed on the portion representing the investment in the contract. In the most extreme case, where the investment in the contract exceeds the distribution (which can only happen on the complete distribution of the IRA), a loss could be recognized in the amount of that excess. But for the overwhelming number of traditional IRAs funded with deductible contributions, the owner has a zero basis in the IRA.

b. Second, taxpayers have a large investment in the contract with respect to Roth IRAs because none of the contributions are deductible. The IRS position is that the loss is a miscellaneous itemized deduction and is therefore not deductible for tax years 2018 through 2025.

2. *Basis strip*

The tax law made some interesting changes in the rollover rules that may offer opportunities to those who want to jump on them.

a. Under the law, the qualified plan can distribute directly or by rollover to an IRA amounts not included in gross income, i.e., the employee's basis in the plan;[246] this can arise through after-tax contributions or life insurance premium payments (measured by P.S. 58 costs or the new Table 2001 applicable to many split-dollar insurance plans).

b. However, the IRA cannot roll over amounts not included in gross income to a qualified plan or other IRA. The maximum amount that may be rolled over into the qualified plan may not exceed the portion of the amount received that is includable in gross income.[247]

   (i) In general, distributions are treated as consisting of two elements: a portion equal to the product of the exclusion ratio and the distribution, which is not included in gross income; and the balance of the distribution, which is included in gross income. Under the general rule then, the portion representing the IRA owner's basis in the IRA would not be eligible for rollover.

   (ii) Under the 2001 tax law, for the distribution from the IRA in connection with a rollover to a plan other than an IRA or an individual retirement annuity, the general rules for taxing distributions are modified.[248] Instead of aggregating all IRA contracts, §72 is applied on an IRA-by-IRA basis.[249] The portion of such distribution rolled over to an eligible retirement plan is treated as being from income on the contract (to the extent of the aggregate income on the contract from all individual retirement plans of the owner).[250]

   - A rollover from an IRA without any basis may be completely rolled over because all of the distribution consists of amounts that would be included in gross income (but for the exclusion afforded the rollover).
   - This means that, with respect to an IRA in which there is basis, as long as the IRA owner has "income" in other IRAs at least equal to the basis in the IRA being rolled over, the entire amount of the IRA (including the amount of the owner's basis, i.e., "investment in the contract") may be rolled back into a qualified plan.

Planning point:

The Code indicates that "appropriate adjustments" shall be made in applying §72 to other distributions in such taxable year and subsequent taxable years.[251] This use of income from other IRAs seems to leave some portion unaccounted for unless it is the basis in the IRA rolled over. It can be argued then that the rollover of qualified plan to an IRA followed by a roll back into a qualified plan has the effect of stripping the basis from the qualified plan and shifting it into the participant's IRA(s).

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246 I.R.C. §402(c)(2)(B).
247 I.R.C. §408(d)(3)(A)(ii).
248 I.R.C. §408(d)(3)(H)(i).
249 I.R.C. §408(d)(3)(H)(ii)(I).
250 I.R.C. §408(d)(3)(H)(ii)(II).
251 I.R.C. §408(d)(3)(H)(ii)(III).

Example: J has a $100,000 IRA entirely funded by deductible contributions. J also has a $1.5 million qualified plan account, including a $100,000 basis. J may roll over the plan into the IRA even though it includes $100,000 that would not be included in J's gross income in any event. J may roll $1.5 million back into a qualified plan because the IRA consists of at least $1.5 million in income. What is left in the IRA is $100,000 and presumably the $100,000 basis. If J takes a full distribution from the IRA, the entire amount is excluded. Because the additional tax on premature distributions applies only to the extent the distribution is included in gross income, there is no additional tax either. Net after tax, J has $100,000.

If J had taken a $100,000 distribution from the qualified plan directly (if permitted), J would be subject to both income tax and additional tax. The amount included in gross income is $93,333 ($100,000 x $1,400,000/$1,500,000), and the income tax would be $36,960, and the 10-percent additional tax is $9,333, so taxes total $46,293. Net after tax, J has $53,707.

3. Converting to a Roth

Rolling over from a traditional IRA to a Roth IRA is sometimes described as "converting" a traditional IRA to a Roth IRA. This is a taxable rollover in contrast to the nontaxable rollover that occurs when a traditional IRA is rolled over to another traditional IRA. The rollover from a traditional IRA to a Roth IRA is treated as a taxable distribution from the traditional IRA. The 10-percent additional tax under §72(t) (applicable to certain distributions before age 59-1/2) does not apply to this "deemed" distribution. Thus, a (otherwise eligible) young person may convert a traditional IRA to a Roth IRA without penalty.

Note:

The proceeds of a qualified plan cannot be rolled over to a Roth IRA directly. However, nothing precludes a participant from rolling a qualified plan to a traditional IRA and thereafter rolling ("converting") the traditional IRA into a Roth IRA.

a. Roth IRAs have their greatest attraction to those who do not need to withdraw any funds from their IRAs during life, especially those who expect to live well beyond the average life expectancy due to their gender, genetic heritage, and/or health. A traditional IRA participant approaching the age that they are required to take distributions will substantially diminish if not eliminate the account over a long lifespan.

b. Converting to a Roth IRA just before death should be considered as the tax would be paid from the estate, and possibly lower the value of the estate and thus the estate tax of a taxable estate.

c. If an IRA must be used to fund the credit-shelter trust, part of the advantage of escaping estate taxes is mitigated by the necessity of the trust to pay income taxes out of its principal; in many cases, the tax rate on such taxable income will be higher for the trust than for any of the beneficiaries. Although this can be corrected by a withdrawal from the IRA of a sufficient amount (grossed-up by the income tax), this requires the loss of continued deferral inside the IRA. With the Roth IRA conversion, the income taxes are removed from the estate but the deferral of taxes continues and the credit shelter pays no income taxes on the receipt of distributions from the Roth IRA.

Note:

Although either a deductible or nondeductible IRA may also be converted into a Roth IRA, it makes no difference from which IRA the rollover distribution is made, because the amount included in income on conversion does not depend on the source. All IRAs (other than Roth IRAs) are aggregated for purposes of determining the exclusion ratio applicable to the distribution.

Planning point:

Another principle implicit in the IRA regime is that all IRAs are aggregated for distribution purposes. For example, if a taxpayer holds an IRA to which the taxpayer has made only deductible contributions and another to which only nondeductible contributions have been made, a distribution solely from the nondeductible IRA is treated as coming proportionately from the deductible and the nondeductible IRAs both for meeting any minimum-distribution requirements and for determining the tax consequences of the distribution. It is irrelevant from which account the contributions actually come. The taxpayer can neither reduce the amount of taxable income by taking distributions solely from the nondeductible IRA nor increase the amount of taxable income by taking the distribution solely from the deductible IRA. Consequently, the amount of income realized in a rollover into a conversion IRA does not depend on which or whatever combination of non-Roth IRAs are employed.

Note:

Conversions may be used against the net investment income tax in later years. The distribution from the traditional IRA or qualified plan will generate taxable income (but not subject to NII regardless of the plan holdings) and AGI in the year of the conversion. Thereafter, distributions from the Roth will affect neither net investment income nor AGI, reducing the taxpayer's exposure to the 3.8 percent tax. Of course, taxpayers could just take a distribution from the traditional plan and invest in tax-exempt bonds to achieve a similar result, but preservation of the tax-exempt vehicle permits the taxpayer to turn over investments without tax and to invest in growth investments that may produce much higher returns than are possible with municipal bonds; more investment income but less subject to NII tax. This strategy will not fit all taxpayers.

d. The Roth IRA owner, prior to the revamping of the minimum distribution regulations, enjoyed the advantages of being able to change the "designated beneficiary" after age 73 and having that change be effective for determining minimum required distributions after death. The rules have removed this incentive to redesignate by deferring the identification of the designated beneficiary until after the death of the IRA owner rather than locking the designation in place at the required beginning date.

    (i) Section 401 of the SECURE Act stipulates that upon death of a retirement plan account holder, all distributions must be made within 10 years of death to an eligible designated beneficiary, providing the account holder dies after December 31, 2019. Note that spouses, account holder's children who have not reached the age of majority, beneficiaries less than 10 years younger than the account holder, and chronically ill or disabled beneficiaries are NOT subject to the 10-year distribution rule. Section 401 of the SECURE Act eliminates "stretch" IRAs that could be stretched over the life of the beneficiary and grow tax-free for an extended period of time. Section 401 of the SECURE Act does not apply to account holders who die prior to December 31, 2019, and a beneficiary may still "stretch" distributions over his or her own lifetime.

e. In general, there is no advantage to pay taxes now through a conversion rather than later when distributed if the tax rates are the same. However, once the owner reaches RMD age, the Roth IRA begins to enjoy an ever-increasing advantage through continued deferral in comparison to the required minimum distributions. In addition, the new SECURE Act rules stipulating that upon death of a retirement plan account holder, all distributions must be made within 10 years of death to an eligible designated beneficiary, providing the account holder dies after December 31, 2019 makes it increasingly attractive to convert from a traditional to a Roth IRA. Wealthy individuals eligible to take advantage of relatively low tax rates should consider Roth conversions, as beneficiaries will be able to take advantage of the tax-free distributions.

Planning point:

Among the factors that must be taken into account are the size of the IRA, age of owner, tax rates, assumed growth rates, the availability of non-IRA assets to pay taxes, the age at death, and extent to which the beneficiaries may be counted on to take only minimum distributions. The client’s tax rate at withdrawal is one of the most important variables. Therefore, it would seem prudent to consider conversion of some part of the traditional IRA if for no other reason than to hedge potential income-tax changes. Clients nearing the required beginning date who do not need the income are the best candidates, especially if they have non-IRA assets with which to pay the tax.

Note:

The benefits depend on the rate at which the funds are drawn down in the absence of a conversion. An accelerated draw-down of funds increases the tax paid on distributions while simultaneously reducing the period of tax-deferred compounding. These effects make the nonconversion case less attractive and this, in turn, biases the analysis in favor of conversion.

Planning point:

One of the factors influencing the conversion decision is the availability of assets outside the IRA to pay the income-tax liability resulting from the conversion. The reason is obvious: if the taxes are paid from the IRA itself, the amount that remains qualified for tax-deferred compounding declines. To be sure, the individual is out the outside funds so applied together with the earnings on those funds, but the outside fund compounds only on an after-tax basis, while the additional amounts within the Roth IRA compound on a pretax basis.

Caution:

One kind of taxpayer who should be careful is someone whose tax bracket is higher now than the taxpayer’s (or the taxpayer’s heirs’) tax bracket is likely to be whenever the IRA money will be spent. If the marginal tax rate when making a contribution is higher than the rate that will be applied to the distributions -- the typical scenario for most individuals -- then conventional IRAs and other deductible pensions offer a more tax-advantaged investment environment than does a Roth IRA. The tax loss would become a tax gain if the incremental tax on the conversion income were less than the tax on the pension without conversion. Nevertheless, some may wish to consider conversion of some part of the traditional IRA as a hedge against potential income-tax changes. On the other hand, small business owners who plan to sell upon retirement, investors with substantially appreciated portfolios, and someone with a multimillion-dollar pension plan or an inheritance could see their tax rate go up in retirement if their current income corresponds to a 28-percent-or-lower federal tax bracket.

f. The income limitation on converting traditional IRAs to Roth IRAs has been eliminated. Taxpayers may now make such conversions without regard to their AGI.

g. The taxpayer may or may not have a traditional IRA in place. Many taxpayers may not have a current IRA, and the road to getting one is complicated because the funding rules for IRAs are constrained by the phase out rules.

(i) An individual who is an active participant in one of certain types of retirement plans will be unable to make a deductible contribution to an IRA unless the individual's income is below an **applicable dollar amount**.[252] The deductibility of contributions to regular IRAs for active participants is phased out in a pro rata fashion over the applicable phase out range of AGI.

Note:

> If an individual is an active participant, the deduction for contributions to the individual's own IRA may be limited by the phase out rules. However, the contribution to the spousal IRA is deductible subject only to the phase out of AGI for individuals who are not active participants but whose spouses are active participants.

(ii) A spousal IRA deduction cannot be taken unless one spouse has no compensation or unless the spouse elects to be treated as having no compensation.[253] A spouse with less than $7,000 ($8,000 if age 50 or older)[254] in compensation might wish to make an election to be treated as having no compensation in order that a spousal IRA contribution can be made on the spouse's behalf.[255] If the spouse were to establish the spouse's own IRA, the $7,000 ($8,000 if age 50 or older) or 100-percent-of-compensation limitation would limit the contribution to 100 percent of the spouse's compensation.

(iii) For Roth IRAs, the maximum amount is phased out between certain levels of modified AGI. For an individual who is not married, the dollar amount 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. For this purpose, a married individual who has lived apart from the individual's spouse for the entire taxable year and who files separately is treated as not married.[256]

(iv) An individual may make the maximum deductible contributions (if any) and then make nondeductible contributions until the total of both types of contributions equals the limit of $7,000 ($8,000 if age 50 or older), or 100 percent of taxable compensation, if less.[257] This is NOT subject to phase out.

h. What is not phased out is a **nondeductible IRA**. Either taxpayer or his spouse (or both) can fund a nondeductible IRA. A taxpayer can fund two nondeductible IRAs to the extent of $16,500 in 2025, assuming he and his spouse are each age 50 today. This can create a conversion candidate for 2025, and, if this is the taxpayer's only IRA, can (apart from any earnings) be completely tax-free and enable subsequent qualified distributions to be tax-free as well.

Example: Suppose taxpayer (T) has two IRAs, one a traditional deductible IRA having an account balance in 2025 of $80,000; the other is the $20,000 nondeductible IRA

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252 I.R.C. §219(g)(1).
253 I.R.C. §219(c)(1)(B)(i).
254 The inflation adjustments for 2025 for retirement plan related items are found in IRS Notice 2024-80.
255 I.R.C. §219(c)(1)(B)(ii).
256 Treas. Regs. §1.408A-3, A-3 (b).
257 I.R.C. §408(o)(2)(B).

funded as above, which for these purposes has no earnings. Now T could convert the second IRA, but now the conversion will not be tax-free. The reason is that for these purposes one is required to aggregate all traditional IRAs. Even though the distribution is from an IRA that has a $20,000 basis, 80 percent ($80,000/$100,000) of the distribution is deemed to come from the taxable first IRA. The conversion will result in $16,500 of income that must be included in income in one or more years.

However, if instead taxpayer's spouse (S) funded her own nondeductible IRAs as above, she can convert that as a fully nontaxable conversion because she does not have to aggregate her IRA with T's. Thus, none of the $20,000 conversion is taxable in 2025.

Planning point:

While they are generally not nearly as valuable as a Roth contribution or a deductible contribution, nondeductible contributions are not without tax benefit. Nondeductible contributions can not only serve the limited-use purpose discussed above for a single year, but also provide in any event an additional base from which tax-deferred income can be generated, income that when distributed may be taxed at a lower rate than the same principal sum invested outside the IRA in some or all of the years between contribution and the date of distribution.

4. Recharacterization

If a taxpayer has made a Roth IRA contribution and discovers at year-end that he or she has too much MAGI to be eligible to make the contribution a taxpayer may reverse the transaction. Prior to 2018, a taxpayer who converted a regular IRA to a Roth IRA could reverse, or "unwind" the conversion. The Tax Cuts and Jobs Act suspends the ability to reverse a conversion for tax years after 2017, but keeps the provision allowing the recharacterization of a contribution. A Roth IRA conversion made in 2017 could have been recharacterized as a contribution to a traditional IRA if the recharacterization was made by 10/15/2018. A Roth IRA conversion made in 2018 or later cannot be recharacterized.

a. It is best if a recharacterization is made by the due date (plus extensions) of the taxpayer's return for the affected year and reflected on the return for that year. However, the taxpayer can make the recharacterization within six months of the unextended due date of the return for the year in which the contribution or conversion occurred.

b. The Service granted a taxpayer an extension of time to recharacterize three Roth IRAs into traditional IRAs. The taxpayer contacted several IRS employees seeking information. She eventually was advised that she had to accomplish the recharacterization no later than the due date of her 2004 income tax return. However, she was not told how to accomplish the recharacterization or that she could have sought an extension of time to recharacterize. One Service employee advised her to seek a PLR. In the PLR, the IRS granted the taxpayer an extension of 60 days from the date of issuance of the ruling to recharacterize her 2004 Roth IRA contributions. The ruling also noted that after she recharacterized the amounts in Roth IRAs, she must wait 30 days before she would be eligible to reconvert the amounts to one or more Roth IRAs.[258]

5. Qualified charitable distributions from an IRA

A direct distribution from an IRA is treated as a distribution to the IRA owner followed by a contribution by the owner to the charity. For tax purposes, this entails an inclusion in income (depending on the presence of nondeductible contributions or the status as a Roth IRA) followed by a charitable contribution. Up to $108,000 from a plan of an owner at least 70 ½ years old may be excluded; to prevent a "double

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[258] PLR 2006320028. See also PLR 200839039 for extension granted for incorrect advice by enrolled agent.

deduction," such amounts excluded are not deductible by the owner as a charitable deduction. Technically, this provision was one that was regularly extended and expired, then extended again. However, it was again on the list of likely retroactive extenders in legislation, and permanently extended by PATH and preserved by TCJA. Such distributions are credited against the taxpayer's required minimum distributions for that year.

QCDs have become more attractive in recent years in light of increased standard deductions provided by the TCJA. Taxpayers who take the standard deduction cannot deduct charitable contributions, so QCDs can allow such individuals to still receive tax benefits for supporting an eligible charity or nonprofit entity of their choice.

Note:

PATH's permanent extension allows the taxpayer, in effect, an above-the-line charitable deduction because the taxpayer does not include it in income. In addition, it reduces the AGI of the taxpayer for NII tax purposes, which a below-the-line charitable deduction does not. It would also reduce the income tax on income at the taxpayer's highest tax bracket while a charitable deduction might, if the Administration's proposals on itemized deductions are enacted, be limited.

6. Retirement funds under the Bankruptcy Act

Under ERISA, the non-alienation provisions have generally been thought to preclude attachment by a creditor of the participant/beneficiary. The 2005 Bankruptcy Act now specifically treats as exempt the funds in a qualified plan,[259] IRA,[260] deferred compensation arrangements of a state, local government or tax-exempt organization[261] and certain tax-exempt trusts.[262] This exemption is available even if the debtor's state has opted out of the federal scheme. It is not necessary to show that the funds are necessary for the support of the debtor and dependents.

Note:

In the case of an IRA or Roth IRA, but not a SEP-IRA or a SIMPLE-IRA, the exemption is limited to $1,000,000 unless the interests of justice require a higher amount. Because no limit attaches to other exempt retirement funds, there may be additional reason to favor qualified plans or the SEP/SIMPLE over other structures.

An Ohio debtor distributed just under $40,000 from an IRA and deposited the after-tax proceeds into a business checking account. When filing for bankruptcy later in the year, the taxpayer claimed an exemption for the remaining amount of the distribution. Surprisingly, the court held that the remaining funds were exempt from bankruptcy even though they had been commingled with business funds.[263]

The U.S. Supreme Court case was less generous to the debtor.[264] An inherited IRA is a special case and therefore not entitled to the generous bankruptcy exemptions. Because the holder of the inherited IRA may never invest additional funds and those funds must be withdrawn without penalty and within a period that does not consider retirement age, the inherited IRA should not be treated like retirement funds.

This case governs only the 36 states that did not opt out of the federal bankruptcy guidelines.

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259 I.R.C. §§401 and 403.
260 I.R.C. §§408 (traditional) and 408A (Roth).
261 I.R.C. §457.
262 I.R.C. §501 (VEBAs, etc.).
263 *United States v. Karn*, Dkt. No. 13-62446-rk (N.D. Ohio, Aug. 4, 2014).
264 *Clark v. Rameker*, 134 S. Ct. 2242 (2014).

7. Self-certification procedure for a waiver of the 60-day rollover limit

The I.R.S. has provided a self-certification procedure designed to help recipients of retirement plan distributions who inadvertently miss the 60-day time limit for properly rolling these amounts into another retirement plan or IRA.[265] Eligible taxpayers, encountering a variety of mitigating circumstances, can qualify for a waiver of the 60-day time limit and avoid possible early distribution taxes. Normally, an eligible distribution from an IRA or workplace retirement plan can only qualify for tax-free rollover treatment if it is contributed to another IRA or workplace plan by the 60th day after it was received. In most cases, taxpayers who failed to meet the time limit could only obtain a waiver by requesting a private letter ruling from the IRS. Taxpayers who missed the time limit will now ordinarily qualify for a waiver if one or more of 11 circumstances, listed in the revenue procedure, apply to them. They are: (1) an error was committed by the financial institution receiving the contribution or making the distribution to which the contribution relates; (2) the distribution, having been made in the form of a check, was misplaced and never cashed; (3) the distribution was deposited into and remained in an account that the taxpayer mistakenly thought was an eligible retirement plan; (4) the taxpayer's principal residence was severely damaged; (5) a member of the taxpayer's family died; (6) the taxpayer or a member of the taxpayer's family was seriously ill; (7) the taxpayer was incarcerated; (8) restrictions were imposed by a foreign country; (9) a postal error occurred; (10) the distribution was made on account of a levy under §6331 and the proceeds of the levy have been returned to the taxpayer; or (11) the party making the distribution to which the rollover relates delayed providing information that the receiving plan or IRA required to complete the rollover despite the taxpayer's reasonable efforts to obtain the information. Another requirement is that the contribution must be made to the plan or IRA as soon as practicable after the reason or reasons (of the listed 11) no longer prevent taxpayer from making the contribution. This requirement is deemed to be satisfied if the contribution is made within 30 days after the reason or reasons no longer prevent taxpayer from making the contribution.

Ordinarily, the IRS and plan administrators and trustees will honor a taxpayer's self-certification that the taxpayer qualifies for a waiver under these circumstances. Moreover, even if a taxpayer does not self-certify, the IRS now has the authority to grant a waiver during a subsequent examination. It is important to remember that this self-certification is not a per se waiver by the IRS of the 60-day rollover requirement; however, a taxpayer may report the contribution as a valid rollover unless later informed otherwise by the IRS. In addition, the revenue procedure includes a sample self-certification letter that taxpayers can use to notify the administrator or trustee of the retirement plan or IRA receiving the rollover that they qualify for the waiver. The sample letter is replicated herein as follows.

[265] Rev. Proc. 2016-47.

Certification for Late Rollover Contribution

Name
Address
City, State, ZIP Code
Date: ____________________

Plan Administrator/Financial Institution
Address
City, State, ZIP Code

Dear Sir or Madam:

Pursuant to Internal Revenue Service Revenue Procedure 2016-47, I certify that my contribution of $ [*ENTER AMOUNT*] missed the 60-day rollover deadline for the reason(s) listed below under Reasons for Late Contribution. I am making this contribution as soon as practicable after the reason or reasons listed below no longer prevent me from making the contribution. I understand that this certification concerns only the 60-day requirement for a rollover and that, to complete the rollover, I must comply with all other tax law requirements for a valid rollover and with your rollover procedures.

Pursuant to Revenue Procedure 2016-47, unless you have actual knowledge to the contrary, you may rely on this certification to show that I have satisfied the conditions for a waiver of the 60-day rollover requirement for the amount identified above. You may not rely on this certification in determining whether the contribution satisfies other requirements for a valid rollover.

(1) Reasons for Late Contribution

I intended to make the rollover within 60 days after receiving the distribution but was unable to do so for the following reason(s) (check all that apply):

___ An error was committed by the financial institution making the distribution or receiving the contribution.
___ The distribution was in the form of a check and the check was misplaced and never cashed.
___The distribution was deposited into and remained in an account that I mistakenly thought was a retirement plan or IRA.
___ My principal residence was severely damaged.
___ One of my family members died.
___ I or one of my family members was seriously ill.
___ I was incarcerated.
___ Restrictions were imposed by a foreign country.
___ A postal error occurred.
___ The distribution was made on account of an IRS levy and the proceeds of the levy have been returned to me.

___ The party making the distribution delayed providing information that the receiving plan or IRA required to complete the rollover despite my reasonable efforts to obtain the information.

(2) Signature

I declare that the representations made in this document are true and that the IRS has not previously denied a request for a waiver of the 60-day rollover requirement with respect to a rollover of all or part of the distribution to which this contribution relates. I understand that in the event I am audited and the IRS does not grant a waiver for this contribution, I may be subject to income and excise taxes, interest, and penalties. If the contribution is made to an IRA, I understand you will be required to report the contribution to the IRS. I also understand that I should retain a copy of this signed certification with my tax records.

Signature: ______________________________

C. Minimum distributions in kind

1. In general

Owners of self-directed IRAs are permitted to take minimum distributions **in kind**. There may be an opportunity to withdraw from a traditional IRA the stock and securities that the owner wants to continue to own, with the income tax incurred being based on the depressed value.[266] Thus, particularly for taxpayers in low tax brackets for 2025, or those who are facing the specter of higher tax rates in the future on ordinary income, this may be seen as an opportunity to secure either capital gains treatment on the recovered appreciation if the securities are sold during the owner's lifetime, or a basis step-up if the securities are eventually sold by the heirs or the owner's estate. By contrast, if the stock were kept in the account: (a) it would be in the estate, but as an item of income in respect of a decedent not eligible for a basis step-up,[267] and (b) any distribution will be taxed at ordinary income tax rates; in the case where the owner takes a distribution now, only the depressed value will be taxed at such rates with post-distribution appreciation qualifying (with sufficient holding period) for taxation at more favorable rates than those applicable to ordinary income.

Note:

> These rules apply to any plan, IRA or qualified plan, whether self-directed or not. However, in a non-self-directed plan, the taxpayer is less likely to have knowledge of specific investments and may not know what the account portfolio is from day to day because the investment purchase/sell activities are controlled by the trustee. Because the strategy requires some knowledge by the taxpayer of the stock or security enough to want to retain it for at least 12 months, it is not generally practical in those circumstances although theoretically possible. For these purposes, reference will be made to a self-directed IRA, although it could also apply to a self-directed 401(k) plan as well.

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266 Treas. Regs. §1.402(a)-1(a)(1)(iii).
267 I.R.C. §691(a) and §1014(c).

Planning point:

The step-up in basis if the property is held until the owner's death, and capital-gain treatment if the property is sold during the owner's lifetime, may be more valuable than the tax deferral provided by the traditional retirement plan. This may be the time to voluntarily withdraw severely depressed securities that the taxpayer/owner wants to continue to hold for the long term.

The downside? The taxpayer accelerates the payment of income tax.

Note:

This could be tweaked in some cases by taking the capital gain and then repurchasing the stock or securities. This could reduce the capital-gains tax rate on a portion of the recovered value at a 15 percent or 0 percent tax rate, depending on the taxpayer's position.

2. Underlying assumptions

The value here depends on several of the implicit assumptions. First, it is assumed that the taxpayer will not be in a lower bracket at the time of a subsequent distribution. Second, it is assumed that the future tax rates on capital gains (and dividends) will be less than the future tax rates on ordinary income. Third, it is assumed that the taxpayer's gross estate would not exceed the amount covered by the unified credit or no estate tax would be in effect in the year of death, so that an analysis of the federal estate tax consequences could be omitted for purposes of simplicity.

Note:

A dividend, if paid, would represent an additional income item, whether received by the plan or the taxpayer. However, like capital gains, dividends received by the plan are not taxable when received, but only when distributed. When distributed, they lose their character, but are treated as deferred compensation taxable as ordinary income. By contrast, the taxpayer recognizes the dividends as such and experiences no character-transformation that increases the tax rate on such distributions.

- If the tax rates on dividends and capital gains are the same as the ordinary income tax rates, and the taxpayer sells the stock or securities during lifetime, it will make little (but negative) difference[268] whether the shares are withdrawn voluntarily in 2025, or the taxpayer waits and withdraws them at a future date when they are to be sold. If, however, the shares are to be held until death, the timing of the withdrawal does make a difference in the amount of taxes paid with respect to the shares. In that case, the distribution in 2025 would be indicated, realizing that the taxpayer is out of pocket the upfront taxes.
- If the future ordinary-income tax rate will be lower than the 2025 rate, it is advantageous to wait until the future year when the taxpayer has a lower ordinary-income tax rate. This would be undermined if the taxpayer dies before that future year because then the heirs would take the entire distribution out as ordinary income in respect of a decedent, perhaps at a higher income tax bracket than the presumed lower (than 2025) rate applicable to the taxpayer. This risk of a death earlier than hoped for would generally indicate that the 2025 withdrawal is worthwhile unless the taxpayer is insurable and could acquire life insurance in the amount of the tax loss that would be incurred on a premature death at a premium that would not eat up all of the potential tax savings; this seems unlikely in most cases because the taxpayer who otherwise would be required to take minimum distributions is at least 73 years old.

[268] The disadvantage arises in that part of the tax liability would have been accelerated from the later year to 2018.

D. Converting to a Roth IRA

1. To elect to convert, rollover, or designate, or not?

Roth contributions are made with after-tax dollars, so there is no upfront deduction for the participant/owner. The Roth account holding the contributions earns income and grows tax free, and the distributions (assumed, for convenience here and below, to be qualified distributions) are likewise tax free.

a. The choice between taking an upfront deduction, reducing current taxes, with a deferral of tax until distribution of amounts attributable to the pre-tax elective deferrals and taking the tax now on contributions in exchange for tax-free treatment when distributions of amounts attributable to the designated Roth contributions are made in the future is a complex one, requiring first an analysis of tax rates. If the participant expects to have lower tax rates now than when he or she retires and takes a distribution (if at all) from the retirement plan, then the participant is better off making Roth contributions.

Example: Donald, who is over 50, participates in a §401(k) plan with a qualified Roth program feature. He participates in the plan for five years and retires immediately following the end of the fifth year. In each of those years, Donald makes contributions of salary reductions to the plan of $24,500 (assumed to be the maximum in each of those years).

While he is participating in the plan, Donald's tax rate is 35 percent. Effective on the date of his retirement, the tax rate increased to 39.6 percent. At all times, Donald's contributions earn interest at 5 percent. The value of "money lost when taxes are paid," with hypothetical investment activity taking place outside of a tax-exempt trust and therefore requiring a lower return rate to take taxes into account, is computed at 3.25 percent.

If Donald elects to have all of his contributions treated as Roth contributions, at the end of his five years of participation, his Roth account balance would be $135,378, computed as follows (with some rounding):

End of year 1: $24,500.
End of year 2: $50,225 ($24,500 plus $24,500 times 1.05).
End of year 3: $77,236 ($24,500 plus $50,225 times 1.05).
End of year 4: $105,598 ($24,500 plus $77,236 times 1.05).
End of year 5: $135,378 ($24,500 plus $105,598 times 1.05).

At that time, the total value of the taxes Donald paid on the elective deferrals treated as Roth contributions would be $45,754, computed as follows (again with some rounding):

End of year 1: $8,575 (39.6% of $24,500).
End of year 2: $17,429 (39.6% of $24,500 plus $8,575 times 1.0325).
End of year 3: $26,570 (39.6% of $24,500 plus $17,429 times 1.0325).
End of year 4: $36,009 (39.6% of $24,500 plus $26,570 times 1.0325).
End of year 5: $45,754 (39.6% of $24,500 plus $36,009 times 1.0325).

Thus, the net value of Donald's Roth contributions and earnings would be $89,624 ($135,378 minus $45,754). On his retirement, the $135,378 amount in the plan may be distributed to Donald tax free. The taxes on the annual contributions of $24,500 have already been paid.

If Donald elects to have all of his contributions treated as pre-tax elective deferrals, at the end of his five years of participation his plan account balance also would be $135,378, computed as above. If this amount is distributed to Donald, however, the distribution is taxable, so that -- due to the taxes he must pay at the 39.6 percent rate -- Donald would be left with $81,227 ($135,378 minus 39.6 percent of $135,378). Here, Donald would have been better off making Roth contributions.

But suppose that, on the date of his retirement, Donald's tax rate dropped to 30 percent. The net value of Donald's Roth contributions (if he had made them) still would be $89,624, but the amount remaining after a distribution of the amounts attributable to Donald's pre-tax elective deferrals (if he had made them) would now be $94,765 ($135,378 minus 30 percent of $135,378). In this case, Donald would have been better off making the pre-tax elective deferrals. If the tax rate had stayed at 35 percent, the amount remaining after a distribution of Donald's pre-tax elective deferrals would be about $87,996 ($135,378 minus 35 percent of $135,378, with rounding), so Donald still would have been better off with Roth contributions.

The "break even" tax rate in this example, at which Roth contributions or pre-tax elective deferrals would yield the same result, is about 33.8 percent ($45,754/$135,378).

Planning point:

The enactment of the SECURE Act will likely cause an increase in the number of Roth IRA conversions. Under the new legislation, many beneficiaries could face substantial tax consequences due to the requirement that inherited IRA balances must be distributed within 10 years of the original account holder's death. In the case of traditional IRAs, even spreading distributions over 10 years will cause a substantial increase in tax.

One key planning strategy is for IRA account holders to convert existing traditional IRAs into Roth IRAs. Current individual tax rates are historically low, making it an excellent time for traditional IRA account holders to make the Roth conversion. Roth conversions can be spread over multiple years. While Roth IRAs are still required to be distributed within 10 years, it eliminates the income tax burden of the beneficiary. In addition, beneficiaries who inherit a Roth IRA can still take advantage of tax-free growth for 10 years and distribute the entire Roth IRA balance in the 10th year from the original account holder's death.

Planning point:

In an environment where the rates are rising, for those whose post-retirement income is approximately that of the pre-retirement income, the conversion to a Roth account is indicated. Rates may never be lower than they are right now. The TCJA gives taxpayers the opportunity to convert traditional IRAs to Roths at a lower rate than we have enjoyed in years. Conversions could be done over more than one year to take advantage of lower tax brackets.

Many taxpayers find themselves with higher taxable income than they had pre-retirement even though gross income has declined as a result of the reduction in tax deductions for mortgage interest, dependent exemptions, etc., while having higher expenditures in healthcare that are not fully (and increasingly less) deductible.

b. The power of tax-free (not just deferred) compounding is enhanced the longer the accumulation phase (when the participant is continuing to make designations but not yet receiving distributions). The possibility of accruing large account balance that may be distributed without incurring income tax (or certain other tax consequences) may incentivize an employee to make Roth contributions.

Example: Assume now in the above example, that Donald was age 50 initially and makes a $24,500 contribution to his Roth account in each of 21 years until he reaches age 70. The rate of earnings is 5 percent through the end of the fifth year, then, through prudent investment and considering that the account's earnings are not taxed, the earning rate increases to 8 percent through the end of year 21. Minimum required distributions need not be made during the accumulation phase. At the end of year 21, his Roth account balance would be approximately $1,206,742. This amount is computed as follows (with rounding):

End of year 5: $135,378.
End of year 6: $170,708 ($24,500 plus $135,378 times 1.08).
End of year 7: $208,865 ($24,500 plus $170,708 times 1.08).
End of year 8: $250,074 ($24,500 plus $208,865 times 1.08).
End of year 9: $294,580 ($24,500 plus $250,074 times 1.08).
End of year 10: $342,646 ($24,500 plus $294,580 times 1.08).
End of year 11: $394,558 ($24,500 plus $342,646 times 1.08).
End of year 12: $450,623 ($24,500 plus $394,558 times 1.08).
End of year 13: $511,173 ($24,500 plus $450,623 times 1.08).
End of year 14: $576,566 ($24,500 plus $511,173 times 1.08).
End of year 15: $647,192 ($24,500 plus $576,566 times 1.08).
End of year 16: $723,467 ($24,500 plus $647,192 times 1.08).
End of year 17: $805,844 ($24,500 plus $723,467 times 1.08).
End of year 18: $894,812 ($24,500 plus $805,844 times 1.08).
End of year 19: $990,897 ($24,500 plus $894,812 times 1.08).
End of year 20: $1,094,669 ($24,500 plus $990,897 times 1.08).
End of year 21: $1,206,742 ($24,500 plus $1,094,669 times 1.08).

c. While required minimum distributions are required from a qualified plan, whether elective deferrals or designated Roth contributions, only amounts from the Roth account may be distributed and rolled over to a Roth IRA. This can turn off the required minimum distributions until the participant dies.

d. As noted, Roth distributions will not add to AGI for purposes if the net investment income tax applies. For lower-income taxpayers, the Roth distribution will not increase the MAGI for purposes of determining whether and to what extent Social Security benefits are included in gross income. However, MAGI is increased for interest from tax-exempt bonds.

e. In light of the recent economic downturn, it may be especially advantageous for taxpayers to convert a traditional IRA to a Roth IRA. If the taxpayer's assets in their traditional IRA have decreased in value or if they have an NOL, the taxpayer may offset ordinary income generated from the conversion.

2. Room in the bracket?

Individuals who are near the bottom of their bracket (assumed to be not above 24 percent) with a traditional IRA should consider taking advantage of their bracket position by limiting the taxation on a sequence of conversions to a Roth IRA. Later when the taxpayer is in more constrained circumstances, he or she may not be able to take these steps without subjecting himself or herself to increased MAGI that could trigger the Medicare tax. The taxpayer does not have to convert all of the IRA in one year but can convert a portion of the IRA sufficient to produce a satisfactory tax result. This may allow the taxpayer over time to set the stage to avoid completely or substantially required minimum distributions that would otherwise apply.

Note:

Another planning reason for conversion of traditional IRA to Roth IRA or establishing Roth vehicles is independent of the Medicare tax. The medical deduction has a 7.5 percent of AGI haircut, so the higher a taxpayer's AGI, the less of the total medical expenditures are deductible. As noted elsewhere, while distributions from a qualified plan or IRA are not investment income, they increase the taxpayer's AGI and at the same time disallow generally more medical expense deductions. Because the conversion increases AGI, to the extent possible, it should take place in a year in which the taxpayer has little or no deductible (determined after the haircut) medical expenditures; alternatively, discretionary surgery or medical procedures should be delayed until the year following the year of conversion.

3. So why?

Planning point:

The reason for having, or converting to, a Roth IRA is to eliminate future income taxation of distributions coming from the IRA whether to the owner or a subsequent beneficiary until the account is exhausted. This comes at an upfront cost either because the conversion triggers an income inclusion as discussed below, or because a contribution, whether a nondeductible contribution to a traditional IRA or a contribution to a Roth IRA,[269] is after-tax. In general, the upfront cost makes sense when a taxpayer anticipates being in a higher tax bracket when distributions are taken than when contributions or conversions take place; it makes no sense if the taxpayer will be in a lower bracket when distributions are made than when the contributions or conversions occur; and it is a matter of indifference from a tax perspective if the future rates are expected to be the same.[270] The increase in tax rates makes the first alternative more likely for many taxpayers.

The Roth supports avoidance or mitigation of the new tax on net investment income by producing cash flow that is neither investment income nor income included in adjusted gross income.

Converting to the Roth may also mitigate or eliminate the tax effects at the death of a married owner. Required minimum distributions in a traditional IRA do not significantly change in most cases where the spouse is the beneficiary. But since the spouse is, after the two years following the death of the owner, a single taxpayer, the tax imposed on the same amount of distribution will be considerably higher than it is for a married individual. A Roth conversion can serve to remove the additional income taxes that would be paid on the death of the owner by making the conversion at a time when the joint filing tax rates are available.

In addition, the required minimum distribution rules do not apply to a Roth IRA. Note that the SECURE Act 10-year distribution rule applies to all beneficiaries other than eligible designated

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269 Unlike a nondeductible contribution to a traditional IRA, a contribution to a Roth IRA is subject to AGI limitations and phase outs, precluding many high-end taxpayers from making such contributions. Conversely, nothing precludes a taxpayer to make a nondeductible contribution to a traditional IRA, and then convert that traditional IRA to a Roth.

270 This is not exactly true; to some extent being in a slightly lower tax bracket in the future can still make the Roth conversion advantageous.

beneficiaries, who are eligible to withdraw inherited IRAs over their life expectancy, bypassing the 10-year rule.

a. Robert S. Keebler, CPA, has written a number of insightful articles related to the planning and tax issues of conversions[271] and with Stephen J. Bigge[272], identified seven circumstances when someone should consider converting to a Roth IRA:
   (i) To take advantage of favorable tax attributes such as charitable deductions carry-forwards, net operating loss (NOL) carry-forwards, investment tax credits, etc.;
   (ii) Suspension of the required minimum distribution (RMD) rules during the lifetime of the converting taxpayer;
   (iii) Payment of income tax prior to the imposition of estate tax permits greater wealth to be transferred to future generations (due to the fact that no income-tax deduction is allowed for state death taxes levied on IRAs);
   (iv) Greater growth potential, to the extent that outside sources (i.e., taxable brokerage account) are used to pay for the taxes due on the Roth IRA conversion;
   (v) To better utilize an IRA owner's applicable exclusions amount;
   (vi) To effectively reduce the taxable estate of the IRA owner; and
   (vii) To hedge against a projected increase in tax rates when a first spouse dies.

b. Roth IRAs have their greatest attraction to those who do not need to withdraw any funds from their IRAs during life, especially those who expect to live well beyond the average life expectancy due to their gender, genetic heritage, and/or health. A traditional IRA participant approaching age 73 is required to take distributions that will substantially diminish if not eliminate the account over a long life span.

Planning point:

One of the factors influencing the conversion decision is the availability of assets outside the IRA to pay the income-tax liability resulting from the conversion. The reason is obvious: if the taxes are paid from the IRA itself, the amount that remains qualified for tax-deferred compounding declines. To be sure, the individual is out the outside funds so applied together with the earnings on those funds, but the outside fund compounds only on an after-tax basis, while the additional amounts within the Roth IRA compound on a pretax basis.

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271 "A CPA's Guide to Making the Most of the New IRAs" for the American Institute for Certified Public Accountants (1997). Other articles on conversions by Robert Keebler include:
- "Using Roth IRA Distributions to Mitigate Income Taxes and Enhance Overall Wealth," Part I (Feb 2010) and Part II (Apr 2010), Family Tax Planning Forum, *Taxes -- The Tax Magazine*;
- "Navigating the "Bermuda Triangle" of IRAs -- Nonqualified Roth IRA Distributions," Family Tax Planning Forum, *Taxes -- The Tax Magazine* (Feb 2008);
- "Deciphering the Roth IRA Conversion Enigma," Family Tax Planning Forum, *Taxes -- The Tax Magazine* (June 2004);
- "A Tax Alchemist's Paradise in a Post-"Pension Rescue" World -- A Mathematical Perspective," Family Tax Planning Forum, *Taxes -- The Tax Magazine* (April 2004);
- "Roth Segregation Conversion Strategy," Family Tax Planning Forum, *Taxes -- The Tax Magazine* (June 2003).

272 "To Convert or Not to Convert, That Is the Question," Family Tax Planning Forum, *Taxes -- The Tax Magazine* (Oct 2008). This is discussed in greater detail.

Caution:

One kind of taxpayer who should be careful is someone whose tax bracket is higher now than the taxpayer's (or the taxpayer's heirs') tax bracket is likely to be whenever the IRA money will be spent. If the marginal tax rate when making a contribution is higher than the rate that will be applied to the distributions -- the typical scenario for most individuals -- then conventional IRAs and other deductible pensions offer a more tax-advantaged investment environment than does a Roth IRA. The tax loss would become a tax gain if the incremental tax on the conversion income were less than the tax on the pension without conversion. Nevertheless, some may wish to consider conversion of some part of the traditional IRA as a hedge against potential income-tax changes. On the other hand, small business owners who plan to sell upon retirement, investors with substantially appreciated portfolios, and someone with a multimillion-dollar pension plan or an inheritance could see their tax rate go up in retirement if their current income corresponds to a 28-percent-or-lower federal tax bracket. With the enactment of the SECURE Act, designating beneficiaries and projecting future distributions is a necessary planning strategy.

Additional Considerations:

Despite efforts from President Biden and Congressional Democrats, the *Build Back Better Act (BBBA)* was not passed in 2021. Included in the BBBA was a proposal to eliminate traditional IRA to Roth IRA conversions for "applicable taxpayers," defined as those whose adjusted taxable income for the taxable year exceeded:

- $450,000 for Married and Filing a Joint Return or Surviving Spouse;
- $425,000 for Head of Household; and
- $400,000 for Single or Married Filing Separately.

Under the BBBA, applicable taxpayers would no longer be able to convert non-Roth funds in §401(k), §403(b), and §457(b) plans to a designated Roth account for distributions, transfers, and contributions made in tax years beginning after December 31, 2031. Additionally, the BBBA proposed prohibiting all after-tax amounts held in non-Roth accounts in an employer-sponsored retirement plan or a traditional IRA from being converted to a Roth IRA or a designated Roth account for distributions, transfers, and contributions made after December 31, 2021, for all taxpayers, regardless of income level.

While backdoor and mega backdoor Roth strategies survive another year, it is uncertain how long these strategies will remain viable. It is certainly possible that future legislation could once again try to eliminate these strategies, and it is important to keep this possibility in mind when advising clients.

4. Younger generation members

Although college is the first consideration the sandwich or older generation has, after medical and other support items, with respect to the younger generation member, one should not discount the value of tax-exempt compound interest and its effect on establishing a retirement fund. And the first consideration there is a Roth IRA (in some rare cases a Roth contribution program). The tax benefits of a Roth IRA for of a younger generation member are enhanced because the member will pay taxes on the contributions at a presumably low tax rate (remember the kiddie tax does not apply to earned income); withdrawals are tax-free so the younger generation has a large tax-free benefit in their later years without regard to their tax situation at that time. This will also enable such members to reap the benefits of investments without a net investment income tax bite: not only are the distributions not investment income (although derived from investments) but are also tax-free, so they do not add to the member's AGI at the time of the withdrawals.

Note:

> The magic of tax-free compounding is clearly demonstrated by comparing what happens when there are twins, the first of whom contributes $2,000 in each year at ages 18, 19, 20, and 21, and the second of whom contributes $2,000 in each year at ages 26 through 65. Each makes his contribution on the first day of such year and the investment is in mutual funds with a historical (and actually realized) return of 12 percent. At the end of the year the twins reach age 65, the first twin's account balance is $1,567,501.09, while his brother's balance is $1,532,184.26. The twin who makes just four annual $2,000 contributions beginning at age 18 will accumulate over $35,000 more than his twin who makes 40 annual $2,000 contributions starting at age 26! As the presumed rate of return declines, the second twin can catch up in a shorter period of time -- at 8 percent, the crossover occurs at age 65 if the second twin begins his savings program at age 34.

a. If the older generation and/or the sandwich generation help younger generation members start a Roth IRA in their teenage years, it will provide substantial benefits in the future. There are some practical limitations associated with doing so. To be eligible for funding any IRA, the younger generation must have earned income, which presupposes an employment relationship, which in turn assumes the younger generation member can be an employee. This fits in with other discussions regarding the benefits of hiring younger generation members for income-shifting and income-splitting purposes.

b. A transfer to the younger generation is not earned income unless there is a basis for associating the transfer with services performed and that the mutual transfers are reasonably close in value. If the amount of cash given to the younger generation exceeds the value of the services, the excess is a gift and the amount of earned income cannot exceed the value of the child's services. As with any transaction involving related parties, arrangements between the younger generation and family members will be carefully scrutinized.

c. The amount that can be transferred by the younger generation cannot exceed the amount of the earned income of that younger generation member.

Planning point:

> Another potential application is the establishment of a Roth IRA for a younger generation member. However, since a Roth IRA is an individual retirement account, the younger generation member must have earned income to the extent of the contribution. The taxpayer may obtain double duty from hiring the child in the business to the extent of making justifiable deductible compensation.
>
> The contribution to a Roth reduces the taxpayer's adjusted gross income for purposes of clearing the AGI phase-out hurdles so that the taxpayer may make contributions to the taxpayer's own Roth IRA, while at the same time creating earned income permitting the taxpayer's child to make nondeductible contributions to the child's Roth IRA.

Caution:

> While the advantages of a Roth vehicle may seem obvious, there are nonetheless real problems in establishing one. Once a younger generation member reaches the age of majority for their state, the Roth IRA will no longer be a custodial account over which the sandwich or older generation can exercise bridling control. The younger generation may withdraw all of it immediately (or at least well before retirement) and dissipate the funds on extravagances.

E. Health Savings Accounts (HSAs)

1. In general

The Medicare Act of 2003 established a new tax-favored vehicle, the Health Savings Account (HSA) that permits 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.[273] This deduction is taken above-the-line in determining adjusted gross income.[274]

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.[275]

(i) The limit on the annual deductible contributions that can be made to an HSA is modified so that the maximum deductible contribution is not limited to the annual deductible under the high-deductible health plan. Thus, under the provision, the **maximum aggregate annual contribution** that can be made to an HSA is **$4,300** in 2025[276] in the case of self-only coverage; and **$8,550** for 2025 in the case of family coverage.[277]

(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.[278] The **additional contribution amount** is the amount determined in accordance with the following table.[279]

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;[280] 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.[281] The aggregate amount paid for such taxable year to Archer

273 I.R.C. §223(a).
274 I.R.C. §62(19).
275 I.R.C. §223(b)(1).
276 Rev. Proc. 2024-25.
277 Rev. Proc. 2024-25.
278 I.R.C. §223(b)(3)(A).
279 I.R.C. §223(b)(3)(B).
280 I.R.C. §223(b)(4)(A).
281 I.R.C. §223(b)(4)(B).

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 (a) 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),[282] and (b) 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.[283]

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.[284]

b. An individual is not an eligible individual if the individual has coverage under a general purpose health FSA or HRA.[285] Thus, for example, if the health FSA or HRA from which the contribution is made is a general-purpose health FSA or HRA and the individual remains eligible under such arrangement after the distribution and contribution, the individual is not an eligible individual.

2. What is an HSA?

The term health savings account means a trust created or organized in the United States as a health savings account exclusively for the purpose of paying the qualified medical expenses of the account beneficiary, but only if the written governing instrument creating the trust meets the following requirements.[286]

a. Except in the case of a rollover contribution, no contribution will be accepted:

(i) Unless it is in cash; or

(ii) To the extent such contribution, when added to previous contributions to the trust for the calendar year, exceeds the sum of --

- The dollar limitation applicable to family coverage, and
- The additional contribution dollar amount in effect.

b. The trustee is a bank, an insurance company, or another person who demonstrates to the satisfaction of the Secretary that the manner in which such person will administer the trust will be consistent with the requirements of this section.

c. No part of the trust assets will be invested in life insurance contracts.

d. The assets of the trust will not be commingled with other property except in a common trust fund or common investment fund.

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282 I.R.C. §223(b)(5)(A).
283 I.R.C. §223(b)(6).
284 I.R.C. §223(b)(7).
285 I.R.C. §106(e)(4)(B).
286 I.R.C. §223(d)(1).

e. The interest of an individual in the balance in his or her account is nonforfeitable.

3. Eligible individual

The term 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 benefit that is covered under the high-deductible health plan.[287]

Note:

> Regard is given neither to coverage for any benefit provided by permitted insurance, nor to coverage (whether through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care.[288]

Planning point:

> The Service has ruled that if the taxpayer's spouse is covered by a non-HDHP, the taxpayer will be ineligible for an HSA unless he or she is NOT covered under the spouse's plan.[289]

a. The term high-deductible health plan means a health plan:[290]

(i) That has an annual deductible that is not less than $1,650 for self-only coverage, and twice that dollar amount for family coverage; and[291]

(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 for self-only coverage, and twice that dollar amount for family coverage.[292]

(iii) 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.[293]

(iv) 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). [294]

(v) Notice 2020-15 addressed the usage of High Deductible Health Plans (HDHPs) and HSAs in relation to 2019 Novel Coronavirus (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. Notice 2020-15 applies only to HSA-eligible HDHPs.

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287 I.R.C. §223(c)(1)(A).
288 I.R.C. §223(c)(1)(B).
289 Rev. Rul. 2005-25, 2005.
290 I.R.C. §223(c)(2)(A).
291 Rev. Proc. 2023-23.
292 Rev. Proc. 2023-23.
293 I.R.C. §223(c)(2)(B).
294 I.R.C. §223(c)(2)(C).

Note:

> In the case of a plan using a network of providers, the plan does not fail to be treated as a high-deductible health plan by reason of having an out-of-pocket limitation for services provided outside of such network, which exceeds the applicable limitation. Furthermore, the plan's annual deductible for services provided outside of such network is not taken into account for purposes of determining monthly limitations.

b. The term **permitted insurance** means:[295]
   (i) Insurance if substantially all of the coverage provided under such insurance relates to --
   - Liabilities incurred under workers' compensation laws,
   - Tort liabilities,
   - Liabilities relating to ownership or use of property, or
   - Such other similar liabilities as the Secretary may specify by regulations;

   (ii) Insurance for a specified disease or illness; and
   (iii) Insurance paying a fixed amount per day (or other period) of hospitalization.

c. The term **family coverage** means any coverage other than self-only coverage.[296]

d. The term **Archer MSA** has the meaning given such term in §220(d).[297]

4. Tax treatment of accounts

A health savings account is exempt from income taxation unless such account has ceased to be a health savings account. Notwithstanding the preceding sentence, any such account is subject to the tax on unrelated business income of charitable, etc., organizations.[298]

a. If, during any taxable year of the individual for whose benefit any HSA is established, that individual or his or her beneficiary engages in any transaction prohibited by §4975 with respect to such account, such account ceases to be a health savings account as of the first day of such taxable year. For these purposes, the individual for whose benefit any account was established is treated as the creator of such account, and the separate account for any individual within a health savings account maintained by an employer or association of employees is treated as a separate health savings account.[299]

b. If, during any taxable year of the individual for whose benefit a health savings account is established, that individual uses the account or any portion thereof as security for a loan, the portion so used is treated as distributed to that individual. In any case in which any account ceases to be a health savings account by reason of the preceding paragraph as of the first day of any taxable year, there is a deemed distribution on such first day in an amount equal to the fair market value (on such first day) of all assets in the account (on such first day).[300]

c. Any amount treated as distributed under the above rules are treated as not used to pay qualified medical expenses.

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295 I.R.C. §223(c)(3).
296 I.R.C. §223(c)(4).
297 I.R.C. §223(c)(5).
298 I.R.C. §223(e)(1).
299 I.R.C. §223(e)(2).
300 I.R.C. §223(e)(2).

5. Tax treatment of distributions

Any amount paid or distributed out of a health savings account that is used exclusively to pay qualified medical expenses of any account beneficiary is not includable in gross income.[301] However, any amount paid or distributed out of a health savings account that is not used exclusively to pay the qualified medical expenses of the account beneficiary shall be included in the gross income of such beneficiary.[302]

Caution:

> Just because a person can receive insurance coverage tax-free under an employer-provided plan does not mean that such persons can receive distributions from an HSA tax-free. The reason is that the definition of a dependent differs depending on whether the plan is employer-provided, and an HSA is not. In the case of an employer-provided plan (i.e., the HDHP), the definition of a dependent in the case of a qualifying relative is determined without regard to the gross income limitation, while the HSA takes the entire definition. Thus, while a child age 25 (for whom the taxpayer provides more than half of the support) having gross income of $5,050 from the HDHP would be treated as a dependent for those purposes, that same child would not qualify as a dependent for purposes of distributions from the HSA for medical expenses because they would not have been used for qualifying medical expenses.

a. There is an important exception to the inclusion rule stated in the above paragraph. If any **excess contribution** is contributed for a taxable year to any health savings account of an individual, distributions from the health savings accounts of such individual (to the extent such distributions do not exceed the aggregate excess contributions to all such accounts of such individual for such year) are not included in gross income if:
   (i) Such distribution is received by the individual on or before the last day prescribed by law (including extensions of time) for filing such individual's return for such taxable year;[303] and
   (ii) Such distribution is accompanied by the amount of net income attributable to such excess contribution. Any net income described in clause (ii) shall be included in the gross income of the individual for the taxable year in which it is received.[304]
   (iii) For these purposes, the term **excess contribution** means any contribution (other than a rollover contribution), which is neither excludable from gross income under §106(d) nor deductible.

b. The income tax imposed on the account beneficiary for any taxable year in which there is a payment or distribution from a health savings account of such beneficiary that is includable in gross income is increased by 10 percent of the amount that is so includable.[305] This additional tax does not apply:
   (i) If the payment or distribution is made after the account beneficiary becomes disabled or dies;[306] or
   (ii) To any payment or distribution after the date on which the account beneficiary attains the age specified in §1811 of the Social Security Act for Medicare eligibility.[307]

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301 I.R.C. §223(f)(1).
302 I.R.C. §223(f)(2).
303 I.R.C. §223(f)(3)(A)(i).
304 I.R.C. §223(f)(3)(A)(ii).
305 I.R.C. §223(f)(4)(A).
306 I.R.C. §223(f)(4)(B).
307 I.R.C. §223(f)(4)(C).

Note:

> For purposes of determining the amount of the deduction under §213, any payment or distribution out of a health savings account for qualified medical expenses shall not be treated as an expense paid for medical care.[308]

F. Social security distribution planning

1. In general

Social Security is a lifetime annuity (or joint and survivor annuity), that (i) has flexible beginning dates; and (ii) has differing amounts depending on the start dates. If we determine these at different start dates and add both a discount factor and annuity (life-expectancy) factors, we can determine the present values of each. While a present value is not as accurate as an actuarial valuation, it is still a relevant metric for making a decision. This methodology is applied in these materials. It is also noted that the numbers developed must be tempered by the fact that other considerations, such as need, may make the answers moot.

a. The time to claim and receive benefits depends on:
   - Age;
   - Gender;
   - Health;
   - Tax-rate; and
   - Rate of return.

Note:

> A fully insured individual, as noted earlier, means any individual who had not less than forty quarters of coverage if:
> - The individual has reached **age 62**; and
> - The individual has **filed an application** for such benefits.
>
> This means that someone cannot generally claim retirement benefits before reaching age 62, the **earliest date** when a claim for such benefits can be made. However, a fully insured individual does not claim benefits merely by reaching age 62. An individual must make an affirmative application for benefits.

b. The IRS and Department of Treasury issued proposed regulations (REG-132210-18) on November 8, 2019, in response to Executive Order 13847, 83 FR 45321 signed on August 31, 2019. The Executive Order directs the Secretary of the Treasury to examine the life expectancy and distribution period tables in the regulations on required minimum distributions from retirement plans and determine whether they should be updated to reflect current mortality data and whether such updates should be made annually or on another periodic basis. The new proposed regs were a result of the Department of Treasury and IRS review of available mortality data, as they determined that the tables should be updated to reflect current life expectancies. The life expectancy tables and applicable distribution period tables in the proposed regs reflect longer life expectancies than those in the existing regs, published in final form in 2002. The revised RMD factors will be used to calculate RMDs and affect the three different life expectancy tables, including:

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[308] I.R.C. §223(f)(6).

(i) **The Uniform Lifetime Table**: This table is used by most retirement account owners and is used to calculate their RMDs during their lives.

(ii) **The Joint Life and Last Survivor Expectancy Table**: This table is used to calculate RMDs of account owners who have named a spousal beneficiary who is more than 10 years younger.

(iii) **The Single Life Expectancy Table**: This table is used by eligible designated beneficiaries of inherited retirement accounts to calculate their distributions.

- Per the SECURE Act, eligible designated beneficiaries are spouses, disabled or chronically ill individuals, minor children, or a beneficiary who is not more than 10 years younger than the account owner.

If finalized, the proposed regs would have applied for distribution calendar years beginning on or after January 1, 2021. At a January 23 IRS hearing on the proposed regs, the American Retirement Association ("ARA") voiced concerns about the proposed regs' effective date due to the passage of the SECURE Act in December 2019. The ARA supported the updated mortality tables but was concerned about the lack of synchronization between the SECURE Act and the proposed regs. The SECURE Act's effective dates preceded the proposed regs' effective date, and it was not clear how the proposed regs could be finalized without taking into consideration the SECURE Act changes. At the hearing, Harlan Weller, senior actuary, Treasury Office of Benefits Tax Counsel, suggested delaying the proposed regs in order to coordinate with SECURE Act guidance.

Final regs (T.D. 9930) were ultimately released on November 5, 2020, adopting the proposed regulations with some changes, including delaying the effective date by one year. Consistent with the proposed regulations, the final regulations reflect longer life expectancies than those in the existing regs. As such, individuals will be able to take smaller RMDs and retain more in their retirement accounts. These final regs apply for distribution calendar years beginning after December 31, 2021.

c. For a single individual who was never married (and thus not entitled to a spousal benefit), deciding when to retire from a financial perspective is a question of whether the individual is better off taking approximately 75 percent of the primary insurance amount (PIA) at 62 or waiting to get 100 percent at the full retirement age (FRA), or receiving in excess of 100 percent by delaying a claim for retirement benefits past the FRA.

Note:

This is all that is involved in the case of a single individual, but matters are more complicated for a married individual who is subject to the same choices and consequences above and has additional considerations as well.

(i) By claiming benefits early, the worker will receive a greater number of payments than the FRA situation as the lifetime stream starts earlier than the FRA. However, the amount of the individual's monthly benefit is further reduced if the monthly earnings for a month between age 62 and FRA exceed a dollar limitation, currently $1,950.[309] To the extent the individual has earned income in

[309] 2025 Cost of Living Fact Sheet, www.SSA.gov.

excess of this amount, the monthly benefit otherwise receivable by the individual is reduced $1 for every two such dollars.

(ii) By taking benefits at FRA, the individual receives higher payments than the payments that are received by those claiming the benefits before FRA. Full benefits are computed for Full Retirement Age and then reduced for the number of months prior to FRA the benefits are claimed.

- If a taxpayer's full retirement age is 67, and his monthly benefit starting at FRA is $2,000, if he starts collecting benefits at age 62, his monthly benefit is reduced by 30% to $1,400 to account for the longer amount of time that benefits will be received. This reduction in benefits is typically permanent.
- Alternately, if the taxpayer delays receiving benefits until age 70, his monthly benefit would increase to $2,480 due to the result of delayed retirement credits.
- Such taxpayer described in the two preceding bullet points would receive an additional $1,080 per month (77% more) if he delays his benefits until age 70.

Note:

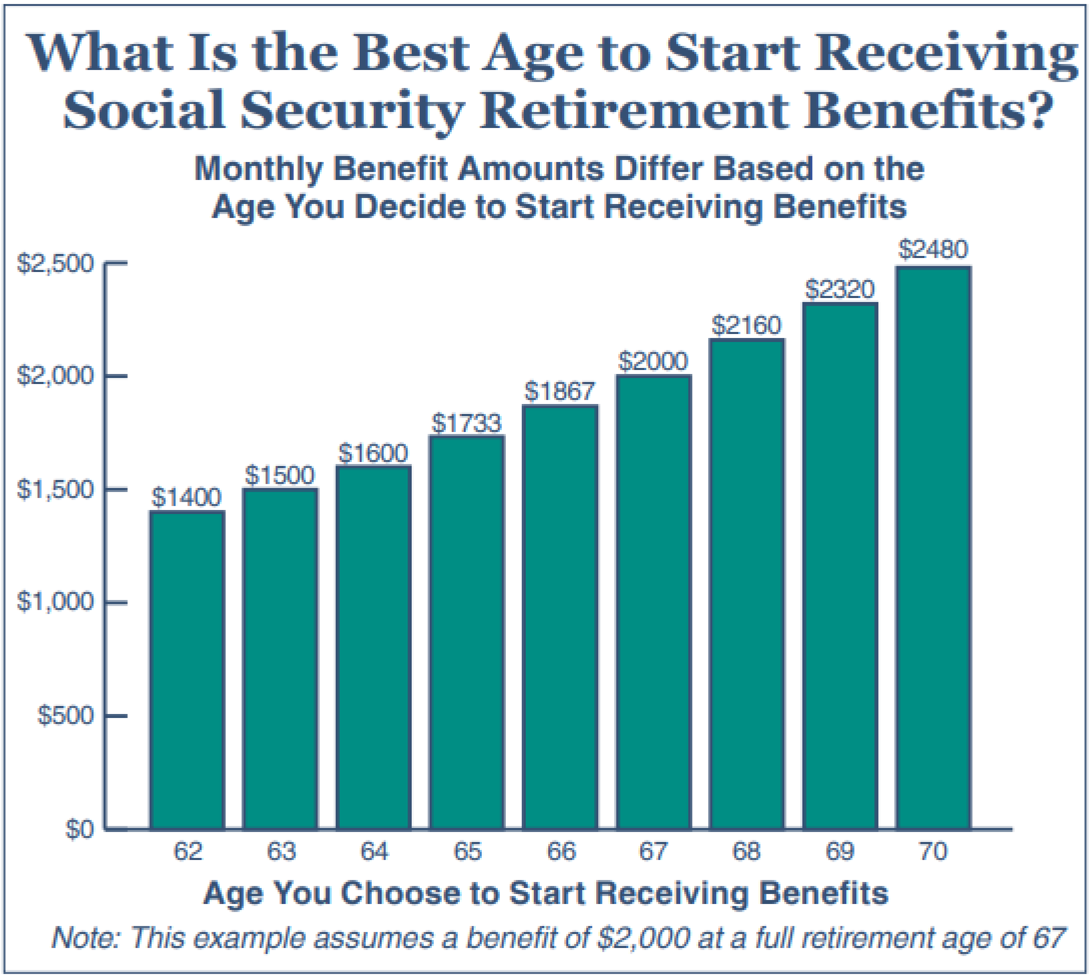
Generally, the present value of full retirement payments commencing at age 66 years will not equal the present value of reduced retirement benefits commencing at age 62 until many years in the future.

d. A worker can earn a delayed retirement credit (DRC) for any month beginning with the month of attainment of FRA and ending with the month before attainment of age 70. Each credit is referred to as an increment month. An increment month is granted for any month in that period for which:

(i) The worker was insured but benefits were not paid because an application was not filed; or

(ii) Benefits were due but the worker elected to have the benefit voluntarily suspended in order to earn DRCs.

e. Conversely, by claiming benefits late, the worker will receive fewer payments than the FRA situation as the lifetime stream starts later than the FRA. Currently, if the worker delays collection past FRA, the full benefits are increased 2/3 percent for the number of months after FRA the benefits are claimed. This is 8 percent annually: in addition, the accrual of credits also is adjusted for inflation by the COLAs applied to FRA benefits.



[310]

[310] 2025 When to Start Receiving Retirement Benefits, www.SSA.gov.

Age to Receive Full Social Security Benefits

Year of Birth	Full Retirement Age (FRA)	Year the Individual Attains Age 62	Year the Individual Attains FRA
1937 or earlier	65	1999 or earlier	2002 or earlier
1938	65 and 2 months	2000	2003 or 2004
1939	65 and 4 months	2001	2004 or 2005
1940	65 and 6 months	2002	2005 or 2006
1941	65 and 8 months	2003	2006 or 2007
1942	65 and 10 months	2004	2007 or 2008
1943-1954	66	2005-2016	2009-2020
1955	66 and 2 months	2017	2021 or 2022
1956	66 and 4 months	2018	2022 or 2023
1957	66 and 6 months	2019	2023 or 2024
1958	66 and 8 months	2020	2024 or 2025
1959	66 and 10 months	2021	2025 or 2026
1960 or later	67	2022 or later	2027 or later

Source: Social Security Administration, https://www.ssa.gov/planners/retire/retirechart.html.

Note: Persons born on January 1 of any year should refer to the previous year of birth. [311]

Planning point:

While not important to a single individual, a deceased worker's DRCs will be used to increase survivor benefits (discussed later) to the widow(er), but not spousal benefits.

2. When to retire?

Should a prospective retiree retire at age 62 or 66 years? As noted, the monthly retirement prior to normal retirement age is reduced by a percentage for each month, so a 48-month early retirement (at age 62) reduces the monthly payment by 25 percent for someone with an FRA of 66 years. Some people decide to continue working full-time beyond retirement age. In that case, people can increase their Social Security benefit in two ways:

- Each additional year a person works adds another year of earnings to his or her Social Security record, which can have the effect of increasing the individual's full retirement age benefit (except, for all intents and purposes, those who have already maxed out benefits by having maximum taxable wages for 35 years); and
- Higher lifetime earnings may result in higher benefits when one retires. As noted above, a person's benefit will be increased by a certain percentage (DRCs) if he/she delays claiming retirement benefits. These increases will be added in automatically from the time an individual reaches full retirement age until that individual starts taking benefits or reaches age 70.

Note:

As the preceding has indicated, a participant (and a spouse, as discussed below) may choose to take Social Security benefits along a continuum stretching from age 62 to age 70. Baby boomers are now approaching the middle bound of this range and are faced, in many cases, with an election that should be the result of an assessment of needs and a financial assessment.

[311] Congressional Research Service, *The Social Security Retirement Age.* Updated January 8, 2021.

3. *Effect of claiming benefits*

In the case of a single worker who was never married, the choice essentially boils down to determining which annuity starting date for a single-life annuity maximizes the present value given a projected term (life) of the benefits.

a. In the case of an unmarried individual, only the retirement benefits of the worker need be considered.

b. The value of an annuity is the net present value of its payments. The number of payments depends on how long one lives and when the payments begin.

c. The number of payments can be actuarially determined based on life expectancy factors at the time of each payment or, more simply but not as accurately, by assuming that:
   - (i) The individual will live his or her life expectancy at the time the payments begin, i.e., 16.2 years; or
   - (ii) The individual will live to a specified age, i.e., 77.

d. Time of claiming and receiving benefits depends on several factors:
   - (i) Age and gender;
   - (ii) Health; and
   - (iii) After-tax rate of return on money received.

Note:

Like private retirement plans, Social Security calls on the participant to make fundamental choices concerning their benefits. Fortunately, there are actually fewer decisions (although a huge number of potential choices) in Social Security than in a qualified plan or in the post-retirement receptacle for most individuals in a rollover IRA. Social Security involves neither the investment choices nor the expenses associated with the maintenance of say a §401(k) plan that might erode the benefits actually received or enjoyed.

e. Social Security is a vestige of the defined benefit era. Up through ERISA, retirement plans, particularly those implemented by large corporations with large numbers of employees, were generally structured as a defined-benefit plan that eliminated investment risk from the employee in favor of a certain and guaranteed level of income that took the form of a lifetime annuity that also eliminated the actuarial risk of outliving a fixed sum amount. The entrepreneurial explosion of small companies with few employees was met in many, if not most cases, by the adoption of defined-contribution plans, whose investment rewards and risks largely mirrored what these companies themselves experienced. The emergence of the §401(k) plan that enabled employers to shift much or all of the funding to the employee accelerated the movement of even Fortune 500 companies to defined-contribution plans or surrogate defined-benefit plans, such as cash-balance plans, which largely shifted more and more of the responsibility to the employee for the ultimate benefit to be received. Inflation can erode the benefit: in a private retirement plan, equal minimum distributions actually reflect less and less purchasing power by reason of the inflationary devaluation of the dollar, while Social Security through the COLA seeks to provide a relatively fixed benefit in terms of purchasing power. While plans offered the possibility of meeting or exceeding inflationary loss through investment gains, many of the historical returns that could give an individual confidence in achieving this have been eroding by changes in the global markets that ratchet down realistic expectations of income.

Note:

In general, all benefits received from a qualified plan or traditional IRA are tax-deferred until they are received, but then are subject to income tax as ordinary income at the taxpayer's highest current tax bracket rate; in contrast, Social Security benefits are nominally not subject to income tax (unlike traditional defined-benefit plans), although may taxpayers will be required to include some (but not all) of their benefits into income under a complex taxation scheme. That less than all benefits are included is fully equivalent to having all those benefits taxed at a lower rate than the taxpayer's higher tax rate AND not increasing the taxpayer's AGI to the same extent as the private plan distribution of the same amount, a fact that further reduces the effective rate of tax with respect to the phase out of itemized deductions, personal exemptions, medical expenses, active participation losses, etc.

f. All that may be fine while working, and retirement seems a long way off, but when Social Security becomes a viable benefit, the time has arrived to examine the defined-contribution plan/IRA critically in comparison to Social Security. As noted above, Social Security provides a variety of timing options that also have an impact on setting the level of the benefits received. Similar timing options are generally available in a qualified plan and almost always in an IRA that gives the participant a menu of options determined by him or her rather than by his or her employer.

Comparison of Social Security and IRAs

Social Security	IRA
Tax-favored	Tax-deferred
No investment risk	Investment risk
Inflation protection	No inflation protection
Longevity protection	No longevity protection
Survivor protection	No survivor protection

Planning point:

Social Security in a society of single-worker families provided a basic option, from which most other options were then determined. A spouse was entitled to a spousal benefit. Another sociological change that has arisen over the past 35 years is the two-wage-earner family, a fact that now gives the spouse a choice between a benefit based on being a spouse, a spousal benefit, or a benefit based on his or her own worker record, a worker benefit.

The greater financial security that Social Security offers relative to an IRA suggests consideration, when retirement comes, of deferring such benefits and looking to IRA distributions, if needed before taking Social Security. In addition, a spouse may have choices to make concerning his or her own Social Security that may now be somewhat independent of the Social Security choice made by the other spouse.

g. Another factor to consider is that, except for Roth vehicles (IRA or §401(k)), usually the entire distribution from a qualified plan or IRA is fully included in adjusted gross income while Social Security payments are, at most, included only to the extent of 85 percent. In light of the additional tax on net investment income that depends in part on levels of adjusted gross income, Social Security may be more tax-efficient than distributions from qualified vehicles.

4. Comparing choices

One could create a spreadsheet that computes the present values of lifetime Social Security benefits and the monthly benefit amounts based on tested specified collection dates, and, given the assumptions, the dates generating the highest lifetime benefits. Monthly benefits are adjusted annually for COLAs.

a. Because Social Security payments may in part be included in taxable income, the after-tax value of the payments must be determined by assuming an inclusion rate and a tax bracket rate of the recipient. For purposes of illustration, we have assumed the inclusion rate to be 85 percent.

Note:

> The major problem is that the number of possibilities of choice involved in the analysis of Social Security is estimated at 100 million. Commercially available software and online material provides tools the financial planner can use to examine the possibilities. Examples of such resources include MaximizeMySocialSecurity.com and products in the ESPlanner line (esplanner.com).

b. The full retirement benefit is assumed to be $2,500. The calculations used 3 percent, 5 percent, and 7 percent before-tax rate of returns.

c. The COLA was assumed to be 2.8 percent.

d. The income tax rate was assumed to be 35 percent. In most cases, retired taxpayers are likely to be in a lower bracket, and this variable can be programmed into a spreadsheet or be a variable parameter that a software program incorporates.

e. The analysis can produce different conclusions based on gender because of the gender-based differential in life expectancies. The individual is generally assumed to live to life expectancy (which is generally less than the median age). We have used the life expectancy tables the Social Security Administration published in 2007.

   (i) The life expectancy of a male at age 62, age 66, and age 70 is 18.85 years (to age 80 years 10 months), 15.67 years (to age 81 years 8 months), and 13.27 years (to age 83 years 3 months), respectively.

   (ii) The life expectancy of a female at age 62, age 66, and age 70 is 21.89 years (to age 83 years 10 months), 18.72 years (to age 84 years 9 months), and 15.72 years (to age 85 years 9 months), respectively.

Note:

> Life expectancy is the average life measured by adding up the ages of all persons in the population, and dividing the sum by the number of individuals in the population. This is not the same as the median age -- i.e., the age at which half of the population has died and half is still alive. There is thus more than a 50-percent probability that an individual will survive past the life expectancy.

Note:

It is important in this (as well as the early versus normal retirement decision) to take into account the investment profile of the client because the after-tax yield of the Social Security benefits received bears on the net present value of the benefits from the starting date for the rest of the client's life. In deciding when to start taking Social Security benefits, the anticipated investment returns on the after-tax Social Security benefits that will be invested and the nature of the taxation of the annual earnings from those investments must be considered. In general, because of the higher yield on capital gains and dividends the greater the value of the earlier years and thus the "break-even" lifetime for later starting Social Security. A computer model is necessary to take into account actuarial factors and different investment performance.

f. The value of an annuity is the net present value of its payments. The number of payments depends on how long one lives and when the payments begin.

g. Assuming a 3 percent/5 percent/7 percent return, viewed as a break-even issue where the only issue is the number of years actually lived by the recipient, the present value of the Social Security payments beginning at age 66 years breaks even with the present value of the payments that would have been made beginning at age 62 after some period of time. If one knew that the individual would not live so long, the annuity beginning at age 62 would be superior to that beginning at age 66 years. Similarly, the break-even for an annuity beginning at age 70 vis-à-vis the annuity beginning at 66 years is another period of time. If one knew that the individual would live beyond that age, the annuity deferred until age 70 would be superior to that starting at age 66 years.

5. Single males

The analysis looks solely at potential claiming of benefits at ages 62 (the earliest), 66 (FRA), and 70 (the latest age at which the amount of the benefit is affected).

a. For a male claiming at age 62, life expectancy is 18.85 years (age 80 years 10 months). In addition, the full retirement benefit is reduced by 25 percent to $1,875.

b. For a male claiming at age 66, the then life expectancy is 15.96 years (age 82 years 0 months). The full retirement benefit is increased by COLA $(1.028)^4$ x $2,500 to $2,716, the same amount of the payment in that year for the male who claimed benefits at age 62, but without the reduction for early payments.

c. For a male claiming at age 70, the then life expectancy is 13.27 years (age 83 years 3 months). The initial payment is $4,116 [$2,716 x $(1.028)^4$ x 1.32 (reflecting both the 32 percent premium and the COLAs for the intervening years)].

d. Summary of present values for **males at 3 percent** before-tax rate of return:

Live to	Claim at 62	Claim at 66	Claim at 70
Age 66 (FRA)	63,487	0	0
Age 70 (No more benefit premium)	129,069	86,863	0
Age 78 8 months (where benefits at FRA exceed benefits at 62)	279,065	279,324	263,371
Age 79 10 months (where benefits at 70 exceed benefits at 62)	300,063	306,575	300,231
Age 80 7 months (where benefits at 70 exceed benefits at 66)	313,710	324,259	324,183
Age 80 10 months (LE 62)	318,242	330,133	332,138
Age 82 0 months (LE 66)	333,528	357,818	369,639
Age 83 3 months (LE 70)	370,600	387,892	410,371

(i) The rate for males claiming at age 62 compares favorably for all such persons who do not live to age 78 years 8 months. For those who will live past that point, waiting to normal retirement age produces higher lifetime benefits, but at age 80 years 7 months the delayed retirement credits at age 70 are poised to become marginally better than claiming at age 66. Waiting until age 70 will be superior to claiming at age 66 if the male lives to age 80 years 7 months.

(ii) Assuming the male lives to his life expectancy (at age 62), the choice of claiming early is inferior financially to waiting until age 66 or age 70.

e. Summary of present values for **males at 5 percent** before-tax rate of return:

Live to	Claim at 62	Claim at 66	Claim at 70
Age 66	61,865	0	0
Age 70	122,596	80,360	0
Age 78 8 months	251,675	244,395	224,542
Age 79 10 months	267,275	266,163	254,029
Age 80 0 months	269,642	269,132	258,184
Age 80 10 months (LE 62)	281,617	284,747	279,197
Age 82	298,236	306,281	308,236
Age 81 8 months	293,534	300,188	300,122
Age 83 3 months (LE 70)	316,009	329,310	339,555

(i) The higher rate of return/discount rate increases the relative value of the earliest payments and:

- Reduces the present values generally at every age;
- Pushes the age 62/age 66 break-even from 78 years 9 months to 80 years (still slightly under the life expectancy at age 62); and
- Pushes the break-even for age 66/age 70 from 80 years 10 months to 81 years 8 months (still slightly under the male life expectancy at age 66).

f. Summary of present values for **males at 7 percent** before-tax rate of return:

Live to	Claim at 62	Claim at 66	Claim at 70
Age 66	60,331	0	0
Age 70	116,565	74,367	0
Age 80 10 months	250,482	246,382	235,111
Age 81 8 months	259,772	258,421	251,418
Age 82 0 month	264,339	264,338	259,432
Age 83 1 month	275,125	278,431	278,520
Age 83 3 months	277,026	280,777	281,698

(i) The higher rate of return/discount rate increases the relative value of the earliest payments and:

- Reduces the present values generally at every age;
- Pushes the age 62/age 66 break-even from 80 years to 82 years 1 month (now slightly over the life expectancy at age 62); and
- Pushes the break-even for age 66/age 70 from 81 years 8 months to 83 years 1 month (still slightly under the life expectancy at age 66).

Note:

Between 5 and 7 percent there is a rate of return at which the present values at the individual male's life expectancy at age 62 are the same whether claimed at age 62 or age 66.

Somewhat over 7 percent there is a rate of return at which the present values at the individual male's life expectancy at age 66 are the same whether claimed at age 66 or age 70.

6. Single females

A woman has a longer life expectancy than a man.

a. For a woman claiming at age 62, life expectancy is 21.89 years (age 83 years 10 months).

b. For a woman claiming at age 66, life expectancy is 18.72 years (age 84 years 9 months).

c. For a woman claiming at age 70, life expectancy is 15.72 years (age 85 years 9 months).

d. Summary of present values for **females at 3 percent** before-tax rate of return:

Live to	Claim at 62	Claim at 66	Claim at 70
Age 66	63,457	0	0
Age 70	129,069	86,863	0
Age 80 10 months	318,242	330,133	332,138
Age 83 10 months (LE at age 62)	373,696	401,985	429,460
Age 82 1 month	341,162	359,835	372,370
Age 84 9 months (LE at age 66)	390,934	424,310	459,703
Age 85 9 months (LE at age 70)	409,874	448,843	495,689

e. Summary of present values for **females at 5 percent** before-tax rate of return:

Live to	Claim at 62	Claim at 66	Claim at 70
Age 66	61,865	0	0
Age 70	129,069	86,863	0
Age 80 1 month	270,802	270,854	260,311
Age 81 8 months	293,534	300,188	300,112
Age 83 10 months	324,242	339,974	353,999
Age 84 9 months	337,159	356,704	376,661
Age 85 9 months	351,176	374,861	401,250

f. Summary of present values for **females at 7 percent** before-tax rate of return:

Live to	Claim at 62	Claim at 66	Claim at 70
Age 66	60,331	0	0
Age 70	116,565	74,367	0
Age 80 10 months	250,482	246,382	235,111
Age 82 1 month	264,339	264,338	259,432
Age 83 10 months	283,257	288,848	292,632
Age 84 9 months	290,940	301,389	309,620
Age 85 9 months	303,318	314,832	327,825

Analysis:

Because the female has a longer life expectancy at each of the test points, the crossover point occurs sooner relative to life expectancy, again earlier than life expectancy.

At each rate of return, the present value of payments taken at age 70 are greater than those at age 66 or age 62, earlier than the life expectancy at either 62 or 66.

A high-earner female should consider delaying payments to age 70 wherever possible (unless she is in poor or below-average health).

7. And yet

And yet, in an era where 8-percent returns are difficult to come by, fully 72 percent of eligible workers claim before reaching FRA.

a. Most individuals are unaware of the consequences of claiming early and are not sophisticated enough to give this important financial decision the analysis it is due.

b. This cannot be explained merely by assuming that those claiming early are those who are likely not to survive to life expectancy (by reason of occupation and poorer-than-average health). Commentators suggest that this is a lifestyle choice, but one that is often made without consideration of its financial implications. The early claim makes even less financial sense in the case of a married couple.

8. Married workers

a. The above has assumed that the decision as to when to take retirement benefits was made by a single person. However, the decision to take an early retirement will have a consequence for the spousal benefit as well where the retiree is married. The single-life annuity analysis cannot be applied in the case of a married couple. Therefore, two adjustments have to be made where the spouse is not eligible to retirement benefits as a worker. First, any delay magnifies the total benefit received by the couple. Second, the life expectancy to be contemplated is a joint life rather than a single life. This brings the break-even points down by several years. This will generally have the effect of making the early claim for benefits even more questionable. Joint life expectancy is a better predictor of the projected term of the annuities.

    (i) **Worker's and spousal/survivor:** Worker will claim a benefit. The nonworking spouse will claim a spousal benefit and, if the spouse survives the worker, a survivor benefit following the worker's death.

    (ii) **Worker's and spousal worker/survivor:** Worker will claim benefits. Working spouse will claim his or her own retirement benefits and, following the death of the other spouse, a survivor benefit, if higher.

b. The joint life expectancy of a couple determines the term that at least one of them will survive. It depends on the ages of the spouses.

    (i) **Ages 66 and 66:** Median (50 percent) is 25.65 years (age 91 years 8 months). Twenty-five percent of such couples will have a survivor who lives 30.3 years (age 96 years 4 months).

    (ii) **Ages 62 and 60:** Median is 30.43 years. Twenty-five percent of such couples will have a survivor who lives 35.19 years from this date.

    (iii) **Ages 66 and 62:** Median is 27.70 years. Twenty-five percent of such couples will have a survivor who lives 32.51 years from this date.

Note:

> Joint life expectancies are generally greater than the greater of the single life expectancy of either spouse individually. Focusing solely on the sets of two individuals who are alive at age 62, there is approximately a 50 percent probability that one will die before age 78 and a 50 percent probability that one or the other will survive to 89. So, if the wife, say, takes Social Security at 62, she may succeed to a larger payment 6 years before her life expectancy because 50 percent of the time her husband will die before reaching age 78. If the husband made it to 70 to begin payments then, in 50 percent of the cases that stream will be paid to the husband or the surviving spouse for 19 years or more (from age 70 to age 89). Of course, these numbers apply only in the case where the spouses, by hypothesis, are the same age. Different numbers will be applicable where there are age differentials.

c. In the case of a single individual who has never been married, the only Social Security benefit that bears on timing is the worker's own retirement benefit. When a spouse (or a minor child) is involved, there are secondary, derivative benefits that themselves may be impacted by the choice made by the primary worker. Of course, spouses can have their own retirement benefit as well. Among the benefits other than the worker's own benefit that need to be considered:
   - (i) **Spousal benefit:** The spousal benefit is 50 percent of the worker's FRA benefit.
   - (ii) **Survivor benefit:** The surviving spouse to claim the greater of the spouse's own (card) benefit or 100 percent of the deceased spouse's worker benefit.

d. For one-earner couples (both still alive), the spouse will choose the spousal benefit when it is available.
   - (i) Spouse must be at least 62, OR have a minor child in his or her care.
   - (ii) Worker must have claimed benefits. Generally, the worker may not claim benefits before age 62.
   - (iii) Amount of spousal benefit depends on two factors:
     - The benefit the worker would receive at FRA (even if claiming earlier); and
     - The age of the spouse when claiming the spousal benefit.

Example: Fred, age 62, is married to Wilma, age 30. Regardless of when Fred claims, Wilma may not claim spousal benefits.

Take the same Example, except Wilma has an infant child of Fred's under her care. Wilma may be entitled to a spousal benefit equal to 50 percent of Fred's FRA benefit without reduction but only if Fred claims retirement benefits and the minor child is entitled to child benefits (i.e., is a dependent of Fred). Spousal benefits are not reduced even if Fred's are by reason of excess earnings or early claiming. The family maximum rules will apply to limit the total monthly benefit to 150 percent of Fred's monthly benefit at FRA.

Note:

When one spouse has zero or low benefit on his or her own card:

(i) The spousal benefit is only available if the worker has **claimed** benefits, and this can happen only if the worker is at least age 62.

(ii) Spouse must generally be at least age 62.

(iii) Spousal benefit reduced if spousal claim is made before spouse reaches FRA to the same extent a retirement benefit would have been reduced. **If the worker claims before FRA, he or she cannot claim and suspend**. This fixes the amount of the spousal benefit. The spousal claim, if made before the spouse's FRA, initiates a claim for the spouse's own benefit (dual eligibility). The size of the spouse's own benefit is not relevant in cases where the spouse's own benefit is less than one-half of the worker's FRA benefit.

Example: Jack has claimed benefits; his FRA benefits are $1,000. Jill, age 63, is entitled to a spousal monthly benefit of $500, but because she claimed three years before her FRA, she must reduce the monthly benefit 20 percent to $400.

Note:

There is no reduction regardless of the age when claimed by the spouse who has a minor child under her care. Thus, in May-December marriages where there is a child, the spousal benefit should always be claimed.

Planning point:

In virtually no situations should a non-working spouse defer her spousal claim to age 70. When a high-earner is wedded to a median-income wife, the choice between a claim by the median-income spouse at age 62 versus age 66 when the high-earner will claim at age 70 is a toss-up, but slightly better than the spouse waiting to age 70 to claim enhanced benefits. However, this toss-up may be broken in favor of the later age (66) because the spouse will not have claimed a spousal benefit and thus might be free to defer a claim for the higher survivor benefit (assuming sufficient funds between date of the high-earner's premature death and the spouse reaching FRA.

One must still approach this strategy not as a cookie-cutter solution. Nothing may be gained, and something actually lost if both spouses are long-lived. The spouse retiring early in this situation will receive less than he or she would have had he or she waited to full retirement or even to age 70. Conversely, workers in relatively poor health probably maximize benefits by taking old-age benefits as soon as possible.

(iv) If worker claims benefits before FRA, the spouse's claim for:

- Spousal benefits are not reduced if the worker claims retirement benefits before the worker's FRA, but only if the spouse is under the spouse's FRA when claiming those benefits.
- Survivor benefits when the worker dies are permanently reduced.

(v) The following chart illustrates the results of a spousal election at various ages by the spouse for a worker who has claimed benefits. It indicates the full spousal benefit at various ages of the spouse, the reduction in the benefit, if any, by claiming before the spouse's FRA, and the impact of the claim at that age on the spousal benefit at ages 66 and age 70.

Jack's age when claimed	Jill's age when claimed	Jack's benefit at FRA or later claim date by Jack	Full spousal benefit (.5 x Jack's FRA benefit)	Reduced spousal benefit (as a result of age when Jill claims)	Spousal benefit, Jill claiming at 66 (inflation-adjusted)	Spousal benefit, Jill at age70
62	58	1,500	750	N/A		
66	62	1,650	825	619	694	780
70	66	1,850	925	925	925	1,040
74	70	2,080	1,040	1,040	N/A	1,040

When Jill claims early (age 62), her spousal benefit is permanently reduced.

Jill gains nothing in the spousal benefit by waiting past age 66. Instead, she has missed four years of spousal benefits. There are no DRCs applicable to a spousal claim.

e. The Senior Citizens Freedom to Work Act of 2000 established:

(i) An individual who has reached FRA may claim the FRA benefit but suspend the collection of the FRA benefit.

Note:

> The above strategy presumes that cash flow is not dependent on Social Security during the time the benefits are suspended, either because one continues working or because one has other resources (IRAs and qualified plans) one can access prior to making the claim for one's own benefits.

(ii) The spouse could claim a spousal benefit (assuming the minimum age requirement is met) even if the worker continues to work.

Note:

The Bipartisan Budget Act of 2015 revised this rule. If the older spouse is on suspension, the younger spouse may not claim a spousal benefit based on the older spouse's card. However, if the older spouse is taking benefits, the younger spouse may file a restricted application to claim a spousal benefit (but no earlier than his or her FRA) but not his or her own benefit and then claim benefits on his or her own card with accrued delayed retirement credits. Thus, if a working spouse has claimed, the other spouse may, **in certain circumstances**, suspend his or her own benefit at full retirement age but may not claim spousal benefits based on the earnings of the working spouse.

The general rule has been that an application for any benefit is a deemed application for other benefits to which the individual is entitled. Thus, when a working spouse claims spousal benefits (based on the other spouse's earnings record) it is also treated as an application for the working spouse's own benefits (based on her own earnings record). Since 2000, however, the law has permitted taxpayers to limit (restrict) the application when filing on or after full retirement age. This exception will no longer apply under the Act. A claim for one benefit will be deemed an application for all benefits even if the applicant has reached full retirement age. Stated somewhat differently, there will no longer be any option to apply, say, for a spousal benefit and to later switch to a delayed individual benefit. Instead, for better or worse, either all benefits start earlier, or all are delayed later. Under the Act, a claim for one benefit will be deemed an application for all benefits even if the applicant has reached full retirement age.

Important: The law does provide a grandfathering provision stating that the new rules on deemed application limiting restricted application will only apply to those individuals who turn age 62 beginning in 2016 or later. Therefore, individuals who were born on or before January 1, 1954 continue to be permitted to file a restricted application for one benefit and to later switch to another. Also, an individual who was age 66 before April 30, 2016 and filed and suspended prior to that date is grandfathered in. For these purposes and for the FRA, a person born on January 1 is considered to be born in the prior year. This constitutes the **certain circumstances** noted above.

(iii) The worker remains eligible to accrue delayed retirement credits for purposes of the worker's own benefits (8 percent for years after FRA).

(iv) The spouse may claim a higher monthly spousal benefit from COLA to the worker's claimed benefit, but not from delayed retirement credits.

Example: Jack claims and suspends at age 66 when his FRA benefit is $1,650 on April 1, 2016. With COLA at age 70, when he claims the retirement benefit it is $1,850. With DRCs, Jack's monthly benefit increases to $2,442. However, Jill's spousal benefit at that time is $925 (.5 x $1,850), not $1,221 (.5 x $2,442).

Note:

Wages or earned income of an individual above the FRA are not reduced. Jack's Social Security benefits are not reduced and may provide a source of cash flow even if Jack does not continue to work.

f. Married couples must also consider the benefit to a widow or widower (survivor benefit) based on the benefit of the deceased spouse. **REMEMBER THE JOINT LIFE EXPECTANCIES**. The greater the FRA (accrued DRCs), the greater the survivor benefit that can be paid to the lower-earning spouse if the higher-earner dies first. When one worker of a two-worker couple dies, the surviving spouse generally becomes entitled to a surviving spouse's benefit equal to 100 percent of the deceased spouse's benefit.

Planning point:

The longer joint life expectancies indicate that at least one spouse (the higher-earner) should claim and suspend and accrue DRCs to maximize not only his or her own benefits but also the survivor's.

(i) A surviving spouse age 60 or over is generally entitled to a survivor benefit if:

- The spouse is not entitled to a benefit in excess of the deceased's benefit. (In such cases where the surviving spouse has a higher benefit than the survivor benefit, the survivor will continue his or her own higher benefit.)
- The spouse **files** for the benefit.
- The spouse has not remarried.

(ii) Claiming the survivor benefit before FRA permanently reduces the amount, but may be necessary if the spouse has no other source of funds.

- The amount of the benefit is the deceased's FRA benefit (even if never claimed).
- Reduction is only if survivor claims before survivor's FRA. Maximum reduction of benefit is 28.5 percent, if survivor claims at age 60.
- Reduction is reduced pro rata over the age of claim between 60 and FRA (28.5/6 = 4.75 percent per year).

Example 1: If survivor claims benefit at age 63, one-half of the period between age 60 and FRA of 66, the reduction of the survivor benefit is 14.25 percent (3 years x .0475).

Example 2: Jack, age 66, has an FRA monthly benefit of $2,000; Jill is age 62 and has a $500 FRA monthly benefit. She elects a reduced spousal benefit ((1 - .25) x .5 x $2,000) = $750 (greater than her own claimed benefit of $375 (1 - .25) x $500). When Jack dies that month, Jill's spousal benefit is converted to a survivor benefit of $1,620 ($2,000 (Jack's FRA) x (1 - .19 [4 years before Jill's FRA] x .0475])) because she had claimed the spousal benefit.

Example 3: The facts are the same, except Jack suspends at 66, lives to age 68 (when his FRA is $2,120), and dies. Jack's FRA is increased by 16 percent in delayed retirement credits to $2,460. Jill's spousal benefit is converted into a survivor benefit of $2,226 ($2,460 x (1 - .095 [2 years before Jill's FRA])).

(iii) The mere claim of the spousal benefit exposed the couple to the risk of a reduced survivor benefit if death occurred before the spouse reached FRA.

Example: Suppose Jill made no claim at age 62. When Jack dies, she has no current claim for benefits. She may:

- Claim her own benefit (no spousal benefit tied to the claim) reduced because taken before FRA; and
- Defer a survivor claim for a reduced reduction.

Jill waits two years when her monthly benefit is $400 and claims the survivor benefit. With COLA adjustments this is $1,918 ($2,120 x (1 - .095 [2 years x .0475])) monthly benefit.

Suppose the same, except Jill waits until she reaches age 66 (when her monthly benefit is $425) to claim survivor benefits. With COLA adjustments this is $2,240 ($2,120 x 1.028 x 1.028 [assumed COLA]), and because Jill does not claim before FRA, it is unreduced.

Note:

To reiterate, when it comes to joint life expectancies of married couples (assumed both spouses are age 62 when benefits could first be claimed), there is an 80-percent probability that at least one will live to age 85, a 57-percent probability that at least one will live to age 90, and a 27-percent probability that at least one will live to age 95. Because taking early retirement means taking a permanent reduction in benefits, and because the most a non-working spouse can succeed to at the working spouse's death is that reduced benefit, it would appear obvious that the higher benefit will almost always prove successful over the (now) long(er) run. Yet, as noted above in the discussion of individual unmarried beneficiaries, Social Security has reported that some 72 percent of retirement income recipients receive the reduced benefits. Benefit timing appears to be more animated by lifestyle choices than on strict financial principles.

Planning point:

As was noted above, the chances of a spouse reaching age 90 or 95 are not insignificant. This exacerbates any permanent reduction over the extended survival period. It does not matter who dies first, as the spouse receives the higher of the spouse's worker's benefit or the spouse's widow's benefit. One consequence of this is that starting the spouse's benefits early is not a permanent problem, because the spouse will succeed to the higher widow's benefits.

Planning point:

In the event the spouse has taken early retirement on her own card, but the other spouse dies before able to accumulate additional credits for delayed retirement, what can be done to make the decision to take early retirement viable? The spouse may be able to reassess the situation, determine that she would be better off repaying her early benefits, and defer to FRA or beyond to a deferred enhanced benefit on her own card.

g. Each working spouse has a choice between his or her own benefit and the spousal benefit based on the other spouse's record.

(i) At FRA a worker may **claim or suspend** the worker's own benefit but remain entitled to the spousal benefit if the other spouse has claimed retirement benefits.

Planning point:

A worker can, by claiming and suspending at FRA:

- Remain eligible for delayed retirement credits for purposes of claiming the worker's own benefits.

Example: Jack, age 66, and Jill, age 63, each have a 95 percent of maximum FRA monthly benefit (currently ~$2,500). Both intend to work to age 70 and will continue to have taxable wages of at least the taxable wage base in later years. Jack can file and/or suspend. Jill can choose to take a spousal benefit (reduced by 20 percent by reason of claiming three years early) but only if Jack claimed. Because this claim takes place before her FRA, she has also made a claim for her own benefit. Her own benefit is permanently reduced by 20 percent.

(ii) It is not possible for **both spouses to elect a spousal benefit**.

Note: The Social Security Gap

According to a Congressional Research Service report, the median earnings of women who were full-time wage and salary workers was 81.5% of their male counterparts in 2019. Since Social Security benefits are linked to earnings, this earnings gap can lead to a "Social Security Gap" for women, as they would, on average, receive lower benefit amounts than men.

Additionally, women are more likely than their male counterparts to take breaks in employment for childcare, and thus have fewer total years of contributions to Social Security. This results in lower overall retirement benefits than their male counterparts. [312]

9. Solvency

Currently, Social Security benefits are provided to over 67 million beneficiaries. Social Security is comprised of two main components: Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI). Together, these components are referred to as “OASDI,” and both programs utilize a trust fund financing mechanism.

A Board of Trustees manages the OASDI trust funds and provides an annual report to Congress regarding the funding status and overall solvency projections. Solvency is defined as the fund’s ability to pay full benefits scheduled under current law on a timely basis.

Until 2009, the OASDI program collected more in tax revenues (via Social Security payroll taxes) than what was required to pay benefits. In such years, the excess revenues were held in interest-bearing U.S. Treasury securities. However, since then, the OASDI trust funds have been facing solvency. One of the main factors causing the solvency issue is the demographic shift known as the "baby boomer" generation. A large number of individuals born between 1946 and 1964 are reaching retirement age and becoming eligible for Social Security benefits. This demographic trend has led to a strain on the trust funds as the number of beneficiaries increases while the number of workers paying into the system decreases.

Since 2021, the OASI Trust Fund has been drawing down asset reserves to finance benefits and will require increasing amounts of asset redemptions during the next decade. In the latest OASDI Trustees Report, the trust fund reserves are expected to be depleted by 2035 (one year later than projected in the prior year report). The projected long-term finances of the combined OASDI fund improved this year primarily due to an upward adjustment in labor productivity levels throughout the projection period and a reduced assumption regarding long-term disability incidence rates. However, these advancements were somewhat mitigated by a decline in the assumed long-term total fertility rate.

The number of beneficiaries (baby boomer generation) is increasing faster than the number of covered workers. Once the trust funds are exhausted, it doesn't mean that Social Security benefits will disappear entirely, but it would result in a shortfall in funding. Unless Congress enacts reforms, the Old-Age and Survivors Insurance (OASI) program would only be able to pay about 79% of scheduled benefits from ongoing payroll tax revenue. The Disability Insurance (DI) Trust Fund, in contrast, remains solvent through 2098, largely due to lower-than-expected disability claims. When viewed together as a combined entity (OASDI), the two trust funds are projected to be depleted by 2035, at which point only around 83% of scheduled benefits could be paid. The Trustees also report a 75-year actuarial deficit of 3.50% of taxable payroll, equivalent to a staggering $22.6 trillion in present value terms. This deficit represents the amount of additional revenue (or equivalent spending reductions) that would be needed immediately to fully fund benefits over the long term.

The report states that in order for the OASDI trust funds to remain solvent through 2098:

1. Revenue would have to increase by an amount equivalent to an immediate and permanent payroll tax rate increase of 3.33 percentage points to 15.73 percent beginning in January 2024;

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312 Social Security: Revisiting Benefits for Spouses and Survivors.

2. Scheduled benefits would have to be reduced by an amount equivalent to an immediate and permanent reduction of 20.8 percent applied to all current and future beneficiaries effective in January 2024, or 24.8 percent if the reductions were applied only to those who become initially eligible for benefits in 2024 or later; or
3. Some combination of the above two approaches would have to be adopted.

Further, the report states that "significantly larger changes would be necessary if action is deferred until the combined trust fund reserves become depleted in 2035."[313]

Legislation has been introduced to address the OASDI trust fund solvency issues, but to date, no legislation has been passed by Congress. Finding a solution to the Social Security solvency issues is a complex task that requires balancing the need for financial sustainability with the goal of ensuring an adequate retirement income for future generations. Any changes to the program must be carefully considered to protect the interests of both current and future beneficiaries.

Taxpayers should consider the increased potential of reduced benefits when planning for retirement. A reduction in benefits would be a significant concern for future retirees who depend on Social Security as a major source of income. A potential 20% to 25% reduction in benefits could drastically alter the retirement landscape. Taxpayers who are currently in or near retirement may need to revisit their income projections, and younger taxpayers should be made aware that full benefits may not be guaranteed under current law.

G. Miscellaneous

1. Medicare

The contribution of amounts from an IRA may enable the taxpayer to avoid higher levels of adjusted gross income that implicates various tax deductions (such as theft losses and medical expense). But it also can reduce Medicare Prescription drug premiums. The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 imposes a new 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, starting in 2007.[314] 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 80 percent of the per-enrollee Part B program costs.[315] The premium applies to individual seniors with adjusted gross income exceeding $80,000 (indexed for inflation) per year and to married couples with adjusted gross income exceeding $160,000 (indexed for inflation) per year. 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.[316] The Medicare Part B premium is adjusted each year based on the income from the most recent available tax return.

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313 The 2024 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds.
314 42 U.S.C. §1395r(i), I.R.C. §6103(l)(20).
315 42 U.S.C. §1395r(i)(3).
316 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 broadest terms, the fully phased in rate will be the percentage that, when applied to $120,000 of a single enrollee's income (i.e., income between $80,000 and $200,000) or $240,000 of a married couple's income (i.e., income between $160,000 and $400,000), will equal 55 percent of the actuarial value of the Part B benefits. MAGI is generally AGI plus tax-exempt income.

Medicare Part B Premium for 2025 (based on 2023 income):

Single MAGI (2023)	Married Filing Jointly MAGI (2023)	Total Monthly Premium
≤ $106,000	≤ $212,000	$185.00
> $106,000 – ≤ $133,000	> $212,000 – ≤ $266,000	$259.00
> $133,000 – ≤ $167,000	> $266,000 – ≤ $334,000	$370.00
> $167,000 – ≤ $200,000	> $334,000 – ≤ $400,000	$480.90
> $200,000 – < $500,000	> $400,000 – < $750,000	$591.90
≥ $500,000	≥ $750,000	$628.90

2. Beneficiary designations

Many older persons have not attended to making appropriate or even any designated beneficiary. In the context of a qualified plan or IRA, an eligible or designated beneficiary is an individual[317] who is designated as a beneficiary under the plan.[318] A beneficiary named as such under the plan is an individual who is entitled to a portion of an employee's benefit, contingent on the employee's death or another specified event. However, the person who is a beneficiary under the plan in accordance with its default rules is not a designated beneficiary.

a. **Eligible beneficiaries** include surviving spouses, a beneficiary who is not more than 10 years younger than the original IRA holder, disabled beneficiaries and chronically ill individuals, and minor children of the original IRA holder. Eligible beneficiaries are **not** required to withdraw the entire inherited IRA balance within 10 years of the date the original account holder dies. Please note that minor children are only exempt from the 10-year rule until they reach the age of majority. Upon reaching the age of majority, they are subject to the 10-year rule.

b. **Designated beneficiaries** include any other individuals who are not eligible beneficiaries. Under the SECURE Act, designated beneficiaries are required to withdraw the entire inherited IRA balance within 10 years of the date the original account holder dies.

c. The importance of having no eligible or designated beneficiary lies in the distribution period. In such case, the distribution must be made using the five-year rule. The beneficiary must withdraw the entire inherited retirement account over a 5-year period.

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317 Only individuals may be designated beneficiaries. A person that is not an individual, such as the employee's estate, may not be a designated beneficiary, and, if a person other than an individual is designated as a beneficiary of an employee's benefit, the employee will be treated as having no designated beneficiary. Treas. Regs. §1.401(a)(9)-4, Q&A-1.

318 Treas. Regs. §1.401(a)(9)-4, Q&A-3.

(i) For practical purposes, beneficiaries who are neither eligible beneficiaries nor designated beneficiaries are non-individual beneficiaries. These beneficiaries include trusts (with no look-through provisions), estates, and any other non-individual entities.

VI. Education

A. Education credits, deductions, and exclusions

1. The American Opportunity credit

In the case of any taxable year beginning after 2008, the Hope Scholarship credit (known as the American Opportunity credit) is an amount equal to the sum of[319] 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,[320] plus 25 percent of such expenses so paid as exceeds $2,000 but does not exceed $4,000.[321]

This generally increases the amount of 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
$1,200	$1,200	$1,200	$240
$1,500	$1,350	$1,500	$300
$2,000	$1,600	$2,000	$400
$2,400	$1,800	$2,100	$480
$2,500	$1,800	$2,125	$500
$3,000	$1,800	$2,250	$600
$3,500	$1,800	$2,375	$700
$4,000	$1,800	$2,500	$800
$5,000	$1,800	$2,500	$1,000
$9,000	$1,800	$2,500	$1,800
$10,000	$1,800	$2,500	$2,000

2. Extended period of application and later years

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),[322] but also to all four years of post-secondary education.[323]

319 I.R.C. §25A(i)(1).
320 I.R.C. §25A(i)(1)(A).
321 I.R.C. §25A(i)(1)(B).
322 I.R.C. §25A(b)(2)(A). I.R.C. §25A(i)(2).
323 I.R.C. §25A(b)(2)(C). I.R.C. §25A(i)(2).

Planning point:

As indicated in 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 years after 2008) credit.[324]

3. Qualified tuition and related expenses

The Act broadens the base of expenses against which the credit may be claimed to course materials.[325] This brings it into equality with the Lifetime Learning credit, which has always included the costs of books in its qualified expenses.[326]

4. Phaseout limits for the credit

The Act increases the limitation for the phaseout of the Hope/American Opportunity credit (but not the Lifetime Learning credit). The credit as computed is reduced (but not below zero) by the amount which bears the same ratio to such credit (as so determined) as the excess of the taxpayer's **modified adjusted gross income** for such taxable year,[327] over $80,000 ($160,000 in the case of a joint return),[328] bears to $10,000 ($20,000 in the case of a joint return).[329] This increases the thresholds from $50,000 ($100,000 in the case of a joint return). As a result of the Consolidated Appropriations Act of 2021, 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 the CAA 2021 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.

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	• Unlimited years •All levels of post-secondary education or courses to improve job skills	Single: $80,000-$90,000 MFJ: $160,000 - $180,000
Lifetime Learning Credit	$2,000 per return	Nonrefundable	•Tuition and Enrollment Fees	•Maximum 4 years of post-secondary education • Must pursue degree	Single: $80,000-$90,000 MFJ: $160,000 - $180,000

324 I.R.C. §25A(b)(2)(B) and §25A(b)(2)(D).
325 I.R.C. §25A(i)(3); I.R.C. §25A(f)(1)(A).
326 I.R.C. §25A(c)(2)(B).
327 I.R.C. §25A(i)(4)(A)(i).
328 I.R.C. §25A(i)(4)(A)(ii). These income limitations are indexed for inflation. I.R.C. §25A(h)(2)(A).
329 I.R.C. §25A(i)(4)(B).

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

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

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 the CAA 2021, the Lifetime Learning Credit was $1,000 ($2,000 credit reduced by 50% due to AGI threshold). As a result of the CAA 2021, the taxpayer can claim the entire $2,000 credit as her MAGI is under the new threshold limits.

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

5. AMT implications

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.[330] 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).[331] This has been extended permanently. However, the American Opportunity tax credit may be applied against the excess of the sum of the regular tax liability plus the AMT[332] over the sum of the nonrefundable personal credits other than the American Opportunity tax credit itself.[333] In either case, this in effect permits this credit to offset and reduce an AMT liability. Fortunately, this means that both the American Opportunity credit and the Lifetime Learning credit may be applied against the alternative minimum tax liability in 2016 and later years without further Congressional action of extenders, protecting the incentive these credits are designed to provide.

6. Partial refundability

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 phaseout, 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.[334]

330 I.R.C. §26(a)(1).
331 I.R.C. §26(a)(2).
332 I.R.C. §25A(i)(5)(A).
333 I.R.C. §25A(i)(5)(B).
334 I.R.C. §25A(i)(6). It is not treated as a Hope credit, so the limitations (other than the income phaseout) of §25A do not apply.

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 phaseout, then the nonrefundable portion of the credit must be applied against the AMT or the regular tax liability in excess of tentative tax[335] and then the refundable portion must be applied as other refundable credits are.

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: Same as above except that Taxpayer's MAGI is $30,000 and he has an income tax liability of $3,000. Neither the Lifetime Learning credit nor the American Opportunity credit is phased out. He may apply the $2,000 as a credit against the income tax. Of the $2,500 American Opportunity credit, $1,000 (.4 x $2,500) is refundable. Taxpayer applies the first $1,000 of the credit against income tax liability, reducing it to zero, and $1,000 refundable portion of the credit as an overpayment of tax subject to refund. Taxpayer loses any benefit with respect to the $500 excess of the nonrefundable portion of the credit over the income tax liability.

Planning point:

> Sometimes these credits can be utilized by the child/student because the parents cannot qualify under the AGI phaseouts. 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. For 2025, the personal exemption is suspended, so the parent is losing any available child credit which may be phased out anyway.
>
> This does not, however, permit the student to take the personal exemption for the child on the child's own return. If the child wants to take the personal exemption, the child must not qualify as a dependent. This requires the child to provide more than one-half of the child's own support. In addition, the credits only benefit the child if the child has some taxable income generating a tax liability against which they may be applied. To accomplish both goals -- and to achieve some potential estate-planning goals as a bonus -- the parents should consider annual transfers up to the annual exclusion amount to their child in order to shift income-tax liability (at least for the period after the child reaches age 18) that will generate enough income-tax liability for the years the educational expenses are paid **by the child** but not enough to cause the child to exceed the modified adjusted gross income limits for such periods at which the credits are phased out.

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 A'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.[336]

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335 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.

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

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.[337]

The new structure of the kiddie tax 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 if, in either case, the child has earned income equal to or in excess of one-half of the child's support. This means that a child, assuming all other conditions are met, may earn up to $37,154 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 in tax year 2025.

Earned income	$37,154
Less Standard deduction	$15,000
Taxable income	$22,154
Tax before credits	$2,500
American Opportunity credit	$2,500
Net tax	$0

Earned income	$33,654
Less Standard deduction	$15,000
Taxable income	$18,654
Tax before credits	$2,000
Lifetime Learning credit	$2,000
Net tax	$0

7. Qualified tuition expenses

As noted above, the CAA 2021 repealed the qualified tuition and related expenses deduction and replaced it with an increased MAGI limitation for the Lifetime Learning Credit.

8. Student Loan Interest Deduction

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.[338] 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. Legislation has been introduced, such as H.R. 5683, *the Student Loan Marriage Penalty Elimination Act,* 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.

[337] See Treas. Regs. §1.25A-1(f)(2), Ex. 2.
[338] I.R.C. §221.

Note:

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

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

Practice Note:

To assist employees who may be unable to save for retirement due to obligations to repay student loan debt, SECURE 2.0 permits such employees to receive matching contributions by reason of repaying their student loans. Specifically, SECURE 2.0 allows an employer to make matching contributions under a 401(k) plan, 403(b) plan, or SIMPLE IRA with respect to “qualified student loan payments.”

Qualified student loan payments are any indebtedness incurred by the employee solely to pay qualified higher education expenses of the employee but limited to the limitation applicable under §402(g) for the year (or, if lesser, the employee’s compensation), reduced by the elective deferrals made by the employee for such year. The limitation under §402(g) for 2025 is $23,500.

Employees must certify annually to the employer making the matching contribution that payment has been made on the loan. Governmental employers are also permitted to make matching contributions in a §457(b) plan or another plan with respect to such repayments.

For purposes of the nondiscrimination test applicable to elective contributions, SECURE 2.0 allows a plan to test separately the employees who receive matching contributions on student loan repayments. The new SECURE 2.0 provision is effective for contributions made for plan years beginning after December 31, 2023.

9. Student Loan Relief

Due to economic conditions, numerous individuals are struggling to pay their student loans. The CARES Act allows employers to provide a student loan repayment benefit to employees on a tax-free basis.[339] Traditionally, an employee’s gross income does not include up to $5,250 of employer payments made under an educational assistance program for the employee’s education.[340] This exclusion did not apply to the education of spouses or dependents. Under the CARES Act, employers can contribute up to $5,250 annually toward an employee’s student loans, which were previously not considered educational payments. Eligible student loan repayments are payments by the employer, whether paid to the employee or a lender, of principal or interest on any qualified higher education loan. This payment would be excluded from the employee’s income. The $5,250 cap applies to the aggregate of the newly established student loan repayment benefit in the CARES Act, as well as any other educational assistance provided by the employer under current law, including tuition, fees, and books. The initial student loan relief applied to payments made after the enactment date and before January 1, 2021. To prevent a double benefit, student loan repayments for which the exclusion is allowable can't be deducted under §221, which allows the deduction of student loan interest subject to a dollar limit and a phase-out above specified taxpayer

339 CARES Act §2206.
340 IRC §127.

income levels. The CAA 2021 extended the exclusion of employer payments of student loans from an employee's gross income through 2025.

10. Student Loan Discharges

Sometimes a taxpayer may have his or her debt forgiven or discharged. Generally, if a taxpayer receives cancellation of debt (COD) income, he or she must report it as taxable income on the tax return during the year the cancellation occurs. If a taxpayer receives cancellation of debt income, he or she will receive a Form 1099-C, *Cancellation of Debt*, from the creditor that lists the amount of canceled debt that is taxable. This is the taxable amount that must be reported on the taxpayer's tax return as "other income."

Although COD income is generally taxable, certain canceled debt is specifically excluded from taxable income. Prior to ARPA, certain cancelled student loan debt was specifically excluded from income due to:

- Death or total and permanent disability of a student,
- A provision in the loan that all or part of the debt will be canceled if the taxpayer worked for a certain period of time, in certain professions, and for any broad class of employers (e.g., a doctor in a public hospital in a rural area), or
- As a result of the Department of Education's Closed School process or the Defense to Repayment discharge process.

ARPA expanded the student loan debt exclusion to exclude from gross income certain discharges of student loans after December 31, 2020, and before January 1, 2026. The expanded student loan discharge exclusion applies to:

1. Private education loans.
2. Loans provided expressly for postsecondary educational expenses, regardless of whether provided through the educational institution or directly to the borrower, if such loan was made, insured, or guaranteed by the United States, a state or local governmental entity, or an eligible educational institution.
3. Loans made by an educational organization qualifying as a 50% charity.
4. Loans made by an educational organization qualifying as a 50% charity or by a tax-exempt organization to refinance a loan to an individual to assist the individual in attending any educational organization but only if the refinancing loan is under a program of the refinancing organization that is designed as described in bullet point (3) above.

As a result, if a student loan is discharged for any reason above, it will not result in discharge of indebtedness income to the borrower. It is important to note that the discharge of a loan made by either an educational institution or a private education lender is not excluded under the expanded ARPA rules if the discharge is on account of services performed for either the organization or for the private education lender. The new ARPA exclusion applies to either partial or full discharge of a student loan, and it is effective for discharges of loans after December 31, 2020.

B. Section 529 -- Qualified tuition programs

Prior to 2002, a qualified tuition program (QTP), sometimes referred to as a §529 plan, 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. However, there are some standard federal income-tax rules that apply to these programs. 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 were they 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.

Currently, tax-exempt status is granted to qualified tuition programs, which include qualified tuition programs 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). 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. For these purposes, the term "eligible educational institution" means an institution that is described in §481 of the Higher Education Act of 1965 (20 U.S.C. 1088), 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.

Note:

> In general, a tuition program maintained by a private institution is not treated as qualified unless it has received a ruling or determination from the IRS that the program satisfies applicable requirements.

Note:

> The educational institution plans, while affording perhaps great opportunities, are not self-executing, and involve a decision by such institutions. Savings plans, which remain solely the province of the states, have proven much more popular. In order for many schools to participate in prepaid tuition plans, coalitions may be required, and whenever two or more institutions meet in the name of anything, antitrust issues may be raised.

Planning point:

> The (younger generation) 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 American Opportunity Tax Credit or the Lifetime Learning credit. However, an amount contributed to a Coverdell education 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.

1. Taxation of QTPs

Qualified tuition programs are themselves exempt from income tax. Beneficiaries under the programs pay tax on the funds when the benefits are received. The benefits are basically taxed under annuity rules, and the portion of the benefits attributable to donor contributions is received tax-free.

However, cash distributions made 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 extends to distributions from qualified tuition programs established and maintained by an entity other than a state (or agency or instrumentality thereof).

Note:

> If the cash distributions out of the qualified tuition program do not exceed the qualified higher-education expenses (as reduced by the in-kind distributions), no amount is included in gross income. If, however, the cash distribution does exceed this limitation, then the amount otherwise included in gross income under §72 is reduced by an amount that bears the same ratio to such amount as such expenses bear to such distributions.

2. Qualified higher education expense

The funds in the QTP can be used for tuition, fees, books, computers and peripheral technology, and supplies needed for higher education. Room and board are also eligible expenses for such plans for beneficiaries who are at least half-time students. If the funds are not used for such expenses, the younger generation member beneficiary will be taxed on the excess of the funds received over the amounts contributed.

3. Elementary and secondary school expense

The TCJA expands the definition of qualified distributions from §529 plans to include distributions made for expenses at an elementary or secondary public, private, or religious school (K-12). The annual limit for distributions for K-12 expenses is $10,000.

Note:

> QTPs may now be used to save for room and board expenses. Prior to 2002, the allowable amount for students living off campus was limited to either $2,500 or $1,500 per academic year, depending on whether the student lived at home.[341] However, the 2001 Tax Act revised the basis for determining the allowable room and board, referring to the allowance included in an institution's cost of attendance as determined in accordance with §472 of the Higher Education Act of 1965. Section 472 of that Act does not include dollar caps on the room and board allowances; instead, it generally leaves it up to the institution to determine the different room and board allowances for students living on or off campus. Accordingly, for tax years after 2001, the room and board limitation cannot exceed, if greater than the above-imposed limitation, the actual invoice the student is charged for residing in housing owned or operated by the eligible education institution. QTPs may now be used to pay expenses not only at public and nonprofit institutions, but also at proprietary schools (i.e., any school that is an eligible educational institution for purposes of the HOPE Scholarship or Lifetime Learning Credits). Accounts in QTPs may now be transferred tax-free from the beneficiary to a broader range of family members. (Stepsiblings and spouses of family members have been added as well as children of brothers and sisters of the purchaser and first cousins of the beneficiary.)[342]

4. Eligible educational institution

The Code defines an eligible educational institution as an accredited post-secondary educational institution offering credit toward a bachelor's degree, an associate's degree, a graduate-level or professional degree, or another recognized post-secondary credential. The institution must be eligible to participate in Department of Education student aid programs. However, see ***3*** above.

5. Annual gift-tax exclusion

Contributions by donors are eligible for the $19,000 **annual gift-tax exclusion** ($38,000 for "split" gifts by married couples in 2025). Therefore, for transfer-tax purposes, such contributions are treated as a completed gift to the beneficiary. 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 ($95,000 or $190,000 for married couples filing jointly) to be made **without gift-tax consequences**. Note that the gift-tax annual exclusion is indexed for inflation beginning in 1999.

Note:

> Section 529 provides that contributions to a QTP are a completed gift of a present interest for federal gift-tax purposes. Section 529 provides a five-year averaging provision for any contributions in one taxable year that are greater than the current $19,000 ($38,000 for married couples) annual exclusion from federal gift tax. This means that if a contribution by any contributor to a single beneficiary in any one tax year is greater than $19,000 ($38,000 for married couples), the contributor may elect to average the amount of the gift over a five-year period. This would allow a maximum contribution of up to **$95,000 ($190,000 for married couples)** in one tax year without federal gift-tax consequences. A contributor who makes a maximum contribution of up to $95,000 ($190,000 for married couples) may not make any additional gifts to the same individual until the end of the five-year averaging period without incurring federal gift-tax consequences. Section 529, as amended, also provides that distributions from a qualified tuition program will not be treated as a taxable gift.

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[341] Prop. Reg. §1.529-1(e).

[342] Notice 97-60, 1997-46 I.R.B. 8, §6, Q&A-1.

6. SECURE Act and SECURE 2.0 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. [343] The student loan interest deduction is not permitted to the extent payments were made from a 529 plan.

This provision of the SECURE Act applies to distributions made after December 31, 2018.

SECURE 2.0 permits beneficiaries of 529 college savings accounts to rollover up to $35,000 over the course of their lifetime from any 529 account in their name to their Roth IRA. Such rollovers are subject to Roth IRA annual contribution limits, and the 529 account must have been open for more than 15 years. The rollover cannot exceed the total amount contributed to the account more than five years before the rollover. Roth income limit restrictions are not applicable to the 529 plan Roth conversion. As a result of this new provision, individuals will have the option to avoid the penalty on a non-qualified withdrawal of leftover 529 plan funds. This new SECURE 2.0 provision applies to distributions after December 31, 2023.

7. Planning

Note:

A contributor to or beneficiary of such a program cannot directly or indirectly direct the investment of any contributions to the program (or any earnings on the contributions).[344] Proposed reliance regulations issued in 1998 permit a selection to be made among different investment strategies designed by the program, but only at the time when the initial contribution is made establishing the account. Later, to provide for some investment flexibility, the Service indicated that the final §529 plan regulations would provide that a program does not violate the Code §529(b)(4) investment restriction if it permits a change in the investment strategy selected for a §529 account once per calendar year, and upon a change in the designated beneficiary of the account.[345] This special rule was conditioned on the program's compliance with a requirement that the program must: (i) allow participants to select only from among broad-based investment strategies designed exclusively by the program; and (ii) establish procedures and maintain appropriate records to prevent a change in investment options from occurring more frequently than once per calendar year or upon a change in the designated beneficiary of the account.

a. High-bracket grandparents should consider using 529 plans, because the cash in a 529 plan grows tax-deferred, so there are no interest, dividends, or capital-gains distributions to report on the child's income tax return while outright gifts are taxable and generally at the sandwich generation parent's tax rates.

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343 The "Setting Every Community Up for Retirement Enhancement Act of 2019," §302(a)(8); §302(a)(9).
344 I.R.C. §529(b)(4),
345 Notice 2001-55, 2001-2 C.B. 617.

Question to ponder:

Can you think of reasons why a parent or grandparent would not want to do this?

Planning point:

Among the federal benefits of a 529 plan is the contribution of after-tax dollars (limited in amount, but not limited by AGI phase outs) that will accumulate tax-free with the tax coming at distribution, but with the added feature of exclusion of earnings attributable a distribution, to the extent made for qualified higher-education expenses. On a state level, tax some states offer a state income tax deduction, some even when the contributions are made to another state's program.

There is some flexibility in switching beneficiaries. The tax-free distribution exclusion for distribution in respect of qualified higher education expenses still apply if a plan owner needs to switch beneficiaries, such as where the beneficiary gets a scholarship and does not need the money saved in the 529 plan; the change of beneficiaries is generally limited (i.e., there is no taxable gift), to changes to another person in the family.

Although, generally, §529 plans can be an attractive college savings device with their tax-advantaged features, in certain instances a parent or grandparent of considerable wealth may be better advised to make only limited use of §529 plans and instead plan on paying the child's college tuition directly to the school because such payments are entirely income and gift tax-free and are not subject to the annual exclusion limits. The parent's or grandparent's annual exclusion gifts could then be devoted to other purposes—such as funding an irrevocable trust, with "Crummey powers of withdrawal," with property that may be expected to appreciate substantially in value.

The donor, who is generally the "account owner," is often a parent or grandparent designating a child or grandchild as beneficiary. However, any person (including trusts, organizations, and custodians under UTMA) may establish a §529 plan on behalf of any individual beneficiary. There are no relationship requirements between the owner and the beneficiary (e.g., the beneficiary does not have to be a dependent of the account owner), and there are no income limitations on who can be a beneficiary. There can be only one beneficiary per plan, but there can be more than one plan per beneficiary. An account owner can create a §529 plan for himself or herself.

It is the person making the contribution, and not the beneficiary, who is the account owner and has control over the distribution of assets. While the account owner can withdraw all or a portion of the account balance for his own account, the portion of the withdrawal that is attributable to the pre-tax earnings (but not the post-tax contributions) of the account would have to pay both income tax and an additional 10-percent tax. There can be only one designated beneficiary of each account and a separate accounting must be kept for each account. Although the account owner need not necessarily be – and generally is not -- the beneficiary of the plan, its assets may not be used as security for loans to any person. The plan is required to prohibit contributions in excess of the amount necessary to qualify for higher education expenses of the beneficiary. The maximum amount that can be contributed to a §529 plan varies from state to state. This is a ceiling on the aggregate contributions for each beneficiary, no matter how many plans are in existence for that beneficiary. If the assets in the plan grow beyond the ceiling, they can stay in the plan, but once the ceiling has been reached, no additional contributions may be made to a §529 plan for that beneficiary.

Even if the parent or grandparent has other purposes in mind for annual exclusion gifts (including gifts to irrevocable life insurance trusts with Crummey powers of withdrawal) and wishes to take advantage of the gift-tax exclusion under §2503(e) for the direct payment of college tuition, §529 plans can still serve as a helpful complementary college savings device to meet the costs of room and board, books, supplies, and fees that the gift-tax tuition exclusion does not cover.

(i) One advantage of transferring money into a 529 plan is the lack of access, even when the younger generation member turns 18; the younger generation has no legal claim to the fund at any time. The older generation grandparent continues to have complete ownership and control for as long as he or she decides to keep the money in the 529 plan.

(ii) A 529 plan offers the only way to remove assets from the donor's estate while retaining all ownership rights. Even though the donor retains a string on this transfer, the contributions into the 529 plan are treated as completed gifts to the account beneficiary; moreover, even though the donee has no right of present enjoyment, the contribution is treated as a present interest gift, making it eligible for the annual gift tax exclusion. Contributions to 529 plans may be treated as spread over up to five years of annual exclusions into one year. Up to $95,000 ($190,000 for a couple) can be placed into a 529 plan for each younger generation grandchild and stay within the gift-tax annual exclusion. This treats the frontloading of more contributions into a 529 plan without exceeding the annual gift tax exclusion (although the balance of the gift may be accelerated if the donor dies before the end of the five-year period.

b. High-income taxpayers should consult their state law to see if a deduction for state income tax purposes is permitted. Some do regardless of whether it is an in-state or an out-of-state 529 plan.

c. Unlike a CESA, because the donor can be the owner of the 529 plan account, the donor can take back the gift at any time (subject to a tax on the earnings together with a 10-percent penalty.

d. If the 529 plan accepts "third-party" contributions, contributions can be made to their accounts rather an account of the donor. A very small number of 529 plans may not accept third-party contributions. If the parents have their own accounts in these particular 529 plans, options of an older generation grandparent include opening the grandparent's own accounts or giving the parents cash with the request that they place the gifts into the 529 accounts for the younger generation grandchildren.

e. A 529 account owned by a parent for a dependent student is reported on the federal financial aid application (FAFSA) as a parental asset. Parental assets are assessed at a maximum 5.64-percent rate in determining the student's Expected Family Contribution (EFC). In other words, every $10,000 of savings results in an approximate reduction of the financial aid package by $564.

f. Along with favorable asset treatment, a 529 account provides favorable treatment in the income portion of the financial aid eligibility formula. A tax-free distribution from a 529 plan to pay this year's college expenses will not be part of the "base-year income" that reduces next year's financial aid eligibility. In order to determine the investment mix that offers the most favorable impact on your child's federal financial aid eligibility, let us first look at how the formula for computing EFC works. The formula counts the following financial resources as being available to pay college expenses:

(i) 20 percent of a student's assets (money, investments, business interests, and real estate);

(ii) 50 percent of a student's income (after certain allowances);

(iii) 2.6 percent to 5.6 percent of a parent's assets (money, investments, certain business interests, and real estate, based on a sliding income scale and after certain allowances); and

(iv) 2 percent to 47 percent of a parent's income (based on a sliding income scale and after certain allowances).

Planning point:

> A retirement account is a good type of asset to own when applying for financial aid, because such assets are not counted at all in determining the expected family contribution (EFC) for purposes of federal financial aid (regardless of whether owned by the sandwich or younger generation). However, taking distributions causes the entire withdrawal (not just the earnings) to be treated as income on the following year's aid application.
>
> Other excluded assets include the equity in the primary home, a family-owned business, insurance policies, and annuities. Gifts to younger generation members that are not in trust are UGMA or UTMA accounts that are treated as student assets that can cause a greater reduction in eligible financial aid than are the assets of a sandwich generation parent. The income produced from such assets is likewise treated as student income for which a larger reduction in financial aid will occur.
>
> So the tax benefits of income shifting through transfers may be outweighed by the total reduction in financial aid that results from the younger generation student's ownership of asset and the income therefrom.

Note:

> A 529 account or CESA owned by a dependent student, or by a custodian for the student, does not have to be included with other student-owned investments. They are reported on the FAFSA as parental assets.

g. If a sandwich generation parent owns the 529 account or CESA, up to 5.6 percent of the value is included in EFC as a parent asset. If older generation grandparents own the account, none of the value is included.

   (i) Withdrawals from 529 plans and CESAs are also treated advantageously. Such withdrawals when used for college are excluded from federal income tax return and are not added back to income when reporting income on a FAFSA unless, in the case of a 529 plan, the plan is owned by a third party not the student or the student's parent.

   (ii) When the older generation (grandparent generally) member is the owner-donor of the 529 account, it is not reportable as an asset on the student's FAFSA but any distributions to or on behalf of the student must be added to student income on the following year's FAFSA; distributions from a sandwich generation member-owned 529 plan are not added to the younger generation's income in the following year.

   - This is not a problem once the younger generation student files the final FAFSA. Distributions from an older generation member-owned 529 plan on or after January 1 of the student's junior year will have no impact on federal financial-aid eligibility. In this case, the account value never gets reported on the FAFSA as an asset, and the distribution never gets reported as student income. This really, however only covers the final 1½ years of college.
   - Many, but not all, 529 plans allow for a change in ownership; the older generation member can transfer account ownership to the younger generation member or more likely to the sandwich generation student's parent. Qualified (i.e., tax-free) distributions from a student-owned or parent-owned 529 are not includable in the student's income on the FAFSA.

- The downside to this approach is that the 529 account value now becomes reportable on the FAFSA, thus reducing aid eligibility by as much as 5.64 percent of the account value. (It is reportable as a parental asset whether the account is owned by the student, by the parent, or by a custodian for the student under the Uniform Transfers to Minors Act.)
- Even this modest negative impact can be avoided through a timing strategy involving a transfer of this year's college funds into a separate 529 account via partial rollover. Ownership of this separate account is then transferred from the grandparent to the student or parent, but only after student has submitted this year's FAFSA. The funds in this 529 account are spent before next year's FAFSA is filed and thus never get reported.
- Because distributions from a 529 plan are not required to be paid directly for college expenses, or somehow be traced to the payment of college expenses, and the only requirement is that the account beneficiary incur qualified expenses during the same year the distributions are taken from a 529 plan, the distributions can be made to the older generation member rather than the student and gift to the sandwich generation parent the amount of the distribution which the parent then uses to pay qualified education expenses. These gifts are not added to the student's income, but they double up as gifts by the older generation member: first on contribution and then on gift to the student's parent.
- The older generation member may take a distribution while the student takes a student loan and pays qualified expenses in each year before the variables no longer matter when the older generation member makes a gift of the accumulated college loans (and distributions from the 529 plan) with which the student repays the education loans.

Planning point:

Many grandparents may setup a §529 plan to help pay for their grandchild's education. Prior to the SECURE Act, if grandparents made distributions from a §529 plan to pay for their grandchild's qualified education expenses, these distributions would be reported as untaxed income on their grandchild's FAFSA. The grandchild's financial aid package could be reduced by up to 50% of the value of untaxed income reported on their FAFSA. If the grandparents used $10,000 from their §529 plan distributions to pay for their grandchild's qualified education expenses, their grandchild's FAFSA could be reduced by up to $5,000.

Since the enactment of the SECURE Act, the grandparents in this example could avoid negatively impacting their grandchild's FAFSA by waiting to take the §529 plan distribution. If their grandchild has $10,000 in student loans, the grandparent can wait until the grandchild graduates and withdraw $10,000 from the §529 plan to pay off the student loans. Since the distribution is taken after the grandchild graduates, nothing would be reported on the FAFSA.

C. Coverdell education savings accounts

A **Coverdell education savings account (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 education savings account for tax purposes.[346]

Technically, although they possess some of the features of regular IRAs, CESAs are not IRAs. But similar to regular nondeductible IRAs and Roth IRAs, CESAs may accept nondeductible contributions, and the earnings on account values are generally tax-deferred. Similar to Roth IRAs, distributions are tax-free -- if they are used to pay qualified education expenses.

While generally exempt from income tax, CESAs are subject to tax on their unrelated business taxable income.[347]

1. Contributions

a. Similar to regular IRAs, contributions may only be made in cash.[348] In contrast with regular IRAs, no contributions may be made to a CESA after the date on which the beneficiary attains age 18[349] and the maximum aggregate contributions (other than rollovers) for a taxable year cannot exceed $2,000.[350] The $2,000 contribution limit is phased out for taxpayers with modified adjusted gross income at $110,000 ($220,000 for joint returns). Contributions may be made by persons unrelated to the beneficiary.

Planning point:

The Service has clarified that the $2,000 annual aggregate rule applies to all CESAs set up for the benefit of a given individual. Thus, the $2,000 limit for a given individual designated beneficiary cannot be circumvented by setting up multiple CESAs naming the same designated beneficiary and contributing $2,000 to each account, even if these accounts were set up and funded by different donors, such as parents and grandparents.

b. Contributions to CESAs are nondeductible.

Planning point:

The $2,000 annual contribution limit can apparently be very easily circumvented. If the donor's (for example, a parent's) MAGI exceeds the phase out range, the parent may simply gift $2,000 to another person whose MAGI does not exceed the phase out range, such as a brother or sister, or conceivably, even the child who is the designated beneficiary of the CESA, who, if the child so desires, apparently may then contribute the $2,000 either to the existing CESA or to another CESA for the benefit of the designated beneficiary.

2. Distributions

- Distributions made on behalf of the account (younger generation) beneficiary to pay for education are not taxed to the extent the distribution does not exceed qualified education expenses for that tax year.

346 Notice 97-60, 1997-46 I.R.B. 8 §Q&A-1.
347 I.R.C. §530(a).
348 I.R.C. §530(b)(1)(A)(i).
349 I.R.C. §530(b)(1)(A)(ii).
350 I.R.C. §530(b)(1)(A)(iii).

- Qualified education expenses include tuition, fees, and books. Room and board charges also qualify if the student is enrolled in the educational institution on at least a half-time basis.
- If the younger generation member does not need the money for education, the account balance can be rolled over to the CESA of certain **family** members who can use it for their education.
- Amounts withdrawn from a CESA that exceed the child's qualified education expenses in a taxable year are generally subject to income tax and to an additional tax of 10 percent.

3. CESA weaknesses

CESAs can be a problem for high-income older generation members. Contributors must have less than $190,000 in modified adjusted gross income ($95,000 for single filers) in order to qualify for a full $2,000 contribution. The $2,000 maximum is gradually phased out if the donor's modified adjusted gross income falls between $190,000 and $220,000 ($95,000 and $110,000 for single filers).

a. Apparently, a sandwich or older generation member who is above the phaseout limit can still get the $2,000 into the CESA by simply gifting that amount to the younger generation child, who in turn places the money in the CESA. Unlike an IRA, the contributor does not need earned income, but like an IRA, contributions made by April 15 can count toward the prior year's limit.

b. However, even when the donor is below the phaseout limit, for grandparents in particular, CESAs pose some issues not faced with 529 plans. Because the $2,000 is an aggregate limitation, donors could easily cause the account to exceed the annual limit even though their contribution by itself does not. A penalty must be paid unless the excess is refunded no later than May 31 in the year following the year of the contribution. Older generation grandparents do not retain the same degree of control over contributed funds as 529 plans allow. Most CESA agreements require that the child's parent or guardian be the responsible individual on the account. Another issue to be faced is the potential forfeiture of amounts unexpended for qualified expenses.

D. Education-favored accounts

1. Coping with the limitations on CESAs

a. General principles:
   - Age-30 limit: When a beneficiary reaches age 30, any balance must be distributed within 30 days and the earnings portion is subject to income tax and the 10-percent penalty tax;
   - No 10-percent penalty if made to a beneficiary (or to the estate of the designated beneficiary) on account of death, disability, or scholarship;
   - A donor may change the designated beneficiary at any time without tax or penalty, as long as the new beneficiary is a member of the family of the old beneficiary;
   - A rollover from a CESA can be made to another CESA within 60 days for the beneficiary **or member of the beneficiary's family**, but only once in a 12-month period; and
   - Direct trustee-to-trustee transfers can be made without limit.

b. Member of the family for CESAs and §529 plans include:
   - Son or daughter (including adopted) or a descendant of either;

- Stepson or stepdaughter;
- Brother, sister, stepbrother, or stepsister;
- Father, mother, or an ancestor of either;
- Stepfather or stepmother;
- Niece or nephew;
- Aunt or uncle;
- Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law;
- Spouse of a designated beneficiary; or
- Cousin, which gives grandparents more flexibility.

c. Estate and gift issues:

- Contributions to a CESA are completed gifts and qualify for the annual $16,000 gift-tax exclusion; and
- Even though a donor can change the beneficiary (a power of appointment), this will not cause the proceeds to be included in the donor's estate.

Planning point:

You will avoid the $18,000 gift limit if parents make a $2,000 contribution to a CESA, then grandparents can make $18,000 in §529 plan contributions.

d. Coordination with a §529 plan:

- You can now contribute to both a CESA and §529 plan;
- Beware of exceeding the $18,000 gift limit for the same beneficiary by the same donor; and
- You can transfer the balance of a CESA into a §529 plan established on behalf of the same beneficiary.

Example 1: Suppose you begin to fund a CESA at birth for a newborn child. If you contribute the maximum $2,000 contribution for 18 years beginning the day after birth and compound the money at eight-percent interest, how much will you accumulate when the child reaches age 18? What if it compounds at 10 percent or 12 percent?

- $80,893 at eight-percent interest;
- $100,318 at 10-percent interest; and
- $122,875 at 12-percent interest.

Example 2: In 2025, you have children ages 14, 11, and 8, and your AGI is below the AGI limit. You wish to maximize tax-free planning with a CESA.

		Contribution compounded at 10-percent interest
Oldest child		
Contribution ages 14-17 (4 years):	$8,000	$9,282
Year 2029 balance:		$9,282
Middle child		
Contribution ages 11-17 (7 years):	$14,000	$18,974
Roll over:	$9,282	$11,237
Year 2032 balance:		$30,205
Youngest child		
Contribution ages 8-17 (11 years):	$22,000	$37,062
Roll over:	$30,205	$36,549
Year 2036 balance:		$73,611
Age 18, available for college in 2036:	$73,611	$80,972
Total contribution:	$44,000	

Since, in 2029, the oldest child is 17 and will go to college in 2029, we could transfer that balance to the next youngest child. When the 11-year old reaches age 17 in 2032, that balance could also be transferred to the youngest child. Finally, when the youngest child is 18 and going to college, assuming a 10-percent return, there will be $80,972 available.

To further explore the planning options, suppose the youngest child does not go to college. Now what do you do? Perhaps you can let the money accumulate until age 30, when it is worth $254,125.

Planning point:

Remember that the oldest child is now 36 and may have a child. Now the balance could be transferred to a grandchild and perpetuate the tax-free accumulation. However, since the account is moving down a generation, a gift and generation-skipping transfer has occurred.

CAUTION: You are currently allowed to withdraw money from a CESA to fund a §529 plan. The money withdrawn from the CESA is still tax-free since used for qualified education, but the contribution to the §529 plan does *not* increase the tax basis in the plan. The end result is earnings built up in the CESA prior to withdrawal continue to be treated as earnings.

The Service issued Notice 2001-81 to flesh out the reporting of rollover contributions from CESAs to include the earnings component.

e. What if you are above the AGI limit?
- Married AGI: $190,000 - $220,000; and
- Single AGI: $95,000 - $110,000.

Example: Parents make AGI of over $500,000 a year and cannot fund a CESA for their child. The parents can make a Christmas present of $2,500 to the child's grandparents. The grandparents' AGI is below the limit, and they could set up a CESA for the grandchild. Parents could still control investments by being custodians of the account.

Planning point:

Making Contributions Before Your Child is Born

Mary, age 27, and married with no children, hopes to have children in the next several years and would like to start a CESA today. Can she do this?

If Mary has a brother or sister with children and they do not make a CESA contribution, can Mary make one for her niece or nephew?

If Mary had 10 nieces and nephews, she could make up to a $20,000 contribution, wait until her child is born, and transfer the beneficiary to her child, since the beneficiaries are cousins.

f. CESAs apply to K-12 education as well as college. The qualified elementary and secondary education expenses that qualify for funding through a CESA include not only expenses for tuition, fees, academic tutoring, special needs services in the case of a special needs beneficiary, books, supplies, and other equipment which are incurred in connection with the enrollment or attendance of the designated beneficiary of the trust as an elementary or secondary school student at a public, private, or religious school, **but also** expenses for room and board, uniforms, transportation, and supplementary items and services (including extended day programs) which are required or provided by a public, private, or religious school in connection with such enrollment or attendance.

Planning point:

Now is the time to fund a computer as well. The education expenses may soon again include expenses for the purchase of any computer technology or 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. However, it does not include expenses for computer software designed for sports, games, or hobbies unless the software is predominantly educational in nature.

2. Section 529 plans

a. There are two basic types of §529 plans:
- Prepaid tuition plans; and
- College-savings plans.

b. Prepaid tuition plans:
- Account owner (e.g., individual) contributes cash to a plan account for a beneficiary (e.g., child) and the contribution purchases tuition credits (e.g., credit hours) based on then-current tuition rates;
- Contributions qualify for annual gift-tax exclusion;
- When beneficiary attends a participating college, his or her tuition credits may be used to pay tuition or expenses, regardless of current tuition rates;
- This difference in value is tax-free;
- Prepaid tuition plans have the advantage of keeping up with inflation of college expenses no matter how high that inflation may go;
- Almost all prepaid tuition plans require that either the account owner or the beneficiary be a resident of the state that operates the plan;
- Most plans are of limited duration (e.g., payout 10 years after the date the beneficiary is scheduled to begin college); and
- Generally, these plans only provide for undergraduate education.

c. College savings plans:

- Account owners contribute cash to a plan account for a beneficiary, and the contribution is invested according to the terms of the plan. In most instances, they are invested in mutual fund types of accounts. When the beneficiary attends virtually any college, the funds in the account may be used to pay for the beneficiary's tuition and other college expenses. Any earnings are tax-free if used for qualified expenses.
- Plans may charge a penalty if monies are not used for qualified expenses.
- The SECURE Act expands §529 education savings accounts coverage to include expenses associated with registered apprenticeship programs
- 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.
- New law: A 10-percent additional tax is imposed on any earnings that are included in taxable income, because they are not used for qualified higher education expenses. This penalty does not apply to distributions that are rolled over within 60 days to a new §529 plan for the same beneficiary, or for a new beneficiary who is a family member of an old beneficiary, or due to death, disability, or scholarship.

Planning point:

However, parents who are already well-heeled have an opportunity to take advantage of the provision in 529 plans allowing individuals to treat transfers as made over a period of five years. Because the annual exclusion amount is $19,000, a single grandparent could transfer as much as $95,000; and with gift-splitting this could increase to $190,000; and this amount in turn can be doubled if the other set of parents are also able to make such a gift. Note that if a parent dies before the end of the five-year period, the "unamortized" portion of the initial gift will be included in the estate.

Wealthier parents could multiply this by applying the same strategy with respect to each grandchild.

Planning point:

Since there is no age restriction on the timing of contributions (unlike a CESA) with respect to the age of the named beneficiary, an individual, age 50, with thoughts of retiring at age 55, might put $100,000 in a §529 plan for himself. When the individual reaches age 55, he could apply to take graduate-school courses abroad and use the proceeds for tuition and room and board. It could be great fun!

Planning point:

One may get the benefit of a year's deferral on state income taxes by making a contribution deductible under state law in December and take the money back out in January.

d. The Code has expanded the definition of qualified higher education expenses for expenses paid or incurred to include expenses for certain computer technology and equipment[351] or Internet access and related services, if such technology, equipment, or

[351] I.R.C. §170(e)(6)(F)(i) defines this as computer software (as defined by I.R.C. §197(e)(3)(B)), computer or peripheral equipment (as defined by I.R.C. §168(i)(2)(B)), and fiber optic cable related to computer use.

services are to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is enrolled at an eligible educational institution.[352] However, it does not include expenses for computer software designed for sports, games, or hobbies unless the software is predominantly educational in nature.

VII. Miscellaneous

A. In general

1. Above the line

Only deductions related to rents, royalties, or the conduct of a trade or business are deductible in computing adjusted gross income of the investor.[353] All other deductions are taken below the line as itemized deductions in computing taxable income.

2. The repeal of the Pease limitation on itemized deductions

The Pease limitation is suspended by the TCJA for tax years 2018 through 2025.[354] This will have a significant impact on clients that have been subject to the limitation.

3. Miscellaneous itemized deductions

Miscellaneous itemized deductions subject to the 2-percent-of-AGI floor are suspended by the TCJA for tax years 2018 through 2025. Examples of miscellaneous items that will not be deductible in 2018 are:

- Investment counsel and advice fees;
- Legal and Accounting fees;
- Subscriptions to newspapers and periodicals related to an investment;
- Transportation costs and phone calls to a broker or investment adviser; and
- Unreimbursed employee business expenses.

Strategies to minimize the impact of losing the miscellaneous itemized deductions include:

- Ask the employer to adopt an accountable plan to reimburse employee business expense.
- Convert from employee to contractor to deduct business expenses and take advantage of the §199A deduction.
- Use mutual fund investments that have the fee deducted from the fund, or use other investment vehicles where the fee will increase basis.

4. Expenses attributable to tax-exempt income

No expenses allocable in whole or in part to tax-exempt interest income on state, municipal, or private activity bonds are deductible.[355] This is most frequently applied to interest paid on a debt incurred or continued **for the purpose of** acquiring or continuing tax-exempt debt obligations,[356] but it actually covers any otherwise deductible expense. Note this is an **intent** issue. Thus, investors must be careful in incurring any debt when holding tax-exempts. The presumed intent has been successfully refuted by a showing that a sale of the tax-exempts would have reduced an investor's liquidity and security.[357] As a

352 I.R.C. §529(e)(3)(A)(iii).
353 I.R.C. §62.
354 I.R.C. §68(f).
355 I.R.C. §265.
356 I.R.C. §265(2).
357 *Wisconsin Cheeseman, Inc. v. U.S.*, 388 F.2d 420, 68-1 U.S.T.C. ¶9145 (7th Cir. 1068).

practical matter, the Service will not explore this issue if the municipals do not exceed more than two percent of the investor's portfolio.

B. Interest-allocation rules

1. In general

The temporary regulations require interest expense on a debt to be allocated in the same manner as the debt to which the interest relates is allocated.[358] The process is one of tracing disbursements of the debt proceeds to specific expenditures. The allocation of interest is **not affected by the use of property used to secure repayment** of the debt to which the interest relates.

Example: Taxpayer A, an individual, pledges corporate stock held for investment as security for a loan and uses the debt proceeds to purchase an automobile for personal use. Interest expense accruing on the debt is allocated to the personal expenditure of buying the automobile even though the debt is secured by investment property.[359]

2. Ordering rules

a. Interest expense is first allocated to one of the following categories:
   - Trade or business expenditure;
   - Passive-activity expenditure;
   - Investment interest;
   - Personal expenditure; or
   - Portfolio expenditure.[360]

b. The interest expense is then subject to the limitation applicable to the expenditure to which the underlying debt is allocated.[361] Thus, for example, if debt proceeds are allocated to an expenditure in connection with a passive activity, an otherwise allowable deduction for the interest expense on the debt is subject to the passive-loss limitation.

Example: Taxpayer A, an individual, incurs interest expense allocated to the following expenditures:

$6,000	Passive-activity expenditure
$4,000	Personal expenditure

The $6,000 interest expense allocated to the passive-activity expenditure is taken into account for purposes of §469 in computing A's income or loss from the passive activity. A may not deduct the $4,000 interest expense allocated to the personal expenditure (except to the extent such interest is qualified residence interest).[362]

358 Temp. Regs. §§1.163-8T(a)(3) and 1.163-8T(c). All examples used are taken from those regulations.
359 Temp. Regs. §1.163-8T(c)(1).
360 Temp. Regs. §1.163-8T(a)(4)(i).
361 Temp. Regs. §1.163-8T(m).
362 Temp. Regs. §1.163-8T(a)(4)(ii), Example 1.

C. Timing rules

1. In general

The general timing rule requires that debt be allocated to an expenditure for the period beginning on the date the proceeds of the debt are used to make an expenditure and ending on the earlier of: (i) the date the debt is repaid; or (ii) the date the debt is reallocated.[363]

a. Interest expense accruing on a debt (presumably under the general compounding formula of economic accrual of interest),[364] for a period will be allocated in the same manner as the debt is allocated from time to time, regardless of when the interest is paid.[365]

b. For the taxable year in which a debt is reallocated, however, compound interest accruing on such debt may be allocated between the original expenditure and the new expenditure on a straight-line basis (i.e., by allocating an equal amount of such interest expense to each day during the taxable year). In addition, a taxpayer may treat a year as consisting of twelve 30-day months for purposes of allocating interest on a straight-line basis.[366]

Example: On January 1, Taxpayer B, a calendar-year taxpayer, borrows $1,000 at an interest rate of 5 percent, compounded semiannually. B immediately uses the debt proceeds to purchase an investment security. On July 1, B sells the investment security for $1,000 and uses the sales proceeds to make a passive-activity expenditure. On December 31, B pays accrued interest on the $1,000 debt for the entire year.

The $1,000 debt is allocated to the investment expenditure for the period from January 1 through June 30, and to the passive-activity expenditure from July 1 through December 31. Interest expense accruing on the $1,000 debt is allocated in accordance with the allocation of the debt from time to time during the year even though the debt was allocated to the passive-activity expenditure on the date the interest was paid. Thus, the $25 interest expense for the period from January 1 through June 30 is allocated to the investment expenditure. In addition, during the period from July 1 through December 31, the interest expense allocated to the investment expenditure is a debt, the proceeds of which are treated as used to make an investment expenditure. Accordingly, an additional $.60 of interest expense for the period from July 1 through December 31 ($25 x .025) is allocated to the investment expenditure. The remaining $25 of interest expense for the period from July 1 through December 31 ($1,000 x .025) is allocated to the passive-activity expenditure.

Alternatively, B may allocate the interest expense on a straight-line basis and may also treat the year as consisting of twelve 30-day months for this purpose. In that case, $25.31 of interest expense (180/360 x $50.62) would be allocated to the investment expenditure and the remaining $56.50 of interest expense would be allocated to the passive-activity expenditure.[367]

2. Special rules for allocation of debt

a. Debt proceeds held on deposit or in an account (i.e., a checking, savings, or money market account) are subject to several rules for allocating interest expense. The deposit of the debt proceeds will be treated as property held for investment, regardless of

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363 Temp. Regs. §1.163-8T(c)(2)(i).
364 Treas. Regs. §1.446-2.
365 Temp. Regs. §1.163-8T(c)(2)(ii)(A).
366 Temp. Regs. §1.163-8T(c)(2)(ii).
367 Temp. Regs. §1.163-8T(c)(2)(iii), Example (1).

whether the account bears interest. Accordingly, the debt and related interest expense are allocated to an investment expenditure when the debt proceeds are deposited and will be reallocated only when the debt proceeds are used for another expenditure.[368]

b. The reallocation is made on the date of the expenditure, but the taxpayer may elect to reallocate the debt as of the later of: (i) the first day of the month in which the expenditure occurs; or (ii) the day on which the debt proceeds are deposited in the account. A taxpayer may use the first-day-of-month convention only if all other expenditures from the account during that month are similarly treated.[369]

Example: Taxpayer C, a calendar-year taxpayer, borrows $100,000 on January 1 and immediately uses the proceeds to open a non-interest-bearing checking account. No other amounts are deposited in the account during the year and no portion of the principal amount of the debt is repaid during the year. On April 1, C uses $20,000 of the debt proceeds held in the account for a passive-activity expenditure. On September 1, C uses an additional $40,000 of the debt proceeds held in the account for a personal expenditure. From January 1 through March 31, the entire $100,000 debt is allocated to an investment expenditure for the account. From April 1 through August 31, $20,000 of the debt is allocated to the passive-activity expenditure, and $80,000 of the debt is allocated to the investment expenditure for the account. From September 1 through December 31, $40,000 of the debt is allocated to the personal expenditure, $20,000 is allocated to the passive-activity expenditure, and $40,000 is allocated to an investment expenditure for the account.

3. FIFO rule

a. If a borrower deposits debt proceeds in an account containing unborrowed funds, the debt generally is allocated to expenditures by treating subsequent expenditures from the account as made first from the debt proceeds.[370]

Example: On January 10, Taxpayer E opens a checking account, depositing $500 of proceeds of "Debt A" and $1,000 of unborrowed funds. The following chart summarizes the transactions that occur during the year with respect to the account.

Date	Amount	Transaction
January 10	$1,500	Proceeds of Debt A and $1,000 deposited
January 11	$500	Proceeds of Debt B deposited
February 17	$800	Personal expenditure
February 26	$700	Passive-activity expenditure
June 21	$1,000	Proceeds of Debt C deposited
November 24	$800	Investment expenditure
December 20	$600	Personal expenditure

The $800 personal expenditure is treated as made from the $500 proceeds of Debt A and $300 of the proceeds of Debt B. The $700 passive-activity expenditure is treated as made from the remaining $200 proceeds of Debt B and $500 of unborrowed funds. The $800 investment expenditure is treated as made entirely from the proceeds of Debt C. The $600 personal expenditure is treated as made from the remaining $200 proceeds of Debt C and $400 of unborrowed funds. The debt is allocated to an investment expenditure for periods during which debt proceeds are held in the account.[371]

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368 Temp. Regs. §1.163-8T(c)(4)(i).
369 Temp. Regs. §1.163-8T(c)(4)(iv).
370 Temp. Regs. §1.163-8T(c)(4)(ii).
371 Temp. Regs. §1.163-8T(c)(4)(ii), Example.

b. If the proceeds of two or more debts are deposited in an account, the proceeds are treated as expended in the order in which they are deposited. There are two exceptions to this rule.

(i) First, a taxpayer may treat any expenditure made from an account within 15 days after debt proceeds are deposited in the account as made from those proceeds.[372]

Example: Taxpayer D incurs a $1,000 debt on June 5 and immediately deposits the proceeds in an account ("Account A"). On June 17, D transfers $2,000 from Account A to another account ("Account B"). On June 30, D writes a $1,500 check on Account B for a passive-activity expenditure. In addition, numerous deposits of borrowed and unborrowed amounts and expenditures occur with respect to both accounts throughout the month of June. Notwithstanding these other transactions, D may treat $1,000 of the deposit to Account B on June 17 as an expenditure from the debt proceeds deposited in Account A on June 5. In addition, D may similarly treat $1,000 of the passive-activity expenditure on June 30 as made from debt proceeds treated as deposited in Account B on June 17.[373]

(ii) Second, if an account consists solely of debt proceeds and interest income, the proceeds may be treated as first made from the interest to the extent of such income at the time of the particular expenditure. To the extent any expenditure is treated as made from interest, it is disregarded in applying the interest expense ordering rules.[374]

D. Planning for interest allocations

1. In general

The "tracing approach" does allow some taxpayers to manipulate the tracing rules to maximize their interest deductions. For example, a sole proprietor may be able to maximize the amount of fully deductible interest expense allocated to trade or business expenditures by borrowing to pay business expenses and making personal expenditures from business receipts.

Example: Accountant needs $20,000 for personal expenses, which is the balance in the business checking account. By transferring $20,000 from the business account to his personal checking account and borrowing $20,000 to pay for business expenses, the accountant has converted what would have been personal interest into business interest.

2. Making the right borrowing

Similarly, upper-income taxpayers may have sufficient liquidity to make business and investment expenditures from borrowed funds and personal expenditures from unborrowed funds.

3. Property used to secure

Finally, since the allocation of interest expense is not affected by the use of property to secure repayment of a debt, a taxpayer may convert nondeductible personal interest to deductible investment interest. For example, a taxpayer may use borrowed funds to purchase an asset for personal use (such as an automobile), incur debt secured by that asset, and use the debt proceeds to replace the funds used to buy the personal asset.

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372 Temp. Regs. §1.163-8T(c)(4)(iii)(B). Notice 89-35 extends the 15-day period to 30 days.
373 Temp. Regs. §1.163-8T(c)(4)(iii)(B), Example (1).
374 Temp. Regs. §1.163-8T(c)(4)(iii)(C).

Example: Accountant withdraws $20,000 from his business money market account and uses it to purchase a car, then obtains a $20,000 loan secured by the car, but deposits the $20,000 in the business money market account. Accountant has converted what would have been nondeductible personal interest into deductible investment interest.

E. Investment interest

1. In general

Investment income, for purposes of the deductibility of investment interest, is defined as the sum of the gross income from property held for investment (other than gain from the sale of property held for investment) and the **excess**, if any, of the net gain attributable to the sale of property held for investment over the net capital gain[375] determined by only taking into account gains and losses from the dispositions of property held for investment, plus, **if elected**, the lesser of net gain or the net capital gain.[376] The gain, if any, so elected is not eligible for the maximum capital gains tax rate as previously described.[377]

Example: A has the following in 2025.

Long-term gain	$50,000
Short-term gain	$25,000
Long-term loss	$0
Short-term loss	$10,000
Investment interest	$40,000
Net gain	$65,000
Net LT capital gain	$50,000
Excess	$15,000
Electable gain	$50,000
Investment Income:	
Without Election:	
Excess	$15,000
With Full Election:	
Excess	$15,000
Electable gain	$50,000
Total	$65,000
With Optimum Election:	
Excess	$15,000
Electable gain	$25,000
Total	$40,000

In the optimum election, $25,000 of the net gain will be subject to the same rates as the taxpayer's other ordinary income; the balance of the gain is net capital gain subject to the maximum tax rate described earlier.

2. Planning points

a. In order to generate sufficient gain to cover any excess investment interest at the end of a tax year, absent the election, the sale of property creating short-term gain will be effective, but that creating long-term gain will not.

375 I.R.C. §1222(11) defines net capital gain as the excess of net long-term capital gains over net short-term capital losses. Net long-term capital gain is the excess of long-term capital gain over long-term capital loss. Net short-term capital loss is the excess of short-term capital loss over short-term capital gain.

376 I.R.C. §163(d)(4).

377 I.R.C. §1(h) (flush language).

b. Practitioners must balance the temporary loss of the investment interest deduction against the **permanent loss** of the maximum capital-gains tax bracket on the gain that would otherwise have to be elected in order to obtain the current deduction. Investment interest expense that is not deductible on account of the investment interest limitation is carried over to later years and deducted when there is sufficient investment interest.[378] One has to take into account the time-value of money during the deferral period, the length of the deferral period, and the tax brackets for the current year and the year to which the excess investment interest will be carried.

c. Investment expenses are those expenses other than investment interest that are directly connected with the production of investment income. Thus, to the extent some capital gain is not included in the definition of investment income because of the definition and the failure to make the election, expenses directly connected with that gain are likewise not deductible. This effectively increases net investment income for purposes of the investment interest limitation. It is unclear exactly how the amount of gain excluded from investment income will be identified, which is necessary in order to identify the expenses that are not included in the definition of investment expenses. This has no effect on the deductibility of those expenses not so included, but must be taken into account in determining whether, and to what extent, the election should be made.

d. In most cases, it will be better to qualify the interest as home-equity interest rather than investment interest as this preserves capital-gains tax rates without the necessity of the above analysis; in any event, the taxpayer's situation can be enhanced even if the borrowing exceeds the $100,000 maximum.

F. Mortgage interest

Caution:

Mortgage interest that is otherwise deductible is nonetheless nondeductible interest when it is used for a purpose that the Code explicitly declares to be nondeductible interest,[379] such as borrowed money that was used for the following purposes:

(i) To purchase or carry a single-premium life insurance, endowment, or annuity contract;

(ii) To pay interest on a life insurance policy loan where the policy is owned by the taxpayer; or

(iii) To purchase or carry obligations that produce tax-exempt interest (e.g., municipal bonds).

1. Personal interest

Interest that is considered personal interest is generally not deductible after 1990. Examples of personal interest include interest charged on credit cards, car loans, and installment plans. Personal interest is all interest **except** the following:

- Interest on a trade or business debt (the trade or business of performing services as an employee is excluded);
- Investment interest;
- Interest that must be taken into account in computing income/loss from a passive activity;
- **Qualified residence interest**; and
- Interest on the unpaid portion of estate taxes for which payment is deferred.[380]

378 I.R.C. §163(d)(2).
379 Temp. Regs. §1.163-10T(b).
380 I.R.C. §163(h)(2).

2. Qualified residence interest

The term “qualified residence interest” means any interest that is paid or accrued during the taxable year on **acquisition indebtedness** with respect to any **qualified residence** of the taxpayer, or **home-equity indebtedness** with respect to any qualified residence of the taxpayer.[381] For purposes of the preceding sentence, the determination of whether any property is a qualified residence of the taxpayer shall be made as of the time the interest is accrued.

a. The term “acquisition indebtedness” means any indebtedness that is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, and is secured by such residence (i.e., there is a mortgage against the residence).[382]

Note:

> Any indebtedness secured by stock held by the taxpayer as a tenant-stockholder in a cooperative housing corporation (CHC) shall be treated as secured by the house or apartment that the taxpayer is entitled to occupy as such a tenant-stockholder. If stock described in the preceding sentence may not be used to secure indebtedness, indebtedness shall be treated as so secured if the taxpayer establishes that such indebtedness was incurred to acquire such stock. Thus, if a potential homeowner needs to finance the purchase of the share in the CHC, its share loan will generally be collateralized by a lien on the stock rather than the unit itself, and this is sufficient to enable the owner to treat interest on such amount as qualified acquisition interest.

(i) Such term also includes any indebtedness secured by such residence resulting from the refinancing of indebtedness meeting the above requirements of the preceding sentence, but only to the extent the amount of the indebtedness resulting from such refinancing does not exceed the amount of the refinanced indebtedness.

(ii) The aggregate amount treated as acquisition indebtedness for any period shall not exceed $750,000 ($375,000 in the case of a married individual filing a separate return). This is in the case of tax years 2018 through 2025. The $1M/$500,000 limitations applied before 12/15/2017. The TCJA changed the treatment of home equity debt and lines of credit. They may no longer be used for simply any purpose and still be deductible. They must be used to buy, build, or substantially improve the home that secures the loan. Also, they are included in the total $750,000 limitation, and there is no separate limitation solely for home equity (previously $100,000).

- Section 101(a) of the Disaster Act provided for the exclusion from gross income up to $2M (Married Filing Joint, $1M maximum for Single) of discharge of qualified principal residence indebtedness and extends this credit for discharges of indebtedness after December 31, 2017 and prior to January 1, 2021. The CAA 2021 extended the exclusion from gross income of discharge of qualified principal residence indebtedness through 2025. It also reduced the maximum exclusion amount from $2,000,000 to $750,000 (for married filing jointly filers). Qualified principal residence indebtedness includes any debt incurred in acquiring, constructing or substantially improving a principal residence that is secured by the principal residence.

  The CAA 2021 extended the treatment of mortgage insurance premiums as qualified residence interest for the mortgage interest deduction through 2021. This provision has not been extended, although future legislation may reinstate this deduction.

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381 I.R.C. §163(h)(3)(A).
382 I.R.C. §163(h)(3)(B).

Note:

A divided Ninth Circuit, reversing the Tax Court, held that the debt limit provisions regarding the deduction of interest on home acquisition and home equity indebtedness apply to unmarried co-owners of a residence on a per-taxpayer basis rather than on a per-residence basis.[383] Two unmarried co-owners of real property each claimed a home mortgage interest deduction on up to $1 million of home acquisition debt and $100,000 of home equity debt. The taxpayers challenged the IRS's assessment in Tax Court, arguing that the statute's debt limits apply per taxpayer such that they were entitled to deduct interest on up to $1.1 million of home debt each. The Tax Court agreed with the IRS. If a taxpayer's total mortgage debt exceeds the debt limits, a Treasury regulation, provides the method for calculating qualified residence interest: the usual method: qualified residence interest is calculated by multiplying the total interest paid by the ratio of the applicable debt limit over the total debt.[384] Although the statute is specific with respect to a married taxpayer filing a separate return, the Code does not specify whether, in the case of residence co-owners who are not married, the debt limits apply per residence or per taxpayer. That is, is the $1.1 million debt limit the limit on the qualified residence, irrespective of the number of owners, or is it the limit on the debt that can be claimed by any individual taxpayer?

- In reversing the Tax Court, the Ninth Circuit concluded that §163(h)'s debt limits apply per taxpayer. Both provisions limit "[t]he aggregate amount treated" as acquisition or home equity debt, but neither says to whom or what the limits apply. Had Congress wanted to make clear that the debt limits apply per taxpayer, it could have drafted the provisions to limit "the aggregate amount each taxpayer may treat as" acquisition or home equity debt. But it did not. Or, had Congress wanted to make clear that the debt limits apply per residence, it could have provided that the debt limits must be divided or allocated in the event that two or more unmarried individuals co-own a qualified residence. But, again, it did not. Congress clearly singled out married couples for specific treatment when it explicitly provided lower debt limits for married couples yet, for whatever reason, did not similarly provide lower debt limits for unmarried co-owners. By expressly providing that married individuals filing separate returns are entitled to deduct interest on up to $550,000 of home debt each, Congress implied that unmarried co-owners filing separate returns are entitled to deduct interest on up to $1.1 million of home debt each.
- The dissent disagreed with the majority's disregard of the Service's authority and expertise in providing a reasonable interpretation of the Code. The memorandum, like the Tax Court below, adopts a per-residence interpretation of §163(h)(3)'s debt limit provisions. Its statutory analysis consists of one paragraph, which reads:
    - A 2009 Chief Counsel Advice noted that acquisition indebtedness is defined, in relevant part, as indebtedness incurred in acquiring a qualified residence of the taxpayer -- not as indebtedness incurred in acquiring [a] taxpayer's portion of a qualified residence. The entire amount of indebtedness incurred in acquiring the qualified residence constitutes "acquisition indebtedness." The amount treated as acquisition indebtedness for purposes of the qualified residence interest deduction is limited to $1,000,000 of total, "aggregate" acquisition indebtedness. Chief Counsel found this evident from the parenthetical which limits the aggregate treated as acquisition indebtedness to $500,000 for a married taxpayer filing a separate return.[385]

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383 *Voss v. Commissioner*; Nos. 12-73257, 12-73261 (9th Cir. 2015), rev'g sub nom. *Sophy v. Commissioner*, 138 T.C. 204 (2012).
384 Treas. Regs. §1.163-10T(e).
385 CCA 200911007 (March 13, 2009).

- The IRS adopted a straightforward application of this statute when there is a single taxpayer or a married couple filing jointly. If a qualified residence serves as security for debt that is more than the specified $1.1 million, only the interest payments on the allowed $1.1 million of the debt are deductible. In the case of an individual taxpayer, the IRS calculates the proportion of the taxpayer's total interest payments that is deductible by dividing the $1.1 million of debt by the total amount of debt secured by the qualified residence. So if the qualified residence is security for $2.2 million in debt, the taxpayer can calculate the proportion of interest payments that is deductible by dividing $1.1 million (the total aggregate debt allowed by the statute) by $2.2 million (the total amount of debt secured by the qualified residence). The result is that the taxpayer can deduct one half of the interest the taxpayer paid on the total debt.

Planning point:

Under the decision, spouses filing jointly who own a qualified residence encumbered with a $2.2 million loan could deduct one half of their total interest payments (based on dividing the $1.1 million debt limit by the $2.2 million debt). But if two unmarried taxpayers owned a qualified residence with the same $2.2 million loan, the taxpayers could deduct 100 percent of their interest payments because each taxpayer could treat $1.1 million as acquisition or home equity debt (i.e., based on the $1.1 million debt limit divided by each taxpayer's "portion" of the debt, $1.1 million). The IRS has announced its acquiescence with *Voss*,[386] limiting unmarried co-owners to a deduction for interest paid on a maximum of $2.2 million, rather than $1.1 million, of acquisition and home equity indebtedness.

b. The term "home-equity indebtedness" means any indebtedness (other than acquisition indebtedness) secured by a qualified residence to the extent the aggregate amount of such indebtedness does not exceed the fair market value of such qualified residence, reduced by the amount of acquisition indebtedness with respect to such residence. Interest related to home-equity indebtedness will be deductible if used to buy, build, or substantially improve the home that secures the loan.

c. The term "**residence**" as used in the qualified-residence-interest exception includes, in addition to houses, condominium units, cooperative housing units, and any other property that the taxpayer uses for personal purposes as a dwelling unit. This generally includes a mobile home, a motor home, or a boat with living accommodations.

d. A **qualified residence** is a home that is either the principal residence[387] of the taxpayer or any **one** other residence of the taxpayer elected by the taxpayer. The second home must be used as a residence by the taxpayer under the vacation-home rules,[388] which require that a dwelling be used for personal purposes for the greater of 14 days or 10 percent of the number of days during the year that the dwelling is rented.[389] The total interest would be allocated between the rental use and the personal-residence use if the dwelling is rented for more than 14 days. If the dwelling is not rented at any time during the year, it may be treated as a qualified residence regardless of the personal use.

Planning point:

Taxpayers may choose yearly which dwelling to treat as their second home for the qualified-residence-interest limitation.

386 AOD 2016-02.
387 Treas. Regs. §1.1034-1(c)(3).
388 I.R.C. §163(h)(5)(A)(i)(II).
389 I.R.C. §280A(d)(1). However, a home that is neither used nor rented may also qualify. I.R.C. §13(h)(4)(A)(iii).

Note:

Interest is deductible on mortgage debt principal only to the extent that the **average balance** across the year of all secured debts on a **qualified residence** does not exceed the **adjusted purchase price** of the qualified residence (as of the end of the tax year).[390] The "adjusted purchase price" is equal to the individual's initial cost basis when the property was acquired, increased by the cost of any improvements to the residence.[391]

This restriction applies most commonly when a taxpayer finances an initial home purchase for nearly the entire purchase price, and then seeks to extract additional borrowing after the residence increases in value, which would exceed the adjusted purchase price.

3. Definition of qualified residence

The term "qualified residence" means the taxpayer's principal residence or the taxpayer's second residence.[392]

a. The term "principal residence" means the taxpayer's principal residence within the meaning of former §1034. For these purposes, a taxpayer cannot have more than one principal residence at any one time.[393]

b. A taxpayer cannot have more than one second residence at any time. The term "second residence" means a residence the taxpayer uses as a residence that the taxpayer **elects to treat as a second residence**.

c. Whether property is a residence shall be determined based on all the facts and circumstances, including the good faith of the taxpayer. A residence generally includes a house, condominium, mobile home, boat, or house trailer that contains sleeping space and toilet and cooking facilities. A residence does not include personal property, such as furniture or a television, which, in accordance with the applicable local law, is not a fixture.

Note:

A U.S. district court denied a couple a tax refund, finding that they were not entitled to exclude the gain on the sale of an apartment because they failed to prove they used it as their principal residence for two of the five years preceding the sale.[394] Taxpayers have lived at an apartment unit in a co-op they purchased in the early 1980s. In 1990, they purchased the adjacent apartment, but never structurally modified either to combine or otherwise create internal access between the two units.[395] They held a separate stock certificate for each unit, reflecting ownership of two sets of shares in the co-op. They leased the adjacent unit for a number of years. Their son, with his pregnant wife, moved into the other unit for approximately two years on a rent-paying basis during which time the son and his family maintained a separate phone line, kitchen, and mailbox from those of the taxpayers. Approximately nine months after the son's family moved out, the taxpayers sold the adjacent unit.

- To obtain the benefit of the exclusion on the sale of a principal residence, the adjacent unit must qualify as part of taxpayers' principal residence and taxpayers must have owned and used that unit as their principal residence for at least two of the last five years prior to the sale. The Service agreed that during two periods, amounting to approximately 12 months, taxpayers' use of the adjacent unit made it part of their principal residence. To get another 12 months of use, taxpayers have to show that they used that unit as part of their "principal residence" during 12 of the months their son's family was there. Although a

390 Temp. Regs. §1.163-10T(c)(1).
391 Temp. Regs. §1.163-10T(k)(1).
392 Treas. Regs. §1.163-10T(p)1).
393 Temp. Regs. §1.163-10T(p)(2).
394 *Cohen v. United States*; No. 1:12-cv-05828 (S.D.N.Y. 2014).
395 The Court did not view such an interior connection to be necessary to claim the exclusion.

principal residence may include land surrounding the dwelling, the legislative history indicated that the exclusion was to apply only if the dwelling the taxpayer sold was actually used as his principal residence for the period required.[396] In establishing whether a taxpayer has satisfied the two-year use requirement, **occupancy of the residence is required**.[397] Occupancy is a necessary but not sufficient condition to showing that a property was a residence.

The Code provides in connection with the exclusion that if the taxpayer holds stock as a tenant-stockholder in a cooperative housing corporation, the use requirements are applied to the house or apartment which the taxpayer was entitled to occupy as such stockholder[398].

- Taxpayers argued that they in fact occupied the unit while their son and his pregnant wife were there because they viewed them to be part of their family unit. The court did not treat the living arrangement as one where all the adults and children were living together occupying the two apartments. Taxpayers treated them similar to the renters who had been occupying the adjacent unit during the 12-year period shortly before they moved in. They treated the unit as an income-generating property inasmuch as they claimed depreciation on the property, required the tenants to pay their own cable, electric, and gas bills. The unit did not qualify as their principal residence during these periods. Little changed in these arrangements or how the taxpayers treated the unit when their son was there.
  - (i) They decided to charge them a significant rent, only slightly less than the amount they had been receiving from the previous tenants.
  - (ii) They continued to declare the rental income from the unit as business income.
  - (iii) They also claimed depreciation on the property for the full calendar year the son was there.
  - (iv) They maintained a separate phone line, kitchen, and mailbox, and paid for all of their own bills themselves.
  - (v) The taxpayers stored items in the unit both when non-family rental tenants lived there as well as when their child lived there.
- Their main argument that the unit was their principal residence during this period centered on the amount of the monthly payment made by their children because it was less than fair rental. While the amount of the monthly payments had some significance, the issue was whether the payment changed the character of the treatment of the unit as rental property so that they were then "occupying" it.
  - (i) The monthly payments were not a "cost-sharing" arrangement that might be expected in a family group that was occupying a single residence. The monthly payments were intended to approximate the rent that taxpayers had previously received from non-family tenants. The son paid all his own utilities.

Note:

The two families shared meals and visited each other. These interactions came about because of the closeness of the relationship, not because taxpayers were now using the unit as their principal residence. Taxpayers did not use the unit during this time in any way that did not involve members of the son's family. The personal interactions between the families thus did not alter the character of the financial arrangement that governed the son's occupancy of the unit.

  - (ii) With respect to the reduction of the $3,000 payment to a lower figure, that figure was still far above the actual maintenance cost on the apartment and still netted a generous profit for taxpayers. It also reflected an independent desire to benefit the grandchildren's education that avoided going to the trouble of writing a check to the son monthly.

[396] *Gates v. Commissioner*, 135 T.C. 1 (2010).

[397] Treas. Regs. §1.121-1(c)(2)(i); accord *Wickersham v. Commissioner*, T.C. Memo. 2011-17. ("Taxpayers must occupy the residence for 24 full months or for 730 days to meet the 2-year use requirement."); *Farah v. Commissioner*, T.C. Memo. 2007-369.

[398] I.R.C. §121(d)(4)(B).

The apparent reduction in rent was in actuality a mere artifact of the money transfer arrangements. His desire to make such an arrangement in this case had nothing to do with whether taxpayers were "occupying" the unit. Instead, it was based entirely on who happened to be the renter of the unit.

- Taxpayers failed to prove that they used the sold unit as their principal residence for two of the five years preceding its sale.

d. If a residence is rented at any time during the taxable year, it is considered to be used as a residence only if the taxpayer uses it during the taxable year as a residence within the meaning of §280A(d). If a residence is not rented at any time during the taxable year, it is considered to be used as a residence. For these purposes, a residence will be deemed rented during any period that the taxpayer holds the residence out for rental or resale or repairs or renovates the residence with the intention of holding it out for rental or resale.[399]

e. A taxpayer may **elect a different residence** (other than the taxpayer's principal residence) **to be the taxpayer's second residence for each taxable year**. A taxpayer may not elect different residences as second residences at different times of the same taxable year[400] unless:

(i) The taxpayer acquires a new residence during the taxable year, in which case the taxpayer may elect the new residence as a taxpayer's second residence as of the date acquired;[401]

(ii) The property that was the taxpayer's principal residence during the taxable year ceases to qualify as the taxpayer's principal residence, in which case the taxpayer may elect that property as the taxpayer's second residence as of the date that the property ceases to be the taxpayer's principal residence;[402] or

(iii) The property that was the taxpayer's second residence is sold during the taxable year or becomes the taxpayer's principal residence, in which case the taxpayer may elect a new second residence as of such day.[403]

Note:

A taxpayer may treat a residence under construction as a qualified residence for a period of up to 24 months, but only if the residence becomes a qualified residence, as of the time that the residence is ready for occupancy.

Example: X owns a residential lot suitable for the construction of a vacation home. On April 20, 2023, X obtains a mortgage secured by the lot and any property to be constructed on the lot. On August 9, 2023, X begins construction of a residence on the lot. The residence is ready for occupancy on November 9, 2025. The residence is used as a residence within the meaning above during 2025 and X elects to treat the residence as his second residence for the period November 9, 2024, through December 31, 2025. Since the residence under construction is a qualified residence as of the first day that the residence is ready for occupancy (November 9, 2025), X may treat the residence as his second residence for up to 24 months of the period during which the residence is under construction, commencing on or after the date that construction is begun (August 9, 2023). If X treats the residence under construction as X's second residence beginning on August 9, 2023, the residence under construction would cease to qualify as a

399 Temp. Regs. §1.163-10T(p)(3)(iii).
400 Temp. Regs. §1.163-10T(p)(3)(iv).
401 Temp. Regs. §1.163-10T(p)(3)(iv).
402 Temp. Regs. §1.163-10T(p)(3)(iv).
403 Temp. Regs. §1.163-10T(p)(3)(iv).

qualified residence on August 8, 2025. The residence's status as a qualified residence for future periods would be determined without regard to this provision.

Note:

Property that is otherwise a qualified residence will not fail to qualify as such solely because the taxpayer's interest in or right to use the property is restricted by an arrangement whereby two or more persons with interests in the property agree to exercise control over the property for different periods during the taxable year. For purposes of determining the use of a residence, a taxpayer will not be considered to have used or rented a residence during any period that the taxpayer does not have the right to use the property or to receive any benefits from the rental of the property.

4. Interest paid or accrued during the taxable year

For purposes of determining the amount of qualified residence interest with respect to a secured debt, the amount of interest paid or accrued during the taxable year includes only interest paid or accrued while the debt is secured by a qualified residence.[404]

a. The amount of points paid in respect of debt incurred in connection with the purchase or improvement of a principal residence is qualified residence interest.[405]

b. However, the amount of points or other prepaid interest charged to capital account that is qualified residence interest is determined in the same manner as any other interest paid with respect to the debt in the taxable year to which such payments are allocable under §461(g)(1).

c. Under the TCJA, mortgage insurance premiums were NOT considered interest for purposes of the mortgage interest deduction. H.R. 1865 revived this popular expired provision, making the change retroactive from December 31, 2017 through December 31, 2020. The CAA 2021 extended the exclusion from gross income of discharge of qualified principal residence indebtedness through 2025. It also reduces the maximum exclusion amount from $2,000,000 to $750,000 (for married filing jointly filers). The PMI amount allowable as a deduction is phased out by 10% for each $1,000 by which the taxpayer's AGI exceeds $100,000 (for Married Filing Joint taxpayers), phasing out entirely for AGI in excess of $110,000.

Example 1: T designates a vacation home as a qualified residence as of October 1, 2025. The home is encumbered by a mortgage during the entire taxable year. For purposes of determining the amount of qualified residence interest for 2025, T may take into account the interest paid or accrued on the secured debt from October 1, 2025, through December 31, 2025.

Example 2: R purchases a principal residence on June 17, 2025. As part of the purchase price, R obtains a conventional 30-year mortgage, secured by the residence. At closing, R pays 2-1/2 points on the mortgage and interest on the mortgage for the period of June 17, 2025, through June 30, 2025. The points are actually paid by R and are not merely withheld from the loan proceeds. R incurs no additional secured debt during 2024. Assuming that the points satisfy the requirements of §461(g)(2), the entire amount of points and the interest paid at closing are qualified residence interest.

5. Refinancing

Taxpayers refinancing their mortgages to take advantage of lower rates often take out additional amounts to cover their closing costs and may extend the length of the original mortgage. Such changes may result

404 Temp. Regs. §1.163-10T(j)(1).
405 Temp. Regs. §1.163-10T(j)(2)(i).

in recharacterizing some of the refinanced amount as a new mortgage not subject to the grandfather provisions. The result would be a loss of the ability to deduct some of the resulting interest payments.

6. The investment-expense trap

As discussed earlier, miscellaneous deductions subject to the 2-percent-of-AGI floor are suspended for tax years 2018 through 2025. Thus, for those years, investment expenses are not deductible by a non-dealer individual. However, if the taxpayer is a dealer reporting income on Schedule C, the expenses will be allowed as a business expense.

VIII. Taxes

A. Estimated taxes

For the year 2025, estimated taxes paid must be at least 110 percent (100 percent for taxpayers with AGI less than $150,000) of the 2024 tax liability or 90 percent of the actual 2025 tax liability in order to qualify for the safe harbor against the penalty for the underpayment of income tax. Many clients who have a high rate of return on capital are reluctant to pay taxes to the government any earlier than is required.

1. In general

Taxpayers are subject to rather significant penalties for failure to pay estimated taxes in a timely fashion. Ordinarily, this requires equal quarterly payments. The prefunding of the estimated tax liability is the difference between having to pay possibly only additional tax with no penalty and possibly having to pay even more additional tax and penalty.

a. The penalty is equal to the product of the applicable federal short-term rate plus three percentage points and the amount of the underpayment over the period in which the underpayment is outstanding. The first issue that must be addressed is whether on an after-tax basis the taxpayer may be better off just paying the penalty. This, in general, is a function of the taxpayer's **after-tax rate of return** on the excess of the 110-percent safe-harbor estimated taxes over the estimated taxes actually paid (this excess is referred to as the deferred estimated taxes) in comparison to the effective penalty rate on the **underpayment**.

b. Despite potential after-tax benefits in not making the full estimated tax payments, some clients blanch at the sound of the word "penalty," and accountants may have a hard sell in explaining why the penalty may be financially advantageous.

2. Planning tactics

Because the penalty is computed based on the total underpayment when the taxpayer cannot use the safe harbor, the greater the income actually earned, the greater the penalty -- while the amount of the taxpayer's benefit is based on the deferred estimated taxes only. This means that if the client does too well, the benefit of the deferred estimated taxes may be completely overwhelmed by the increased underpayment of tax penalty.

For purposes of the following discussion, ATROR is the taxpayer's after-tax rate of return, PRATE is the penalty rate, and PYTAX is the prior year's tax liability.

a. The opportunity cost of paying the estimated tax is equal to (ATROR - PRATE) x 1.1 x PYTAX. How much tax liability above the amount determined can the taxpayer have before the additional penalty exceeds the opportunity cost?

$$(X - 1.1 \times PYTAX)\ PRATE = (ATROR - PRATE) \times 1.1 \times PYTAX$$
$$X = \frac{\underline{(ATROR - PRATE) \times 110 \times PYTAX}}{PRATE} + 1.1 \times PYTAX$$

Suppose the taxpayer's ATROR is 8 percent, the penalty rate is 3 percent,[406] and the prior year's tax liability is $100,000.

$$X = \frac{0.05 \times \$110{,}000}{0.03} + \$110{,}000$$

X = $183,333 + $110,000 = $293,333

Thus, only when the tax liability increases to more than $293,333 does it make sense to pay any estimated tax at all! Under the facts of this case, all income is taxed to the taxpayer at the 37-percent rate. Thus, taxable income of the taxpayer must increase by $522,522 ($193,333/.37).

b. When a safe harbor is not available, the required quarterly **estimated tax payments** are determined by 90 percent of the actual tax liability for 2025. End-of-the-year estimated tax payments, although sufficient to meet the taxpayer's tax liabilities in amount, will generally subject the taxpayer to underpayment penalties because the underpayment penalty began running on the deficiency in required payments on earlier quarterly estimated tax due dates. Such payments are always treated as paid when they are actually paid.

Note:

If the taxpayer makes considerable income, failure to qualify for the estimated-tax-payments safe harbor can expose the taxpayer to a penalty of unacceptable proportions. If, for example, it becomes necessary for the taxpayer to exercise a nonqualified stock option in 2025 that results in an additional $100,000 of income over the baseline of income that corresponded to the estimated tax payments actually made, and assuming a three-percent underpayment rate, the additional tax of $37,000 would generate a penalty of approximately $1,188 (assuming the underpayment was outstanding for a period of one year). Thus, it is often necessary to have fallback positions to reduce or eliminate any penalty in excess of an amount acceptable to the taxpayer.

3. The W-2 solution

In contrast, the amount of the **income-tax withholding** for the taxable year is deemed a payment of estimated tax, and an equal part of such amount is deemed paid on each due date for such taxable year, unless the taxpayer establishes the dates on which all amounts were actually withheld, in which case the amounts so withheld are deemed payments of estimated tax on the dates on which such amounts were actually withheld.[407] Hence, the taxpayer can make up any deficiency at the end of the year by having up to 100 percent of the net salary after the payment of other employment taxes withheld, throwing back the withholding to each due date of estimated taxes.

406 Revenue Ruling 2021-6.
407 I.R.C. §6654(g)(1).

Planning point:

> An additional and difficult to gauge inclusion in the estimated tax base is the net investment income tax; the very uncertainty of dividends, gains, and other items (including an individual's participation level) makes this problematic on April 15. Thus, the tactics described here may be employed in concert with a year-end assessment that can produce a more informed determination of NII tax liability.

Planning point:

> This can always be accomplished if the taxpayer controls the taxpayer's employer, and generally through most payroll departments. Of course, it is not available if the taxpayer is solely a self-employed person. And even where the extra withholding is available, the taxpayer cannot have withheld any more than the aggregate net salary to be paid to the taxpayer over the balance of the year. Depending on the absolute size of the amount of estimated taxes to be made up and/or the remaining net salary, the taxpayer may not be able to escape the penalty entirely. But the taxpayer can still employ the 110-percent safe harbor, so the amount of the deficiency to be made up is not 90 percent of the 2025 actual tax liability over the estimated taxes actually theretofore made, but 110 percent of the 2024 actual tax liability over the estimated taxes actually theretofore made.

4. The qualified-plan solution

Individuals who are in current payout status from a qualified plan or IRA may alleviate the timing problem by directing the plan administrator to withhold up to the entire amount of any required or permitted distributions (grossed-up for the income-tax effect of the distributions). The distribution from a qualified plan or IRA is a designated distribution that is generally treated as the payment of wages.[408] Therefore, any taxes withheld are treated as income taxes withheld in an equal amount on each due date of estimated tax for the taxable year.

a. The taxpayer may use distributions from a qualified plan only if the taxpayer is over a certain age; otherwise the distributions may be prohibited by the terms of the plan, or be subject to an additional 10-percent penalty that may exacerbate rather than relieve a penalty situation. The amount that can be withdrawn in pension plans may be limited by the joint-and-survivor annuity or single-life annuity under the terms of the plan. Moreover, such distributions are prohibited until the participant has reached the retirement age under the plan, usually age 65. There is more flexibility in a profit-sharing plan or §401(k) plan because distributions prior to retirement are generally available, but such withdrawal rights must be available to all participants, not just for the taxpayer, particularly when the taxpayer is an owner of the employer. IRAs are generally more flexible because access to the account can be tailored to the individual, and any amounts up to the entire account can be withdrawn at any time, subject to penalties for premature withdrawals.

b. In either case, taking more than the required minimum distribution from a qualified plan or IRA has its own disadvantages that may outweigh the underpayment of tax penalty that may otherwise have to be paid. Moreover, the amount that must be taken is increased by the fact that any amount taken from either one increases the income-tax liability and the potential underpayment that must be rectified.

5. The IRA solution

If the taxpayer is not already in pay-out status, the taxpayer has two options: (i) if the taxpayer is employed, the taxpayer may have up to the entire amount of any before-the-end-of-the-year bonus

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408 I.R.C. §3405(f).

withheld; or (ii) if the taxpayer has an IRA, the taxpayer can use the IRA-rollover rules. Here it is assumed that the taxpayer has sufficient cash to make a year-end payment of estimated tax from the taxpayer's own funds. An individual who holds amounts in an IRA may request a distribution of any amount up to the full account balance and also withholding on up to 100 percent of that distribution. Because a designated distribution includes distributions from an IRA, the withheld tax is treated as paid from wages in equal amounts on the due dates of the estimated tax during the taxable year.

Caution:

> A distribution from an IRA prior to age 59-1/2 may be subject both to income tax and to a penalty tax on a premature distribution. Both of these adverse tax consequences, which otherwise would outweigh the avoidance of the underpayment penalty on estimated taxes, do not arise if the taxpayer returns the amount of the distribution (including the amount withheld) to the IRA within 60 days of the date of the distribution. Thus, suppose the taxpayer finds on December 1 that there will be an underpayment of $15,000 (from the 110 percent of 2024 tax liability or 100 percent of actual 2025 liability) and he has $15,000 in the bank account and $15,000 in an IRA. If the taxpayer merely deposits $15,000 from the bank account with the federal government on December 30, there will nonetheless be an underpayment penalty. But there is no underpayment penalty if the taxpayer requests a $15,000 distribution from the IRA with 100-percent withholding. Fifteen thousand dollars is paid to the government and treated as though paid pro rata on the due dates for the estimated tax payments. This eliminates the penalty but for the underpayment of taxes attributable to the deemed distribution of $15,000 to the taxpayer (and the penalty, if any, if the distribution is premature). This hypothetical additional underpayment is eliminated by the taxpayer's deposit of the $15,000 from the bank account into the IRA no later than February 28 of the following calendar year. This converts the deemed distribution into a simple rollover, not subject to income tax and generating no additional penalty since there is no distribution, let alone a premature one.

Note:

> As noted earlier, reduction of income will prove advantageous as tax rates rise and the deferral of return taxation permits investments that return dividends and interest to enjoy a tax benefit similar to that of unrealized gains. Increases in the employment taxes on wages and investment income summon taxpayers to find portfolio strategies that avoid such charges.

B. AMT

1. Sources of AMT

What are the sources for the AMT add-backs? Itemized deductions are probably the largest add-backs for most taxpayers, and the particular itemized deduction most involved is the deduction for state and local (income and property) taxes. Personal exemptions have historically been the next most-frequent culprits in increasing the alternative-minimum-tax base over the regular tax base, followed by miscellaneous itemized deductions. The repeal of the deductions for personal exemptions and miscellaneous itemized deductions and the limitation on the deduction for state and local taxes makes it much less likely that a taxpayer will be hit with the dreaded alt min tax. Also, the alt min exemption amount has been raised as has the phaseout floor of the exemption.

2. AMT exemption

The TCJA raised the AMT exemption for tax years 2018 through 2025. The exemption for couples filing married filing joint and for surviving spouses is $137,000 for 2025; the exemption for taxpayers filing single or as head of household is $88,199; and the amount for married filing separate filing status is

$68,500.[409] Also, for taxpayers filing as married filing joint or surviving spouse, the phase out of the exemption is increased from $150,000 to $1,000,000 for 2018,[410] $1,020,600 for 2019, $1,036,800 for 2020, $1,047,200 for 2021, $1,079,800 for 2022, $1,156,300 for 2023, $1,218,700 for 2024, and $1,252,700 for 2025. For taxpayers filing as other statuses, the phase out begins at $500,000 [411] for 2018, $510,300 for 2019, $518,400 for 2020, $523,600 for 2021, $539,900 in 2022, $578,150 in 2023, $609,350 in 2024, and $626,350 in 2025.

3. Incentive stock options

Incentive stock options (ISOs) are granted by employers to help attract new employees and to retain their current employees. When granted, the corporation sets an option price for the corporate stock and, when the stock value increases, the employee may purchase the stock at favorable prices. Generally, the exercise of this option does not increase regular taxable income. However, the excess of the fair market value of the stock over its option price is a positive adjustment for AMT purposes in the first year in which the stock rights are freely transferable or are not subject to substantial risk of forfeiture. No adjustment is required if the option is exercised and the stock is sold in the same year, since any gain would have already been included in income. The gain or loss on the disposition of the stock may be different for regular income tax and AMT since the basis for regular tax is the cost, and the basis for AMT is the fair market value at the date the options are exercised.

Example: In 2019, Tina exercised an incentive stock option that had been granted by her employer, ABC Corporation. Tina acquired 100 shares of ABC stock for the option price of $200 per share. The rights in the stock become freely transferable and not subject to a substantial risk of forfeiture in 2025. The fair market value of the stock at the date of the exercise was $220 per share. What is the amount of her AMT adjustment for 2025?

Tina's 2025 AMT adjustment is a positive $2,000 ($20 x 100 shares). The difference in the fair market value at the exercise date of $220 and the option price of $200 is taxable under AMT in the first year in which it is not subject to forfeiture.

Note:

One of the problems many taxpayers have faced over the past couple of years is the exercise of ISOs only to see the price tumble from dot-com highs to dot-gone lows. While the exercise of the options does not trigger regular income tax, the spread (the excess of the option stock's fair market value on the date of exercise of the option over the option price paid by the employee) is treated as an adjustment for alternative-minimum-tax purposes. For many, the AMT liability has exceeded the fair market value of the stock acquired by the exercise. While the AMT liability may generate a credit, it may take years before the AMT can be recovered, if at all. However, if the taxpayer disposes of the stock within the same calendar year as the exercise (a disqualifying disposition), the Code limits the amount of the adjustment to the excess of the amount realized on the disposition of the stock over the amount paid for the stock. Therefore, accountants should generally recommend exercise of any ISO as close to January 1 as possible to give the maximum amount of time to determine, through monitoring of the valuation direction, whether a disqualifying disposition should be undertaken.

A disqualifying disposition in the year of the exercise when the stock declines after exercise results in a reduction in the amount of ordinary income that is recognized for regular tax purposes.

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409 Rev. Proc. 2023-43.
410 I.R.C. §55(d)(4)(A)(ii)(I).
411 I.R.C. §55(d)(4)(A)(ii)(II).

Note:

> A disqualifying disposition of the stock has the effect of treating the exercise of the option like a nonqualified stock option, i.e., under the rules of §83. Assuming the ISO has no substantial risk of forfeiture and is transferable, this has the effect of: (i) limiting the compensation income to the spread at the time of the exercise; and (ii) starting the clock running on the holding period of the stock for capital-gain purposes. Ordinarily, the gain will be short-term unless the stock is sold more than one year after exercise but within two years of the grant of the ISO.

The Tax Relief and Health Care Act (as modified by Emergency Economic Stabilization Act of 2008) sought to alleviate some of the tax pain that the AMT may inflict on taxpayers from the presence in connection with ISOs and employee stock purchase plan.[412] Under the regular tax, the exercise of an incentive stock option is tax-free if the stock is not disposed of within one year of exercise of the option or within two years of the grant of the option.[413] The individual then computes the long-term capital gain or loss on the sale of the stock using the amount paid for the stock as the cost basis. If the holding period requirements are not satisfied, the individual generally takes into account at the exercise of the option an amount of ordinary income equal to the excess of the fair market value of the stock on the date of exercise over the amount paid for the stock. The cost basis of the stock is increased by the amount taken into account.[414]

a. Under the individual alternative minimum tax, the exercise of an incentive stock option is treated as the exercise of an option other than an incentive stock option. Under this treatment, generally the individual takes into account as ordinary income, for purposes of computing AMTI, the excess of the fair market value of the stock at the date of exercise over the amount paid for the stock.[415] When the stock is later sold, for purposes of computing capital gain or loss for purposes of AMTI, the adjusted basis of the stock includes the amount taken into account as AMTI. The adjustment relating to incentive stock options is a **deferral adjustment,** and therefore generates an AMT credit in the year the stock is sold.[416] The individual AMT attributable to deferral adjustments generates a minimum tax credit that is allowable to the extent the regular tax (reduced by other nonrefundable credits) exceeds the tentative minimum tax in a future taxable year. Unused minimum tax credits are carried forward indefinitely.

b. An individual's minimum tax credit allowable for any taxable year beginning before January 1, 2013, is not less than the AMT refundable credit amount.

    (i) Now, the AMT refundable credit amount for a year beginning before 2013 (before any reduction by reason of adjusted gross income) is an amount (not in excess of the long-term unused MTC for that year) equal to the greater of: (1) 50 percent of the long-term unused minimum tax credit; **or** (2) the AMT refundable credit amount (if any) for the prior tax year—the preceding year's credit amount—before any reduction by reason of adjusted gross income.

    (ii) A taxpayer’s AGI is no longer relevant for purposes of a phaseout of the credit by reason of the changes made by EESA.

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412 I.R.C. §422.

413 I.R.C. §422.

414 If the stock is sold at a loss before the required holding periods are met, the amount taken into account may not exceed the amount realized on the sale over the adjusted basis of the stock. If the stock is sold after the taxable year in which the option was exercised but before the required holding periods are met, the required inclusion is made in the year the stock is sold.

415 If the stock is sold in the same taxable year the option is exercised, no adjustment in computing AMTI is required.

416 If the stock is sold for less than the amount paid for the stock, the loss may not be allowed in full in computing AMTI by reason of the $3,000 limit on the deductibility of net capital losses. Thus, the excess of the regular tax over the tentative minimum tax may not reflect the full amount of the loss.

Note:

> Prior to the 2006 tax law, employers were required to provide to employees information regarding the transfer of stock[417] pursuant to the exercise of an incentive stock option and to transfers of stock under an employee stock purchase plan where the option price is between 85 percent and 100 percent of the value of the stock.[418] An employer, with respect to returns applied to calendar years beginning after the date of enactment, will be required to make an information return with the Service, in addition to providing information to the employee, regarding the transfer of stock pursuant to exercise of an incentive stock option, and to certain stock transfers regarding employee stock purchase plans.

C. Net investment income tax

1. Tax on unearned income

Beginning in 2013, a tax is applied annually in an amount equal to 3.8 percent of the lesser of **net investment income** for such taxable year,[419] or the excess (if any) of: (i) the **modified adjusted gross income** (MAGI) for such taxable year;[420] over (ii) the **threshold amount**.[421] For these purposes, the threshold amount means: (i) in the case of a taxpayer making a joint return or a surviving spouse, $250,000; (ii) in the case of a married taxpayer filing a separate return, one-half of that dollar amount determined under paragraph (i); and (iii) in any other case, $200,000. These amounts are not indexed for inflation.

Question to ponder:

> Why would these amounts not be inflation-indexed?

2. MAGI and AGI

The tax does not apply when the taxpayer has MAGI under the threshold. Thus, one strategy to avoid the tax is to structure the taxpayer's MAGI to be less than the threshold.

a. In some cases, a conversion of the character of the income received can be beneficial if it is excluded because it does not enter into the AGI calculation. Examples of this are health care premiums and other fringe benefits.

b. Modified adjusted gross income means adjusted gross income increased by the excess of the amount excluded from gross income under §911(a)(1), over the amount of any deductions (taken into account in computing adjusted gross income) or exclusions disallowed under §911(d)(6) with respect to the amounts excluded from gross income under §911(a)(1).[422]

c. The only deductions allocable to the classes of gross income described above that are taken above the line and thus can reduce MAGI are those attributable to rents and royalties. Otherwise, the entire gross income can push the MAGI above the threshold level without any reduction for deductions. Many of the below-the-line deductions will be miscellaneous itemized deductions, which will not be fully deductible. Expenses paid to an investment manager to manage an investment portfolio are subject to the two-percent floor. By contrast, such management fees incurred by a publicly offered mutual fund are

417 I.R.C. §6039.
418 I.R.C. §423(c).
419 I.R.C. §1411(a)(1)(A)(i).
420 I.R.C. §1411(a)(1)(B)(i).
421 I.R.C. §1411(a)(1)(B)(ii).
422 I.R.C. §1411(d).

netted into the shareholder's reported dividends and capital gains distributions, effectuating in essence an above-the-line deduction.

Example: J, a high-income individual, earns $100,000 of gross interest income in 2025 from a hedge fund, but the interest income is subject to a $20,000 management fee that is a miscellaneous itemized deduction that the individual investor is not otherwise able to deduct. J would be subject to an additional net investment income tax of $3,800 ($100,000 x 3.8 percent), even though the investor will receive only $80,000 after payment of the manager's fee. The effect is to gross up the effective investment income tax rate on the cash received.

Planning point:

When possible, take a deduction above-the-line rather than below it.

Note:

Because this tax is determined under a section of the Code (§1411) different from the section that determines self-employment tax (§1401), it likewise is not deductible, because it is only one-half of those taxes so computed that are eligible for the deduction.

A self-employed taxpayer could be paying up to an additional 4.7-percent nondeductible tax (.9 percent + 3.8 percent). For a self-employed person in the highest (nominally 37 percent) bracket, this would be the equivalent of an additional OASDI and Medicare tax of 7.46 percent (4.7/(1 - .37)).

Example: J, a married taxpayer, has $220,000 of compensation and $30,000 of net investment income. Because J has no more than $250,000 of compensation income, his wages are not subject to the additional 0.9-percent tax on excess compensation. Because J does not have AGI in excess of $250,000, J's investment income is not subject to the additional 3.8-percent tax.

Suppose J could be paid a $50,000 bonus. If it were paid, not only would J pay income tax on the additional $50,000 of (presumably all included in taxable) income but also J would now have $270,000 of compensation, subjecting both the full $50,000 to the Medicare tax and also the $20,000 excess compensation to an additional 0.9-percent tax ($180). J would now have $300,000 of AGI exposing $30,000 (the lesser of the $30,000 investment income and the $50,000 [$300,000-$250,000] excess AGI) to the 3.8-percent tax ($1,140). Assume J pays a 35-percent tax rate on the $50,000 of income ($17,500). J's effective tax rate on the additional compensation is 37.64 percent ($18,820 [$17,500 + $1,140 + $180]/$50,000).

Note:

One should not assume, however, that because a taxpayer exceeds the $250,000 AGI threshold the taxpayer is in the 35- or 37-percent bracket. A high level of itemized deductions could put the taxpayer in the 32% bracket.

Planning point:

The tax does not apply to the extent the taxpayer has no net investment income.

d. A C corporation can be used to manage the extent of a taxpayer's MAGI. If it makes no distributions, nothing is added to MAGI, which in many cases will limit or eliminate the amount of unearned income subject to net investment income tax. In other years, if the

MAGI is so low that the inclusion of a dividend (or compensation) will not increase the MAGI above the threshold amount, this may not be as important.

Planning point:

> Formation of a C corporation can create a taxpayer that can accrue such items without incurring a net investment income tax (although it may be subject to the accumulated-earnings or personal holding company tax). It also can accumulate income without triggering the Medicare tax on earned income, by not paying compensation to certain individuals. This may work particularly well in a start-up that qualifies as qualified small business stock -- the failure to pay dividends (assuming the penalty corporate taxes do not apply) does not necessitate a double tax, since a subsequent sale will exclude the gain attributable to the retained earnings (if within the limitations under §1202).
>
> Avoiding the tax on earned income is not available in a partnership, as earned income passes through as such and the partner may, thereby, be subject to tax on unearned income as such and on the earned income of the partnership as such.

3. Net investment income in general

In general, net investment income means the excess (if any) of:

a. The sum of --

 (i) Gross income from **interest, dividends, annuities, royalties, and rents** (category 1 income) except to the extent excluded by the **ordinary course of a trade or business exception**;[423]

 (ii) Other gross income derived from a **trade or business** that is a **passive activity or trading in financial instruments or commodities**;[424] and

Note:

> This refers to a §162 trade or business, so §212 income of category 1 or category 3 generally is not in this category. However, otherwise category 1 income or category 3 income that is tentatively excluded by reason of the applicable trade or business exceptions may be included as category 2 income. For example, a limited partner in a partnership which has rental real estate as its §162 trade or business would generally have category 2 rental income unless the limited partner can establish material participation.

 (iii) **Net gain** (to the extent taken into account in computing taxable income) attributable to the disposition of property, except to the extent excluded by the exception for gain or loss attributable to **property held in a trade or business other than a passive activity or a trader of financial instruments or commodities**;[425] over

Note:

> The trade or business exception only applies to what would otherwise be category 1 income; the held in a trade or business only applies to what would otherwise be category 3 income.

b. The deductions allowed by income tax that are **properly allocable** to such gross income or net gain.[426]

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423 Treas. Regs. §1.1411-4(a)(1)(i).
424 Treas. Regs. §1.1411-4(a)(1)(ii).
425 Treas. Regs. §1.1411-4(a)(1)(iii).
426 Treas. Regs. §1.1411-4(a)(2).

Investment income for purposes of the Net Investment Income Tax does not include:

- Earned income;
- Income from an active trade or business;
- Tax-exempt interest (such as municipal bonds);
- Any distribution from a plan or arrangement described in §§401(a) (qualified plans), 403(a) (qualified annuity plans), 403(b), IRAs, SIMPLEs, and SEPs, Roth IRAs, or 457(b) governmental plans; and
- Excluded gain on the sale of a principal residence. (Note: gain in excess of the exclusion amount is subject to Net Investment Income tax.)

4. Ordinary course of a trade or business exception

Gross income from category 1 is excluded from net investment income if it is derived in the ordinary course of a trade or business other than a passive activity or trading in financial instruments or commodities, i.e., category 2 income with a narrow exception for working capital. For a **trade or business** that is a passive activity or trading in financial instruments or commodities, category 2 includes all other gross income that is not category 1 gross income or category 3 net gain.[427] This is discussed below. To determine whether gross category 1 income is derived in a trade or business, the following rules apply.

a. In the case of an individual, estate, or trust that owns or engages in a trade or business directly (or indirectly through ownership of an interest in an entity that is disregarded as an entity separate from its owner), the determination of whether gross income in category 1 is derived in a trade or business is made at the **individual,** estate, or trust level.

b. In the case of an individual, estate, or trust that owns an interest in a pass-through entity (for example, a partnership or S corporation), and that entity is engaged in a trade or business, the determination of whether gross income in category 1 is --

   (i) Derived in a passive trade or business is made at the **owner level**; and

   (ii) Derived in a trade or business of trading financial instrument or commodities is made at the entity level.

5. Gains

a. Net gains arise from a disposition of property, including a sale, exchange, transfer, conversion, cash settlement, cancellation, termination, lapse, expiration, or other disposition (including a deemed disposition, for example, under §877A, for expatriation).[428]

   (i) The calculation of net gain may **not be less than zero**.

   (ii) Excess losses allowable in the regular income tax are permitted to offset **gain** from the disposition of assets other than capital assets that are subject to §1411.[429]

Note:

In particular, such losses may offset depreciation recapture income if such gain is not shielded by the held in a trade or business exception. For example, a limited partner may use a currently deductible loss (which may be determined by the limitation on deductible capital losses) not shielded by the held in a trade or business exception (i.e., from the sale of C corporation stock) to

[427] Treas. Regs. §1.1411-4(a)(3).
[428] Treas. Regs. §1.1411-4(d)(1).
[429] Treas. Regs. §1.1411-4(d)(2).

offset the ordinary gain component of the gain on the sale of rental real estate not held in a §162 trade or business. See **Example 2**, below.

b. Net gain attributable to the disposition of property is the **gain recognized** from the disposition of property reduced, but not below zero, by losses deductible under §165 (losses incurred in a trade or business; losses incurred in a transaction entered into for profit; and certain losses arising from fire, storm, shipwreck, or other casualty, or from theft), including losses attributable to casualty, theft, and abandonment or other worthlessness. For these purposes, net gain includes, but is not limited to, gain or loss attributable to the disposition of property from the investment of **working capital**; gain or loss attributable to the disposition of a **life insurance contract**; and gain attributable to the disposition of an **annuity contract** to the extent the sales price of the annuity exceeds the annuity's surrender value.[430]

For purposes of these examples, assume that the taxpayer is a United States citizen and uses a calendar taxable year, and that Year 1 and all subsequent years are taxable years in which §1411 is in effect:

Example 1: (i) In Year 1, A, an unmarried individual, realizes a capital loss of $40,000 on the sale of P stock and realizes a capital gain of $10,000 on the sale of Q stock, resulting in a net capital loss of $30,000. Both P and Q are C corporations. A has no other capital gain or capital loss in Year 1. In addition, A receives wages of $300,000 and earns $5,000 of gross income from interest. For income-tax purposes, A may use $3,000 of the net capital loss against other income. The remaining $27,000 is a capital loss carryover. For purposes of determining A's Year 1 net gain, A's gain of $10,000 on the sale of the Q stock is reduced by A's loss of $40,000 on the sale of the P stock. In addition, A may reduce net investment income by the $3,000 of the excess of capital losses over capital gains allowed for income-tax purposes.

(ii) In Year 2, A has a capital gain of $30,000 on the sale of Y stock. Y is a C corporation. A has no other capital gain or capital loss in Year 2. For income-tax purposes, A may reduce the $30,000 gain by the Year 1 $27,000 capital loss carryover. For purposes of determining A's Year 2 net gain, A's $30,000 gain may also be reduced by the $27,000 capital loss carryover from Year 1. Therefore, in Year 2, A has $3,000 of net gain.

Example 2: The facts are the same as in **Example 1**, except that in Year 1, A also realizes a gain of $20,000 on the sale of Rental Property D, all of which is treated as ordinary income under §1250. For income-tax purposes, A may use $3,000 of the net capital loss against other income. The remaining $27,000 is a capital loss carryover. For purposes of determining A's net gain, A's gain of $10,000 on the sale of the Q stock is reduced by A's loss of $40,000 on the sale of the P stock. A's $20,000 gain on the sale of Rental Property D is reduced to the extent of the $3,000 loss allowed against ordinary income. Therefore, A's net gain for Year 1 is $17,000 ($20,000 gain treated as ordinary income on the sale of Rental Property D reduced by $3,000 loss allowed).

Example 3: (i) In Year 1, A, an unmarried individual, sells a house that A has owned and used as A's principal residence for the five years preceding the sale and realizes $200,000 in gain. In addition to the gain realized from the sale of A's principal residence, A also realizes $7,000 in long-term capital gain. A has a $5,000 short-term capital loss carryover from a year preceding the effective date of §1411.

430 Treas. Regs. §1.1411-4(d)(3)(i).

(ii) For income-tax purposes, A excludes the $200,000 gain realized from the sale of A's principal residence from A's Year 1 gross income. In determining A's Year 1 adjusted gross income, A also reduces the $7,000 capital gain by the $5,000 capital loss carryover allowed.

(iii) For NII tax purposes, A excludes the $200,000 gain realized from the sale of A's principal residence from A's Year 1 gross income and, consequently, from A's net investment income. In determining A's Year 1 net gain, A reduces the $7,000 capital gain by the $5,000 capital loss carryover allowed.

Example 4: (i) In Year 1, A, an unmarried individual who is not a dealer in real estate, purchases Greenacre, a piece of undeveloped land, for $10,000. A intends to hold Greenacre for investment.

(ii) In Year 3, A enters into an exchange in which A transfers Greenacre, now valued at $20,000, and $5,000 cash for Blackacre, another piece of undeveloped land, which has a fair market value of $25,000. The exchange is a transaction for which no gain or loss is recognized under §1031.

(iii) In Year 3, for income tax purposes, A does not recognize any gain from the exchange of Greenacre for Blackacre. A's basis in Blackacre is $15,000 ($10,000 substituted basis in Greenacre plus $5,000 additional cost of acquisition). For purposes of the NII tax, A's net investment income for Year 3 does not include any realized gain from the exchange of Greenacre for Blackacre.

(iv) In Year 5, A sells Blackacre to an unrelated party for $35,000 in cash.

(v) In Year 5, for income-tax purposes, A recognizes capital gain of $20,000 ($35,000 sale price minus $15,000 basis). For purposes of the NII tax, A's net investment income includes the $20,000 gain recognized from the sale of Blackacre.

(i) Net gain does not include gain or loss attributable to property (other than property from the investment of working capital) **held** in a trade or business that is not a category 2 trade or business.[431]

Note:

Net gain does not include gains and losses excluded from net investment income by any other provision. For example, certain gain or loss attributable to the disposition of certain interests in partnerships and S corporations and the net unrealized appreciation attributable to employer securities realized on a disposition of those employer securities are excluded from NII.[432]

(ii) For purposes of calculating net gain (and any allowable properly allocable loss), capital losses are reduced by the lesser of: (1) the amount of capital loss taken into account in the current year in offsetting capital gains (and with respect to ordinary income); or (2) the amount of net capital loss excluded from net investment income in the preceding year by reason of the capital loss carryover limitation.[433]

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431 Treas. Regs. §1.1411-4(d)(4)(i)(A).
432 Treas. Regs. §1.1411-4(d)(3)(ii).
433 Prop. Regs. §1.1411-4(d)(4)(iii).

6. Special rules applicable to rental activities

To the extent that gross rental income described in category 1 is treated as not derived from a passive activity by reason of it being rented for use in a trade or business activity in which the taxpayer materially participates for the taxable year that is not rented incidental to a development activity or as a consequence of a taxpayer grouping a rental activity with a trade or business activity under general grouping rules, such gross rental income is deemed to be derived in the ordinary course of a trade or business thereby eliminating it from net investment income.[434]

a. To the extent that gain or loss resulting from the disposition of property is treated as nonpassive gain or loss by reason of it being rented for use in a trade or business activity in which the taxpayer materially participates for the taxable year that is not rented incidental to a development activity or as a consequence of a taxpayer grouping a rental activity with a trade or business activity under the general grouping rules, then this gain or loss is deemed to be derived from property used in the ordinary course of a trade or business.[435]

b. One of the most important rules is a **safe harbor** accorded to rental real estate operations and only to rental real estate (not personal property rentals). In the case of a **real estate professional** that participates in one or more **rental real estate activities** for **more than 500 hours during such year**, or has participated in such real estate activities for **more than 500 hours in any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year**,[436] then --

    (i) Such gross rental income from that rental activity is deemed to be derived in the **ordinary course of a trade or business**;[437] and

    (ii) Gain or loss resulting from the disposition of property used in such rental real estate activity is deemed to be derived from **property used in the ordinary course of a trade or business**.[438]

c. The inability of a real estate professional to satisfy the safe harbor does not preclude such taxpayer from establishing that such gross rental income and gain or loss from the disposition of property, as applicable, is not included in net investment income under any other provision of §1411.[439]

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434 Treas. Regs. §1.1411-4(g)(6)(i).
435 Treas. Regs. §1.1411-4(g)(6)(ii).
436 Treas. Regs. §1.1411-4(g)(7)(i).
437 Treas. Regs. §1.1411-4(g)(7)(i)(A).
438 Treas. Regs. §1.1411-4(g)(7)(i)(B).
439 Treas. Regs. §1.1411-4(g)(7)(iii).

Note:

The key element of this safe harbor is that it eliminates the need for the taxpayer to otherwise establish that the rental real estate is a §162 trade or business rather than a §212 transaction entered into for profit; this issue is discussed below. But it also applies pressure to establish and substantiate that the taxpayer has sufficient **participation**[440] (750 hours and at least half of all personal services performed) in real property trades or businesses as well as sufficient participation in rental real estate to qualify (500 hours); and for these purposes the **only standard** that qualifies is 500 hours. For passive activity purposes, taxpayers without a limited partnership interest may use any of **seven tests** of material participation; for a limited partner, one could use one of **three tests** (one of which, personal services, would generally not be applicable to rental real estate). One can qualify for treating rental income as nonpassive income for income-tax purposes yet not qualify as trade/ business income from nonpassive activity for NII tax purposes.

Rental real estate activity used in this is a rental activity within the meaning of the passive activity loss regulations. An activity is a rental activity for a taxable year if: (i) during that taxable year, tangible property held in connection with the activity is used by customers or held for use by customers; and (ii) the gross income attributable to the conduct of the activity during such taxable year represents (or, in the case of an activity in which property is held for use by customers, the expected gross income from the conduct of the activity will represent) amounts paid or to be paid principally for the use of such tangible property (without regard to whether the use of the property by customers is pursuant to a lease or pursuant to a service contract or other arrangement that is not denominated a lease).

However, there are important exceptions where the use of tangible property is not a rental activity for the taxable year: (i) the average period of customer use for such property is seven days or less (motels, many hotels); (ii) the average period of customer use for such property 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 the property available for use by customers (many hotels, some commercial); (iii) extraordinary personal services are provided by or on behalf of the owner of the property in connection with making such property available for use by customers (without regard to the average period of customer use) (dormitories, hospitals); (iv) the rental of such property is treated as incidental to a nonrental activity of the taxpayer; (v) the taxpayer customarily makes the property available during defined business hours for nonexclusive use by various customers (golf course); or (vi) the provision of the property for use in an activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest where the property is provided to the entity in the taxpayer's capacity as an owner of an interest in such partnership, S corporation, or joint venture.[441] As to these activities, taxpayer may continue to show material participation to avoid passive activity loss restrictions but must also establish that the activity rises to the level of a §162 trade or business to take advantage of the derived in the ordinary course of a trade or business or held in a trade or business exceptions to NII inclusion.

An election to treat all rental real estate as a single rental activity under the real estate professional rules also applies for these purposes. However, **any rental real estate that the taxpayer grouped with a trade or business activity under the general grouping rules where the real estate activity is insubstantial in relation to the trade or business or where the activity and the trade or business have common ownership AND, in either case, is an appropriate economic unit, is not a rental real estate activity**.[442]

440 Treas. Regs. §1.1411-4(g)(7)(ii)(A). Any participation in the activity that would count towards establishing material participation under §469 shall be considered.
441 Temp. Regs. §1.469-1T(e)(3).
442 Treas. Regs. §1.1411-4(f)(7)(ii)(B).

Planning point:

Because there is no statutory or regulatory definition of a trade or business, the task of establishing tests to determine the existence of a trade or business has fallen to the courts. The courts have developed two definitional elements, one in relation to profit motive and the other in relation to the scope of the activities. While there can be no trade or business unless the taxpayer enters into and carries on an activity with a good faith intention to make a profit or in the belief that a profit can be made from the activity, this is generally not a problem for most activities, including rental real estate. But when we turn to the scope of the activities, rental real estate often falls short of the trade or business level.

This is further confused by the fact that the term trade or business is used in different contexts with different meanings, e.g., the term trade or business is used in §469 (passive activity loss rules) to define a passive activity as an activity that involves the conduct of any trade or business, and in which the taxpayer does not materially participate. Given that a rental activity is generally included within the definition of a passive activity, one could conclude that a rental activity is a trade or business -- and it is, but only because §469 defines a trade or business as any activity in connection with a trade or business OR any activity with respect to which expenses are allowable as a deduction under §212 (profit-making). In other words, a §469 trade or business is either a §162 trade or business or a profit-making activity. Thus, rental activity can be characterized as a passive activity because it is either is a §162 trade or business or a profit-making activity.

But for NII tax purposes, the ordinary course of a trade or business exception only applies if there is a §162 trade or business; an activity, such as most rental real estate operations, that is merely a transaction entered into for profit, is not a trade or business. Similarly, it appears that rental real estate could not be held in a trade or business if the rental activity is not a §162 trade or business; net gain from the sale would appear to be included in NII in any event, while gain or loss on the sale of the rental property held in a §162 trade or business would be excluded. So this classification of a rental operation as a §162 or §212 activity will be a central focus of planning in connection with the NII tax.

One of the most recent cases of whether a taxpayer was involved in a trade or business by the Supreme Court confirmed that the taxpayer's gambling activities did not involve the offering of goods or services to the public because they were pursued full-time, were regular, and were the source of the individual's livelihood.[443] This should be contrasted with an earlier case in which the management of securities investments and collecting the income therefrom was not a trade or business, regardless of the investment size, continuity of effort, or time devoted to the activity.[444] A taxpayer who owns several parcels of land, manages them through an agent, pays taxes, expenses, and mortgage payments on them, and purchases and sells the parcels as conditions dictate is engaged in a trade or business because the management is considerable, regular, and continuous.[445] Mere ownership of real property rented under a net lease does not constitute a trade or business because mere collection of net rent does not involve sufficient management activity.[446]

One aspect of the scope of activities amounting to a trade or business is that there is a participation that is regular, continuous, and substantial. This is the same set of words used in §469 to define material participation, but it is clear that various methods the regulations offer a taxpayer for material participation can be met without the operation being a trade or business in its scope.

Note that for NII purposes, a rental activity that is not a §162 trade or business is not a category 2 passive activity for these purposes either, even though it is a passive activity for passive activity purposes.

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443 *Commissioner. v. Groetzinger*, 480 U.S. 23 (1987).
444 *Higgins v. Commissioner*, 312 U.S. 212 (1941), aff'g 111 F.2d 795 (2d Cir. 1940), aff'g 39 B.T.A. 1005 (1939).
445 *Pinchot v. Commissioner*, 113 F.2d 718 (2d Cir. 1940).
446 *Neill v. Commissioner*, 46 B.T.A. 197 (1942).

7. *Covered trades or businesses*

A trade or business is covered by category 2 if the trade or business involves the conduct of a §162 trade or business, and said trade or business is either a passive activity ("passive activity") with respect to the taxpayer;[447] or the trade or business of a trader trading in financial instruments or commodities (collectively "a trading activity") (sometimes referred to as "§1411 trade or business").[448]

For these purposes, a passive activity is a trade or business; and such trade or business is a passive activity with respect to the taxpayer within the meaning of the passive activity loss rules and regulations.[449]

a. To the extent that any income or gain from a §162 trade or business is recharacterized as "not from a passive activity" by reason of significant participation, property rented incidental to development activity, or property rented to a trade or business activity in which the taxpayer materially participates for the taxable year, such §162 trade or business does not constitute a passive activity for these purposes solely with respect to such recharacterized income or gain.[450]

b. To the extent that any gain from a trade or business is recharacterized as "not from a passive activity" by reason of the substantially appreciated property formerly used in a passive activity rule that was not held for more than 50 percent of the period during which the taxpayer held the interest in the nonpassive activities, such §162 trade or business does not constitute a passive activity for these purposes solely with respect to such recharacterized gain.[451]

c. To the extent that any income or gain from a trade or business is recharacterized as "not from a passive activity" and is further characterized as portfolio income as from property held from investment or as property held in a passive activity for more than 50 percent of the period during which the taxpayer held that interest in property in activities other than passive activities, then such trade or business constitutes a passive activity for these purposes solely with respect to such recharacterized income or gain.[452]

In each example, unless otherwise indicated, the taxpayer uses a calendar taxable year, the taxpayer is a United States citizen, and Year 1 and all subsequent years are taxable years in which the NII tax is in effect:

Example 1: A, an unmarried individual, rents a commercial building to B for $50,000 in Year 1. A is not involved in the activity of the commercial building on a regular and continuous basis; therefore, A's rental activity does not involve the conduct of a trade or business, and under the passive activity loss rules, A's rental activity is a passive activity. Because the activity is not a §162 trade or business, A's rental income of $50,000 is not derived from a trade or business that is a passive activity. However, A's rental income of $50,000 still constitutes category 1 gross income from rents because rents are included in the determination of net investment income whether or not derived from a passive activity trade or business.

Example 2: In Year 1, A, an unmarried individual, owns an interest in PRS, a partnership for federal income tax purposes. PRS is engaged in two activities, X and Y, which constitute trades or businesses, and neither of which constitute trading in

[447] Treas. Regs. §1.1411-5(a)(1).
[448] Treas. Regs. §1.1411-5(a)(2).
[449] Treas. Regs. §1.1411-5(b)(1).
[450] Treas. Regs. §1.1411-5(b)(2)(i).
[451] Treas. Regs. §1.1411-5(b)(2)(ii).
[452] Treas. Regs. §1.1411-5(b)(2)(iii).

financial instruments or commodities. A has properly grouped X and Y together as one activity (the grouped activity). A participates in X for more than 500 hours during Year 1 and would be treated as materially participating in activity X if A's material participation were determined only with respect to activity X. A only participates in Y for 50 hours during Year 1. If not for the grouping of the X and Y activities together, A would not be treated as materially participating in Y. However, A materially participates in the grouped activity. Therefore, for these purposes, neither X nor Y is a passive activity with respect to A. Accordingly, with respect to A, neither X nor Y is a passive activity trade or business.

Example 3: B, an unmarried individual, is a partner in PRS, which is engaged in an equipment leasing activity. The average period of customer use of the equipment is seven days or less (and therefore meets the exception from status as rental activity). B materially participates in the equipment leasing activity. The equipment leasing activity constitutes a trade or business. In Year 1, B has modified adjusted gross income of $300,000, all of which is derived from PRS. All of the income from PRS is derived in the ordinary course of the equipment leasing activity, and all of PRS's property is held in the equipment leasing activity. Of B's allocable share of income from PRS, $275,000 constitutes gross income from rents. While $275,000 of the gross income from the equipment leasing activity meets the category 1 definition of rents, the activity meets one of the exceptions to rental activity and B materially participates in the activity. Therefore, the trade or business is not a passive activity with respect to B for these purposes. Because the rents are derived in the ordinary course of a trade or business neither a passive or trading activity, the ordinary course of a trade or business exception applies, and the rents are not category 1 income. Furthermore, because the equipment leasing trade or business is not a trade or business that is a passive or trading activity, the $25,000 of other gross income is not category 2 net investment income. However, the $25,000 of other gross income may be net investment income if it is attributable to PRS's working capital. Finally, gain or loss from the sale of the property held in the equipment leasing activity will not be subject to category 3 characterization because, although it is attributable to a trade or business, it is not a trade or business to which the NII tax applies.

Example 4: Same facts as **Example 3**, except B does not materially participate in the equipment leasing trade or business and therefore the trade or business is a passive activity with respect to B for these purposes. Accordingly, the $275,000 of gross income from rents is category 1 because the rents are derived from a trade or business that is a passive activity with respect to B. Furthermore, the $25,000 of other gross income from the equipment leasing trade or business is category 2 because the gross income is derived from a trade or business that is a passive activity. Finally, gain or loss from the sale of the property used in the equipment leasing trade or business is subject to category 3 characterization because the trade or business is a passive activity with respect to B.

Example 5: C, an unmarried individual, is a partner in PRS, a partnership engaged in a trade or business that does not involve a rental activity. C does not materially participate in PRS. Therefore, the trade or business of PRS is a passive activity with respect to C for these purposes. C's $500,000 allocable share of PRS's income consists of $450,000 of gross income from a trade or business and $50,000 of gross income from dividends and interest that is not derived in the ordinary course of the trade or business of PRS. Therefore, C's $500,000 allocable share of PRS's income is subject to NII tax. C's $50,000 allocable share of PRS's income from dividends and interest is subject to category 1 characterization because the share is gross income from dividends and interest that is not derived in the ordinary course of a trade or business (that is, the ordinary course of a trade or business exception is inapplicable). C's $450,000 allocable share of PRS's income is subject to category 2 characterization because it is gross income from a trade or business that is a passive activity.

8. Exceptions

a. There are items that are not included in gross income at all, such as tax-exempt interest, which fit into the category of investment income but do not constitute gross income. Other gross income, if recognized from a trade or business of trading in financial instruments or commodities, or with respect to which the taxpayer is passive, is included in net investment income.

Note:

Distributions from an IRA or qualified plan are expressly excluded from net investment income, but except for a Roth-variety arrangement or except to the extent of the return of after-tax contributions, it is included in the taxpayer's gross income and MAGI. Such distributions, while themselves not subject to the tax, may push the excess MAGI above or increase its excess to require more of the unearned income to be included in net investment income.

Example: J, married, has MAGI from all other sources of $230,000, which includes $50,000 of unearned income. J receives a distribution from an IRA of $40,000. If the IRA is a traditional IRA (with no after-tax contributions), J's MAGI increases to $270,000. The lesser of the MAGI excess of $20,000 ($270,000 - $250,000) and the $50,000 net investment income is $20,000. J is liable for $760 tax ($20,000 x .038). If the distribution was from a Roth IRA, the excess MAGI would be $0 ($230,000 - $250,000), so none of the earned income would be subject to the Medicare tax.

b. Net investment income does not include any distribution from a plan or arrangement described in §§401(a) (qualified plans), 403(a) (qualified annuity plans), 403(b) (tax-deferred annuities), 408 (IRAs, SIMPLEs, and SEPs), 408A (Roth IRAs), or 457(b) (governmental and tax-exempt organization deferred-compensation plans).[453]

Planning point:

HOWEVER, distributions from such plans are generally fully taxable [in contrast to, say, a Roth IRA or Roth §401(k) plan] and add to the taxpayer's AGI (and MAGI). Thus, the effect is secondary. Although retirees will not be taxed on retirement distributions themselves, the distributions may cause some or all of the taxpayer's other investment income, traditionally a large percentage of a retiree's income, to be subject to the additional 3.8-percent net investment income tax.

c. In general, NII does not include any item "taken into account" in determining self-employment income that is subject to tax under §1401(b) for such taxable year. For these purposes, taken into account means income included and deductions allowed in determining net earnings from self-employment. However, amounts excepted in determining net earnings from self-employment under §§1402(a)(1)-(17), and thus excluded from self-employment income, are not taken into account in determining self-employment income and thus may be included in NII if such amounts are otherwise so described. In general, if net earnings from self-employment consist of income or loss from more than one trade or business, all items taken into account in determining the net earnings from self-employment with respect to these trades or businesses are considered

453 I.R.C. §1411(b)(5).

taken into account in determining the amount of self-employment income that is subject to tax under §401(b) and therefore not included in net investment income.[454]

Note:

> Some of the amounts excluded are:
>
> - Rentals from real estate and from personal property leased with the real estate together with the deductions attributable thereto, unless such rentals are received in the course of a trade or business as a real estate dealer;
> - Dividends on any share of stock, and interest on any bond, debenture, note, or certificate, or other evidence of indebtedness, issued with interest coupons or in registered form by any corporation (including one issued by a government or political subdivision thereof), unless such dividends and interest are received in the course of a trade or business as a dealer in stocks or securities;
> - Any gain or loss which is considered as gain or loss from the sale or exchange of a capital asset, from the cutting of timber, or the disposal of timber, coal, or iron ore, if §631 applies to such gain or loss, or from the sale, exchange, involuntary conversion, or other disposition of property if such property is neither stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, nor property held primarily for sale to customers in the ordinary course of the trade or business;
> - The deduction for net operating losses provided in §172;
> - Certain community income;
> - A resident of Puerto Rico shall compute his/her net earnings from self-employment in the same manner as a citizen of the United States but without regard to §933;
> - The deduction for personal exemptions;
> - Certain exclusions for an individual who is a duly ordained, commissioned, or licensed minister of a church or a member of a religious order;
> - The exclusion from gross income provided by §931;
> - Certain retirement payments paid to a partner;
> - The exclusion from gross income provided by §911(a)(1);
> - In lieu of the deduction provided by §164(f) (relating to deduction for one-half of self-employment taxes), there shall be allowed a deduction equal to the product of the taxpayer’s net earnings from self-employment for the taxable year (determined without regard to this bullet), and one-half of the sum of the rates imposed by subsections (a) and (b) of §1401 for such year [determined without regard to the rate imposed under paragraph (2) of §1401(b)];
> - The distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services;
> - Certain church employee income;
> - The deduction provided by §199; and
> - Each spouse’s share of income or loss from a qualified joint venture shall be taken into account as provided in §761(f) in determining net earnings from self-employment of such spouse.
>
> The most important of these are the exclusion for rents and the exclusion for a limited partner. It is important to note that a real estate professional is not the same as a dealer. A dealer is engaged in a §162 trade or business, but not necessarily so for a real estate professional.

d. Take advantage of the trade or business exception for category 1 (interest, dividends, rents, royalties) and category 3 (gains on disposition of property) income to keep such items out of net investment income for the year. However, the trade or business exception can be lost if such income is treated as category 2 (passive) income. This is

454 Prop. Regs. §1.1411-9(a).

particularly important for taxpayer positions in real estate. To the extent that gross rental income described in category 1 is treated as not derived from a passive activity by reason of it being rented for use in a §162 trade or business activity in which the taxpayer materially participates for the taxable year that is not rented incidental to a development activity or as a consequence of a taxpayer grouping a rental activity with a trade or business activity under general grouping rules, such gross rental income is deemed to be derived in the ordinary course of a trade or business thereby eliminating it from net investment income.[455]

(i) To the extent that gain or loss resulting from the disposition of property is treated as nonpassive gain or loss by reason of it being rented for use in a trade or business activity in which the taxpayer materially participates for the taxable year that is not rented incidental to a development activity or as a consequence of a taxpayer grouping a rental activity with a trade or business activity under the general grouping rules, then this gain or loss is deemed to be derived from property used in the ordinary course of a trade or business.[456]

(ii) One of the most important rules is a safe harbor accorded to rental real estate operations and only to rental real estate (not personal property rentals). In the case of a **real estate professional** that participates in one or more **rental real estate activities** for **more than 500 hours during such year**, or has participated in such real estate activities for **more than 500 hours in any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year**,[457] then --

- Such gross rental income from that rental activity is deemed to be derived in the **ordinary course of a trade or business**;[458] and
- Gain or loss resulting from the disposition of property used in such rental real estate activity is deemed to be derived from **property used in the ordinary course of a trade or business**.[459]

Note:

An election to treat all rental real estate as a single rental activity under the real estate professional rules also applies for these purposes. However, **any rental real estate that the taxpayer grouped with a trade or business activity under the general grouping rules where the real estate activity is insubstantial in relation to the trade or business or where the activity and the trade or business have common ownership AND, in either case, is an appropriate economic unit, is not a rental real estate activity**.[460]

(iii) The inability of a real estate professional to satisfy the safe harbor does not preclude such taxpayer from establishing that such gross rental income and gain or loss from the disposition of property, as applicable, is not included in net investment income under any other provision of §1411.[461]

455 Treas. Regs. §1.1411-4(g)(6)(i).
456 Treas. Regs. §1.1411-4(g)(6)(ii).
457 Treas. Regs. §1.1411-4(g)(7)(i).
458 Treas. Regs. §1.1411-4(g)(7)(i)(A).
459 Treas. Regs. §1.1411-4(g)(7)(i)(B).
460 Treas. Regs. §1.1411-4(f)(7)(ii)(B).
461 Treas. Regs. §1.1411-4(g)(7)(iii).

Planning point:

Because there is no statutory or regulatory definition of a trade or business, the task of establishing tests to determine the existence of a trade or business has fallen to the courts. The courts have developed two definitional elements, one in relation to profit motive and the other in relation to the scope of the activities. While there can be no trade or business unless the taxpayer enters into and carries on an activity with a good faith intention to make a profit or in the belief that a profit can be made from the activity, this is generally not a problem for most activities, including rental real estate. But when we turn to the scope of the activities, rental real estate often falls short of the trade or business level.

This is further confused by the fact that the term trade or business is used in different contexts with different meanings, e.g., the term trade or business is used in §469 (passive activity loss rules) to define a passive activity as an activity that involves the conduct of any trade or business, and in which the taxpayer does not materially participate. Given that a rental activity is generally included within the definition of a passive activity, one could conclude that a rental activity is a trade or business -- and it is, but only because §469 defines a trade or business as any activity in connection with a trade or business OR any activity with respect to which expenses are allowable as a deduction under §212 (profit-making). In other words, a §469 trade or business is either a §162 trade or business or a profit-making activity. Thus, rental activity can be characterized as a passive activity because it is either is a §162 trade or business or a profit-making activity.

But for NII tax purposes, the ordinary course of a trade or business exception only applies if there is a §162 trade or business; an activity, such as most rental real estate operations, that is merely a transaction entered into for profit, is not a trade or business. Similarly, it appears that rental real estate could not be held in a trade or business if the rental activity is not a §162 trade or business; net gain from the sale would appear to be included in NII in any event, while gain or loss on the sale of the rental property held in a §162 trade or business would be excluded. So this classification of a rental operation as a §162 or §212 activity will be a central focus of planning in connection with the NII tax.

A case of whether a taxpayer was involved in a trade or business by the Supreme Court confirmed that the taxpayer's gambling activities did not involve the offering of goods or services to the public because they were pursued full-time, were regular, and were the source of the individual's livelihood.[462] This should be contrasted with an earlier case in which the management of securities investments and collecting the income therefrom was not a trade or business, regardless of the investment size, continuity of effort, or time devoted to the activity.[463] A taxpayer who owns several parcels of land, manages them through an agent, pays taxes, expenses, and mortgage payments on them, and purchases and sells the parcels as conditions dictate is engaged in a trade or business because the management is considerable, regular, and continuous.[464] Mere ownership of real property rented under a net lease doesn't constitute a trade or business because mere collection of net rent does not involve sufficient management activity.[465]

One aspect of the scope of activities amounting to a trade or business is that there is a participation that is regular, continuous, and substantial. This is the same set of words used in §469 to define material participation, but it is clear that various methods the regulations offer a taxpayer for material participation can be met without the operation being a trade or business in its scope.

Note that for NII purposes, a rental activity that is not a §162 trade or business is not a category 2 passive activity for these purposes either, even though it is a passive activity for passive activity purposes.

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462 *Commissioner v. Groetzinger*, 480 U.S. 23 (1987).

463 *Higgins v. Commissioner*, 312 U.S. 212 (1941), aff'g 111 F.2d 795 (2d Cir. 1940), aff'g 39 B.T.A. 1005 (1939).

464 *Pinchot v. Commissioner*, 113 F.2d 718 (2d Cir. 1940).

465 *Neill v. Commissioner*, 46 B.T.A. 197 (1942).

Caution:

Rental activities are considered passive unless a taxpayer qualifies as a "real estate professional." In general, this requires satisfying two tests:

- More than one-half of the taxpayer's personal services performed throughout the year must be performed in real property trades or businesses (not necessarily §162 trades or businesses) in which the taxpayer materially participates; and
- The taxpayer must perform more than 750 hours of services during the year in real property trades or businesses (not necessarily §162 trades or businesses) in which the taxpayer materially participates.

The safe harbor eliminates this §162 issue.

Example 1: A taxpayer owns and operates a small apartment complex leased to residential tenants for profit. The taxpayer works 2,000 hours per year at the apartments, and has no other profession or other employment. The rents will be excluded from NII if the taxpayer meets the ordinary course of business exception. Here, the apartment activity by itself probably constitutes a §162 trade or business. The inclusion of the rents in NII depends on whether the taxpayer is passive. Here, the taxpayer is a real estate professional because more than one-half of his personal services are performed in the real property trade or business of renting, operating, managing, and leasing real property (in which the taxpayer materially participates), and the taxpayer performs more than 750 hours of services in such trade or business. Taxpayer tests for material participation. Because the taxpayer participates in the apartment rental activity for more than 500 hours during the year, such activity is not passive with respect to the taxpayer. As a result, the taxpayer satisfies the ordinary course exception, and the rental income is excluded from NII.

Example 2: The facts are the same as in **Example 1**, but now assume the taxpayer works in the apartment business for 600 hours during the year as the sole owner and operator (with no other employees), and also acts as a real estate broker for 1,500 hours per year. The rental income is not NII because the ordinary course exception should continue to apply on these facts. The apartments continue to qualify as a §162 trade or business activity. In addition, the taxpayer should qualify as a real estate professional by reason of his real estate broker activity. With respect to the apartments, the taxpayer should materially participate because his participation exceeds 500 hours.

Example 3: The facts are the same as in **Example 1**, but now assume the taxpayer works in the apartment business for only 501 hours per year, and the taxpayer also has three other employees at the apartments who each work 499 hours per year. The apartments continue to qualify as a §162 trade or business activity. In addition, the taxpayer continues to qualify as a real estate professional (in the event the apartments were not otherwise a §162 trade or business), and he materially participates in the apartments because he participates for more than 500 hours per year, and his participation is not less than the participation of any other person at the apartments.

Example 4: A taxpayer works 1,500 hours per year as a real estate contractor. The taxpayer also owns undivided interests in 11 large apartment complexes (each a §162 trade or business having multiple full-time managers and employees) that the taxpayer helped construct, and the taxpayer works for only 50 hours per year for each complex providing contractor services. Each apartment produces annual income for the owners, including the taxpayer. The taxpayer's share of the rental income from the apartments might be NII if the taxpayer does not satisfy the ordinary course exception. Here, because the apartments meet the trade or business test, the answer turns on whether the taxpayer is passive or nonpassive with respect to the apartment activities. On an individual activity basis, the taxpayer fails to materially participate in any of the apartments (because he does not meet any of the safe harbors for material participation).

As a full-time real estate contractor, however, the taxpayer is a real estate professional, and thus is eligible to elect to treat all of his interests in rental real estate as a single activity for purposes of determining material participation. Here, if the taxpayer makes this election, his total time in the combined rental real estate activity is 550 hours, which satisfies the 500-hour test for material participation. Thus, by making the grouping election, the taxpayer is able to satisfy the ordinary course of business exception.

Example 5: The facts are the same as in **Example 4**, but now assume that two of the apartment complexes are held in limited partnerships in which the taxpayer is a limited partner, and more than 10 percent of the taxpayer's rental income is derived from such partnerships. As a limited partner, a taxpayer may rely on only three of the seven tests for material participation -- the 500-hour test, the five-out-of-ten test, and the personal service activity test (not relevant in this context). Where a real estate professional elects to treat all interests in rental real estate as a single rental real estate activity, and at least one interest in rental real estate is held by the taxpayer as a limited partnership interest, the combined rental real estate activity will be treated as a limited partnership interest of the taxpayer for purposes of testing material participation. Because the 500-hour test is available to limited partners, however, the taxpayer continues to materially participate in the combined activity, with the result that his share of the rental income is excluded from NII under the ordinary course exception. The five-out-of-ten rule could apply in some cases where taxpayer met the 500-hour test in five of the prior ten taxable years, if needed to meet the safe harbor.

Planning point:

The ordinary course exception is often tied to the passive activity rules, which creates a planning opportunity by controlling the level of the taxpayer's participation, or to make certain favorable tax elections, in order to achieve material participation under one of the safe harbors. With respect to a passive income generator ("PIG"), a taxpayer would not have thought material participation should be monitored, because the passive activity loss rules do not apply to income (although this concern would be heightened by the ownership of passive activities generating losses). With respect to the NII, such income is exposed to tax unless it meets the ordinary course of business exception. By increasing participation or making certain tax elections with respect to grouping of properties, taxpayers may be able to convert the income from passive to nonpassive to avoid, in some cases, the 3.8-percent NII tax [but in some cases, business income will be subject to: (a) the Medicare tax (2.9 percent); and (b) the additional Medicare tax (0.9 percent), totaling 3.8 percent].[466] But at what cost? If a taxpayer has passive losses from one source that can be used to offset passive income from another source, if the taxpayer converts the passive income to nonpassive income in order to avoid the 3.8-percent NII tax, the taxpayer no longer will be able to offset such income with the passive losses for regular income-tax purposes. Better to swallow the 3.8-percent tax than to subject the income to a 37-percent tax.

(iv) While the anti-PIG rules under the passive activity loss regulations are detrimental to taxpayers for income tax purposes, they convert what otherwise might be passive income into nonpassive income. However, the regulations deal with this for **§162 trades or businesses where there are no safe harbors for non-real estate professionals**.

- Under the self-rental rule, an amount of the taxpayer's gross rental income for the tax year from an item of property equal to the net rental

[466] However, while none of the net investment income tax is deductible, the self-employed individual may deduct one-half of the regular Medicare taxes paid (1.45 percent). So on an after-tax basis the 3.8-percent taxes are not equal.

activity income for the year from that item of property is treated as not from a passive activity if the property is rented for use in a §162 trade or business activity in which the taxpayer materially participates for the tax year.

Example 1: The taxpayer is a full-time physician (and not a real estate professional) who operates her medical practice through an S corporation in which she materially participates. The taxpayer constructs a new medical office building and leases it to the S corporation at a rental sufficient to create net passive income that she (incorrectly) hopes can be used to offset passive losses from other sources. The two activities are not grouped.

Rental activity normally is per se passive. The anti-PIG rule, however, converts the otherwise passive rental income into nonpassive income (regardless of whether the taxpayer materially participates). As a result, if the rental activity constitutes a §162 trade or business, then the rental income is excluded from NII under the ordinary course exception.

Note:

The self-rental rule is particularly helpful because a taxpayer need not be a real estate professional in order to take advantage of it. If the self-rental rule applies, then rental income is not considered passive, thus clearing a major hurdle toward application of the ordinary course exception.[467]

Example 2: A family limited partnership consisting of taxpayer, taxpayer's spouse, and taxpayer's three children, each holding 20 percent of the interest in the partnership, leases real property to a law firm in which taxpayer is a partner. As to 20 percent of the rents received -- the taxpayer's distributive share -- the self-rental rule applies to treat it as nonpassive income that is excluded from category 1 net investment income. As to the remaining 80 percent, the self-rental rule does not apply to the rents in respect of the children's distributive shares, so the rent is category 1 if the rental is not a trade or business, or category 2 net investment income assuming they do not materially participate in the partnership rental activity.

As to the spouse, there are two interpretations at play. On one hand, the passive activity loss regulations permit the material participation of one spouse to count for the other; however, the same participation cannot be counted twice, once for the taxpayer and once again by attribution to the spouse. Such attribution, if limited to the activity at issue (i.e., the rental activity), clearly doesn't permit the self-rental rule to apply to the spouse. In essence, this interpretation requires the participation in the law firm by the taxpayer to be attributed to the spouse not merely in the rental activity but also in the legal practice activity so that the spouse, not even licensed for law practice, is treated as materially participating in that firm; thus the spouse is renting to a law firm in which she owns an interest and materially participates. On the other hand, if the spousal attribution is treated most broadly, the spouse could be treated as materially participating in the rental activity and the legal practice activity by virtue of the taxpayer's participation in both activities (if such participation can also be counted for the taxpayer). This example, like many issues in the tax law, shows the difficulty in interpreting tax law to many situations. One practical solution would be to have one spouse gift his or her interest to the other spouse so that 40 percent of the income would clearly avoid the 3.8-percent tax since it would meet the self-rental rule.

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467 Temp. Regs. §1.469-2T(f)(3).

Note:

> There is no related party attribution to apply the self-rental status of one partner to any of the other partners regardless of whether they are related under §267.

- If less than 30 percent of the unadjusted basis of a property used or held for use by customers in a rental activity during the tax year is subject to the allowance for depreciation, the passive activity loss regulations require that an amount of the taxpayer's gross income from the activity equal to the taxpayer's net passive income from the activity will be treated as not from a passive activity. For purposes of this exception, "unadjusted basis" means adjusted basis determined without regard to any adjustment described that decreases basis. This recharacterization rule is equally applicable for NII tax purposes.

Example 3: The taxpayer is a limited partner in a partnership. The partnership acquires vacant land for $300,000, constructs improvements on the land at a cost of $100,000, and leases the land and improvements to a tenant. The partnership then sells the land and improvements for $600,000, thereby realizing a net gain on the disposition.

The gain is not included in NII, assuming the rental activity qualifies as a §162 trade or business. Here, the unadjusted basis of the improvements ($100,000) equals 25 percent of the unadjusted basis of all of the property ($400,000) used in the rental activity. Therefore, under the nondepreciable property exception, an amount of the taxpayer's gross income from the activity equal to the net passive income from the activity (which is computed by taking into account the gain from the disposition, including gain allocable to the improvements) is treated as not from a passive activity. Because the net gain is treated as nonpassive, and because the rental activity constitutes a trade or business, the ordinary course exception applies, and the net gain is excluded from NII.

Planning point:

Grouping: The concept of an appropriate economic unit is not defined, but the regulations indicate that whether activities constitute an appropriate economic unit and, therefore, may be treated as a single activity, depends upon all the relevant facts and circumstances, identifying, but not limited to the following factors, not all of which are necessary for a taxpayer to treat more than one activity as a single activity, but are given the greatest weight in determining whether activities constitute an appropriate economic unit for the measurement of gain or loss for these purposes:[468]

(i) Similarities and differences in **types of trades or businesses**;[469]
(ii) The extent of **common control**;[470]
(iii) The extent of **common ownership**;[471]
(iv) **Geographical** location;[472] and
(v) **Interdependencies** between or among the activities (for example, the extent to which the activities purchase or sell goods between or among themselves, involve products or services that are normally provided together, have the same customers, have the same employees, or are accounted for with a single set of books and records).[473]

A rental activity may not be grouped with a trade or business activity unless the activities being grouped together constitute an appropriate economic unit and:

- The **rental activity** is **insubstantial** in relation to the trade or business activity;[474]
- The **trade or business activity** is **insubstantial** in relation to the rental activity;[475] or
- Each owner of the trade or business activity has the same proportionate ownership interest in the rental activity, in which case the portion of the rental activity that involves the rental of items of property for use in the trade or business activity may be grouped with the trade or business activity.

9. Christian Sezonov et al. v. Commissioner[476]

A court case, *Christian Sezonov et al. v. Commissioner,* found that taxpayers were not considered real estate professionals.

Facts:

Christian and Francine Sezonov are married taxpayers who resided in Ohio when the Court was petitioned. During the period at issue, Mr. Sezonov was the sole member of Design Build Service, LLC (DBS), a single-member LLC that was operated as a wholesale HVAC business. In 2013, DBS purchased two Florida properties, one on Reybell Ln in Palm Coast, FL ("Reybell property"), and one on Marina Bay Drive in Flager Beach, FL ("Marina Bay property"). Specifically, the Reybell property was purchased in April 2013 and the Marina Bay property was purchased in November 2013. Through DBS, the Sezonovs rented both properties in 2013 and 2014, but they maintained their primary residence in Ohio.

The Sezonovs leased the Reybell property to its previous owners until June 14, 2013. After the previous owners moved out, the Sezonovs cleaned and furnished the property to prepare it for future rentals. The Reybell property was leased to a tenant for a one-year lease term in September or October 2013.

468 Treas. Regs. §1.469-4(c)(2).
469 Treas. Regs. §1.469-4(c)(2)(i).
470 Treas. Regs. §1.469-4(c)(2)(ii).
471 Treas. Regs. §1.469-4(c)(2)(iii).
472 Treas. Regs. §1.469-4(c)(2)(iv).
473 Treas. Regs. §1.469-4(c)(2)(v).
474 Treas. Regs. §1.469-4(d)(1)(i)(A).
475 Treas. Regs. §1.469-4(d)(1)(i)(B).
476 *Christian Sezonov et al. v. Commissioner*; T.C. Memo. 2022-40.

After purchasing the Marina Bay property, the Sezonovs hired contractors to repair the property to prepare it to be a short-term vacation rental property. The Marina Bay property was first made available to rent in December 2013, and it was rented for the first time in January 2014. Most leases were short-term, one-month leases.

Mrs. Sezonov was responsible with advertising the rentals and communicating with renters via email. In between rentals, Mrs. Sezonov would clean and prepare the Marina Bay property for the next tenants, or she would hire a cleaner to do so. Mr. Sezonov assisted in responding to rental inquiry emails and performing maintenance and repairs, but Mrs. Sezonov participated in most of the day-to-day activities and management.

The Sezonovs did not maintain contemporaneous records of the hours they worked on the rental properties; however, when the case was pending in 2019 and 2020, they created time logs estimating the amount of time spent working on the rental properties in 2013 and 2014. Mrs. Sezonov estimated that she spent approximately 476 hours working on the rental properties in 2013 and 80 hours working on the rental properties in 2014. Mr. Sezonov estimated that he spent approximately 405 hours working on the rental properties in 2013 and 26 hours working on the rental properties in 2014. The Sezonovs relied on documents such as rental agreements and emails to assist them in estimating time spent working on the properties.

When the Sezonovs timely filed their 2013 and 2014 returns, they reported the income, expenses, and losses associated with the rental properties on Schedule E, and they did not make an election to aggregate their rental activities under §469(c)(7)(A). In October 2017, the IRS issued a statutory notice of deficiency to the Sezonovs, disallowing Schedule E loss deductions claimed on their 2013 and 2014 federal returns. The Sezonovs timely petitioned the Court.

Issues and Analysis:
Taxpayers bear the burden of proving that they are entitled to any deduction, and they generally must maintain adequate records to substantiate the nature, amount, and purpose of the claimed deduction.

Section 162 allows a taxpayer to deduct ordinary and necessary expenses paid or incurred in carrying on a trade or business, but special rules apply to passive activity losses. Under §469, individuals cannot take a deduction for passive activity losses, defined as the excess of the aggregate losses from all of the taxpayer's passive activities for the taxable year over the aggregate income from all of his passive activities during the taxable year. [477]

Passive activities include any trade or business in which the taxpayer does not materially participate, or any rental activity regardless of whether the taxpayer materially participates in such activity. [478] As discussed in the materials, an exception is provided for real estate professionals. As a result, any rental activities performed by a real estate professional are treated as a trade or business subject to material participation requirements of §469(c)(1) rather than as a passive activity.

[477] IRC §469(d)(1).
[478] IRC §469(c)(1); §469(c)(2).

Under §469(c)(7)(B), a taxpayer qualifies as a real estate professional for a given year if:

- 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
- 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.

The requirements of a real estate professional outlined under §469(c)(7)(B) are met in the case of a joint return if either spouse separately satisfies such requirements.

Per §469(c)(7)(A), a taxpayer may elect to treat all interests in rental real estate as one activity, otherwise, each interest in rental real estate is treated as a discrete real estate activity. For purposes of the 750-hour requirement, all of the taxpayer's real property trade or business activity is taken into account. Per Temporary Treasury Regulation §1.469-5T(f)(4), a taxpayer's participation in an activity may be established by any reasonable means, and contemporaneous daily time logs are not required. The Sezonovs argued that both of them were considered real estate professionals for the 2013 and 2014 tax years based on their estimated time logs.

Conclusion:

The Court found that the time logs were insufficient to prove either of the Sezonovs qualified as a real estate professional. The Court cited that Mrs. Sezonov spent a combined total time of approximately 476 hours on the rental properties in 2013, and Mr. Sezonov spent a combined total time of approximately 405 hours on the rental properties in 2013. Similarly, Mrs. Sezonov spent a combined total of approximately 80 hours on the rental properties in 2014, and Mr. Sezonov spent a combined total of approximately 26 hours on the rental properties in 2014.

Neither of the Sezonovs met the 750-hour requirement to be classified as real estate professionals in each of the years at issue. Additionally, Mr. Sezonov failed to satisfy the requirement of §469(c)(7)(B)(i) because he did not spend more time working in the real estate rental business than in his HVAC business in either year. As a result, the Court classified the 2013 and 2014 rental activities as passive activities and sustained the IRS's determination disallowing the passive activity losses.

10. Drocella v. Commissioner [479]

Facts:

In 2018, Mr. and Mrs. Drocella both worked full time for their respective employers and owned and managed six rental real estate properties. The Drocellas stated that the work they performed in connection with the rental real estate properties included renting the properties, performing renovations, and handling tenant and/or guest issues.

The Drocellas maintained handwritten logs (from January through November 2018) containing information such as the dates and times that work was performed with respect to the rental real estate properties, as well as who performed the work (Mr. Drocella and/or Mrs. Drocella).

A total of 1,501.27 hours were accounted for on the log, with Mr. Drocella logging over 750 hours, and Mrs. Drocella logging under 750 hours. The Drocellas were unable to substantiate the number of hours that they performed as employees in their full-time positions.

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479 *Drocella v. Commissioner,* T.C. SUMM. OP. 2023-12.

The Drocellas filed a joint tax return, reporting AGI of $160,627. Their tax return included Schedule E, *Supplemental Income and Loss*, for the six rental real estate properties, for which the Drocellas claimed a $62,983 rental real estate loss deduction. On February 9, 2021, the IRS sent a Notice of Deficiency to the Drocellas, disallowing their rental real estate loss deduction.

Issues and Analysis - Real Estate Professionals:
Under IRC §469, rental activities are generally classified as passive. Deductions against passive activities can generally offset income from passive activities, but any loss cannot be deducted from income other than passive activities. Taxpayers typically do not materially participate in passive activities.

Under IRC §469(c)(7)(B), an exception exists for Real Estate Professionals. This exception applies to taxpayers if:

- 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
- 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.

In the case of a joint return, the Real Estate Professional requirements are satisfied if either spouse separately satisfies the requirements.

If a taxpayer meets the qualifications of a Real Estate Professional, §469 passive activity rules do not apply, and the taxpayer's rental real estate activity, if conducted as a trade or business or for the production of income, is not treated as a passive activity.

Conclusion:
Both Mr. and Mrs. Drocella said that they were full-time employees, but neither provided the number of hours they performed as employees, only stating that they both worked as “full-time employees.” The Court found that the taxpayers could not prove that more than one-half of either Mr. or Mrs. Drocella’s total personal services performed in trades and businesses were performed on their rental real estate activities during the 2018 tax year.

As a result, since the Drocellas did not meet the Real Estate Professional requirements, the Court determined that they were not allowed to deduct the rental real estate loss for 2018.

11. Summary of planning strategies

a. Management of AGI to keep it as close to the threshold amount as possible.
   (i) Because the underage from the AGI threshold is not carried over from year to year, there is no particular advantage in creating an AGI well below it (although this may be the right tactic looking at the income tax, and in some cases the investment income tax).
   (ii) Ideally, in cases where the AGI may be coming in low, it may well be right to reduce the amount of income in later years that can otherwise generate excess AGI by accelerating some of the income to the current year, where its effect will be negligible or none at all.
   (iii) Conversion of potential future taxable income into nontaxable income that is not included in AGI.

(iv) Acceleration for years in which investment income is low.

Note:

This is a simple view of the situation, but the planner should take additional items into account. For example, if a client makes significant medical expenses, acceleration of income will have the effect generally of reducing those deductions, because the higher the AGI, the higher the floor amount. On the other hand, the acceleration of income can increase the amount of the available charitable deduction which at certain levels may be more valuable than the increase in the income tax.

Moreover, there may be other ways to manage AGI by focusing on deductions that are taken above the line; such deductions will help the level of AGI for purposes of the investment income tax but not the excess wages. In particular, self-employed and owners of S corporations should examine the possibilities of using business deductions, health insurance, HSAs, and IRA and qualified plan contributions as additional considerations in managing AGI.

Employees should consider exclusions on fringe benefits as a substitute for wages but which do not increase AGI; in addition, they are not subject to payroll taxes at all and thus are not subject to the additional tax on excess compensation.

b. Increase tax-favored income.

(i) Converting taxable interest to tax-exempt interest will serve to reduce AGI and MAGI, which will limit the excess over the $250,000 threshold to minimize or eliminate any additional Social Security tax on wages or unearned income.

Planning point:

One has to take the costs of conversion into account. The sale of a corporate bond could produce gain or loss, while withdrawal of funds from a money-market account into tax-exempt bonds or fund (or a tax-exempt money-market account) would not.

Any fringe benefit is taxable and must be included in the recipient's pay unless the law specifically excludes it. However, exclusions apply to certain fringe benefits. Any benefit not excluded is taxable.

(i) If the recipient of a taxable fringe benefit is an employee, the benefit is subject to employment taxes and must be reported on Form W-2. If the recipient of a taxable fringe benefit is not an employee, the benefit is not subject to employment taxes.

(ii) The Code provides special treatment for certain benefits that are:
- **Not taxable** to the recipient of the benefit;
- **Deductible** to the provider of the benefit; and
- **Not subject to employment taxes.**

(iii) Examples of the latter benefits are:
- **Accident and health benefits;**
- Achievement awards;
- Adoption assistance;
- Athletic facilities;
- De minimis (minimal) benefits;
- Dependent-care assistance;
- Educational assistance;
- Employee discounts;
- Employee stock options;
- Group-term life insurance coverage;
- **Health savings accounts (HSAs);**
- Lodging on the business premises;
- Meals;
- No-additional-cost services;
- Retirement planning services; and
- Working condition benefits.

The bold-faced items listed under (iii) are those that would, however, be subject to the tax benefits limitation contained in the Administration proposal.

Ironically, partners/members and more-than-two-percent shareholders of an S corporation covered by a health plan fare better than taxpayers who pay their own medical expenses. First, the deduction for medical insurance is taken above-the-line, reducing AGI, while an individual takes the medical deduction below-the-line, having no impact on AGI. Second, the business owner can deduct the full amount of the expenses (to the extent of the owner's business income), while the individual is limited by the applicable percentage (7.5 percent) of AGI floor.

(ii) Converting taxable interest to tax-deferred interest or income may reduce the level of current income.
- The interest on U.S. Series EE bonds or inflation-indexed U.S. Series I savings bonds is generally deferred until redemption or maturity of the bond or the election by the taxpayer to include all accrued interest.
- The appreciation on stocks is generally not subject to current taxation. Purchase of undervalued stocks today gives the taxpayer further flexibility to time when to recognize gains. Many such "growth" stocks have enhanced appreciation potentiality by reason of their policy of not paying dividends, reducing further the amount subject to current taxation, and to inclusion in MAGI and investment income.

- Investment in **tax-deferred annuities** can postpone the tax effects of the income accruals on the underlying investments until distributions occur; during the accumulation phase, there is no addition to MAGI or unearned income.
- Investment in life insurance contracts and borrowing amounts out of such contracts for cash-flow purposes, if needed, will not cause MAGI problems.

Note:

Not only the increase in income-tax rates but also the post-2012 tax on investment income will be selling points for salespersons in the insurance annuity industry in the coming years. Like a retirement plan vehicle, the tax-exemption acts as a blocker to the current inclusion (and ultimate characterization) of the growth. Investment income within the policy is not included and when it does come out it is tax-exempt (if the policy matures), yet not tax-exempt interest.

- A Coverdell education savings account may be established for qualified higher education expenses of a designated beneficiary. Earnings on contributions are distributed tax-free to the beneficiary, provided they are used to pay the beneficiary's qualified education expenses. The contribution may not exceed $2,000, is not deductible, and may fund both elementary and secondary education expenses (kindergarten through grade 12) whether in a public, private, or religious school. The earnings on those contributions are tax-deferred, while held by the account. Qualified expenses include tuition, fees, books, supplies, equipment, and room and board. This contribution is phased out for joint filers having MAGI between $190,000 and $220,000, but generally other persons who are not in the phase out can make contributions, including the minor to whom a cash gift has been made. As noted, without a legislative fix, lower amounts apply.

Planning point:

The income limitations on contributions have been circumvented by having a taxpayer who is below the phase out threshold make the contribution, following a gift from a parent above the phase out range in the same amount. Given the potential reduction in the amount a donor can make, this might be the time to have as many multiple $2,000 contributions rather than a like number of $500 contributions in the future.

There have been greater investment choices in Coverdells in comparison to qualified tuition programs, and they permit the owner to switch investments as often as one likes in contrast to the once-a-year option offered in a QTP.

- Nondeductible contributions may be made to state-sponsored and private institution tuition-guarantee §529 plans. Unlike the Coverdell, contributions are not AGI limited. In theory there is no contribution limit, but the contribution will be treated as a gift (of a present interest); this limits the amount to a $18,000 annual exclusion ($36,000 with spousal gift-splitting) without incurring a taxable gift, but donors can elect to treat a lump-sum gift as if made ratably over a five-year period, increasing the amount that can be so given in one year to $90,000 ($180,000 with gift-splitting).

Note:

> The Coverdell and §529 plans, while not deductible, nevertheless generate tax-deferred income, which, when distributed, may be converted into tax-free income to the extent the beneficiary incurs qualified education expenses.

(iii) Tactics to reduce AGI.

- Converting taxable compensation into nontaxable fringe benefits.
- Shifting income to others.

Planning point:

> Shifting investment income appears to fit both the strategy of controlling MAGI and that of controlling investment income. Even in the case of a minor whose income is subject to kiddie tax, investment income is not included in the parent's gross income (unless the election to do so with respect to certain dividends and interest is made); it is only taxed at the parent's tax rate. Thus, it is not included in the parent's MAGI and it is not the parent's investment income but the child's, and thus is not included in the parent's net investment income calculation.

- Splitting income with a C corporation.
- Deferring income through nonqualified deferred compensation in a non-pass-through business.
- Using installment reporting, if available, on sales of property.
- Reducing business income by reimbursement of employee-paid expenditures.
- Reducing business or rental real estate, S corporation, and partnership income by maximizing expensing allowance and bonus depreciation (if then available).
- Tax-exempt interest income.
- Exclusions of gain on the sale of principal residence.
- Exclusions of gain on like-kind exchanges.
- Exclusions of gain on the sale of business structured as a reorganization.
- Making charitable contributions directly from an IRA to the charity, rather than receiving a distribution that is included in income but only offset below the line.
- Increasing elective deferrals and contributions to qualified plans.
- Changing a qualified plan to a defined benefit plan to increase the amount deductible.
- Increasing contributions to IRAs, if not phased out.
- Increasing contributions to HSAs.

c. The control of the timing of investment income.

(i) Time, where possible, sales on a net basis:

- Some gains are excluded (such as the first $250,000 [$500,000 if married filing jointly] on the sale of a principal residence). Transactions may sometimes be structured as like-kind exchanges. The inside build-up of life insurance policies is not included in gross income.
- Sales of gain property may be limited by sales of loss property.

- Use installment sales or sales by charitable remainder trust to spread investment category income and recognized gain over several years.

(ii) Acceleration of non-investment income to years in which investment income is low.

d. Avoid passive characterization.

e. What should individuals consider in 2025 regarding the additional tax on investment income?

(i) If the taxpayer will have unrecognized built-in gains going into 2025, any built-in capital losses should be considered deferred until they can do double-duty in the years of both higher regular capital gains tax rates and the additional NII tax on such income for taxpayers with sufficiently high AGIs.

(ii) Consider electing out of installment-sale treatment (where available) and recognizing the entire amount of gain in the year of sale (instead of deferring it over the payment period). So the taxpayer can, in essence, elect to recognize the entire gain when the pressure of net investment income will be higher in the future due to low AGI in the current year (other than potential recognized gains) and projected gains. There is no reason why gain sales followed by repurchases over a series of years cannot be effective to control both AGI and net investment income by resetting basis (to reduce future recognized gain).

(iii) Taxpayers that have high-yield stocks should consider, in connection with the disposition of those stocks in 2025 and thereafter, the opportunity to reset the portfolio in more tax-effective investments. This can shift control of the recognition of investment income (at rates as high as 20 percent) from the dividend-paying company to the investor who can time the gain. In addition to non-dividend paying stocks, investments in qualified small-business stocks can provide the additional benefit of gain that is excluded not only from taxable income but also AGI and net investment income. Tax-exempt bonds may work well tax-wise, but are subject to principal risks as interest rates change.

(iv) Although some taxpayers may benefit from making the election to treat long-term capital gain and qualified dividend income as ordinary so as to deduct otherwise not currently deductible interest expense, such expense disallowed by the limitation is carried over to the extent it exceeds the investment income as though incurred in the following year, when it may be more usefully applied against other net investment income. Such carryover may also be an offset in calculating net investment income for purposes of the 3.8-percent tax.

(v) Because passive income -- which is not included in net investment income, as that term is used in connection with the limitation on investment interest expense -- is always included in the net investment income tax base for purposes of the NII tax, taxpayers with multiple passive activities ought to be examining current grouping elections for each activity that may enable a reclassification of such activity from passive to active or vice versa. Passive activity losses (PALs) can be deducted only against passive activity income; regroupings may release the otherwise suspended losses, which may be even more beneficial in the higher tax rate environment than they are today. In the same manner, re-characterizing an activity from active to passive status may suspend otherwise allowable losses, which likewise might be more valuable when projected to be released in future higher tax rate years. The status of future years must take into account the projected extent to which the NII tax might apply.

(vi) Be careful with respect to the disposition of §1231 assets. On the one hand, gain is treated as capital and can be offset by capital losses; most losses on such assets are fully deductible against ordinary income so for regular income tax purposes, they are deductible currently and not carried over to a future year, but if there are inadequate capital gains, they serve less than full application against net investment income tax. Therefore, it may be advisable in such year as a §1231 loss is recognized to sell a capital gain asset to generate enough gain to offset the loss and repurchase the asset at the selling price in order to reduce the category 3 gain that will be recognized in the future on the disposition of the property.

(vii) Taxpayers should consider doing as much of their investing inside a qualified vehicle as possible. Investment activity inside a tax-exempt entity is not taxed as such and when it is distributed (even from a taxable, non-Roth trust) its character as investment income is lost. While distributions from such vehicles can increase AGI, they do not add to the investment income even though all of the distributions arise out of investment income. Of particular note are defined-benefit plans, which are ideal for an older sole proprietor where the actuarial calculation blending mortality and low rates of investment return enable very significant contributions to the plan that: (i) are deductions that reduce AGI and taxable income; and (ii) are not subject to Social Security taxes either when contributed (thereby helping against the 0.9-percent tax on excess wages) or when distributed. Another popular choice is a §401(k) plan, although it is limited to deferring only $70,000 ($78,000 with catch-up contributions, if applicable) and does not escape Social Security taxes when contributed; a simple profit-sharing plan for a sole proprietor without employees is more effective because the contributions would not be subject to Social Security taxes.

(viii) Consider establishing an appropriate retirement savings vehicle, such as a Keogh or a SEP IRA, which would allow for maximum contribution to a qualified plan based on self-employment income. The conversion of IRAs to Roth IRAs will eliminate the inclusion in AGI of future distributions, thereby lowering the exposure to the tax on net investment income.

(ix) Consider the use of a charitable remainder trust in appropriate circumstances and taxpayers to control the timing of NII.

IX. Practice Issues for Planners

A. How confidential are our files from IRS review?

1. Confidentiality is an often misunderstood concept for CPAs

The law does not accord the accountant a greater privilege than that enjoyed by attorneys. Section 7525 provides that information transmitted for the purpose of preparing a tax return, even if transmitted to an attorney, is not considered privileged information. For professionals who give a client both tax advice and tax-return preparation, the IRS will contend that whatever tax advice given, and whenever it was given, falls under the category of “tax-return preparation” that does not qualify as legal advice for purposes of confidentiality privilege under §7525.

For the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability, **the Secretary is authorized to examine books and witnesses pursuant to a summons**.[480] Section 7604 also includes:

> *"If any person is summoned under the internal revenue laws to appear, to testify, or to produce books, papers, records, or other data, the United States district court for the district in which such person resides or is found shall have jurisdiction by appropriate process to compel such attendance, testimony, or production of books, papers, records, or other data."*

Practice note: Privilege of confidentiality

> If the preparer has knowledge of unreported income or less than valid deductions, they will be compelled to testify against the taxpayer. That is, the preparer may be the star IRS witness.

Whenever any person summoned neglects or refuses to obey such summons, or to produce books, papers, records, or other data, or to give testimony, as required, the Secretary may apply to the judge of the district court or to a United States commissioner for the district within which the person so summoned resides or is found for an attachment **against him as for a contempt**. It shall be the duty of the judge or commissioner to hear the application, and, if satisfactory proof is made, to issue an attachment, directed to some proper officer, for the arrest of such person, and upon his being brought before him to proceed to a hearing of the case; and upon such hearing the judge or the United States commissioner shall have power to make such order as he shall deem proper, not inconsistent with the law for the punishment of contempt, to enforce obedience to the requirements of the summons and to punish such person for his default or disobedience.

2. Court case highlights the issue[481]

The IRS issued a summons to a CPA in connection with a civil tax audit. Although the CPA attended the summons hearing, he stated that he would answer questions only if the IRS permitted the client's attorneys also to attend the hearing. Because the IRS refused to allow client's counsel to be present, the CPA refused to testify and provided the IRS with redacted versions of subpoenaed documents.

Section 7602(c) provides that the IRS must provide reasonable notice in advance to the taxpayer that contacts with persons other than the taxpayer may be made in order to challenge the summons in district court. Taxpayer misinterpreted this to believe they had the absolute right to have counsel present at the third-party (CPA) summons hearing. Taxpayers generally could only intervene in a third-party summons case where they could demonstrate a "significantly protectable interest" barring disclosure, e.g., a legal privilege such as an evidentiary privilege.

With respect to tax advice, the same common law protections of confidentiality that apply to a communication between a taxpayer and an attorney shall also apply to a communication between a taxpayer and any federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney. However, §7525 does not suggest that non-lawyer practitioners are entitled to privilege when they are doing other than

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480 I.R.C. §7602.

481 *U.S. v. McEligot*, 115 AFTR 2d 2015-5383, (DC CA), April 06, 2015.

lawyers' work. The privilege does not protect communications between a tax practitioner and a client simply for the preparation of a tax return.

The Court denied a motion to dismiss, concluding that the client's counsel does not have a right to be present at the summons proceeding. The Court ordered the CPA to appear and give testimony before the IRS mindful of the Court's discussion that privilege does not extend to communications between a preparer and client regarding the preparation of tax returns. Having concluded that the redacted documents are not protected by the federal tax practitioner privilege, the Court ordered CPA to produce unredacted versions of the documents under summons to the IRS.

Question to ponder:

What if the communications went beyond preparation of tax returns?

B. Office of Professional Responsibility Update

1. Same as last year, 20,000 total miles, 80% for business, why do you ask?

While a preparer generally may rely in good faith without verification upon information furnished by the client, the practitioner may not, however, ignore the implications of information furnished to, or actually known, and **must make reasonable inquiries.**

The Office of Professional Responsibility supports the IRS's strategy to enhance enforcement of the tax law by ensuring that tax professionals adhere to tax practice standards and follow the law. OPR has exclusive responsibility for practitioner conduct and discipline, including instituting disciplinary proceedings and pursuing sanctions for practitioners that may be **"willfully blind"** in preparing tax returns.

2. How does the disciplinary process work?

OPR's authority and case determinations are independent of the enforcement functions performed by the general IRS population. Referrals to OPR alleging violations of Circular 230 are received from a variety of sources both internal and external. Only rarely does OPR initiate its own projects to identify specific issues for investigation. When a referral is received, OPR independently determines, based on all available facts and circumstances, if a violation has occurred, whether the violation is one which calls into question a practitioner's fitness to continue to practice, and if so, what an appropriate sanction for the conduct is.

Following a preliminary investigation, OPR renders an independent determination as to the likelihood that a violation of Circular 230 has occurred. If a violation is identified, OPR communicates with the practitioner. This is done using a **"Pre-Allegation Notice."** The notice consists of correspondence providing the practitioner with information regarding the conduct alleged, and the fact that OPR has initiated a disciplinary investigation. The notice gives the practitioner an opportunity to provide any evidence or documentation s/he believes is relevant to OPR's determination. After a thorough investigation of the facts and an analysis/consideration of aggravating and mitigating circumstances, OPR determines the lowest level of discipline warranted for the violation(s).

Due process protections are incorporated throughout the disciplinary process. If OPR fails to reach agreement with the practitioner as to an appropriate sanction, a complaint is drafted and the case is referred to the Office of Chief Counsel, General Legal Services (GLS). GLS sends a letter to the practitioner offering a final opportunity to resolve the matter without a hearing. If settlement is not reached, GLS files the complaint to commence a proceeding before an Administrative Law Judge (ALJ). The ALJ proceeding is a civil hearing during which the government and respondent present their evidence. The proceeding is conducted according to the provisions of the Administrative Procedures Act. The case may be settled by concurrence of both parties at any time prior to the hearing.

If a hearing is conducted, and after post-hearing briefs are submitted, the ALJ issues an Initial Decision and Order as to the alleged misconduct and the appropriateness of OPR's proposed sanction. The ALJ may accept OPR's recommendations as to the fact of violation and as to the proposed sanction; may accept the fact of violation but increase or reduce the recommended sanction; or, may reject OPR's recommendations both as to facts and sanctions, and thus dismiss the case.

Following the ALJ's Decision and Order, either party may appeal the case to the Treasury Appellate Authority who will, after receiving briefs from both parties, render the Final Agency Decision. For OPR, a decision by the Appellate Authority is a final determination in the case. In addition, if neither party appeals within 30 days, the ALJ's Initial Decision and Order becomes the Final Agency Decision. Since September, 2007, the text of each Final Agency Decision is made public and is available on IRS.gov.

A practitioner who wishes may file a complaint in U.S. District Court to contest the Final Agency Decision when rendered by the Treasury Appellate Authority. This proceeding is also conducted according to the Administrative Procedures Act during which the Federal district judge will review findings of facts based only on the administrative record and will set aside agency action only if arbitrary or capricious, contrary to law, or an abuse of discretion. The proceeding is not a trial de novo.

3. OPR targeting preparers compensated through "shared refunds"

In a May 2013 release, OPR announced a crack-down on return preparers who take their fee out of a portion of their clients' tax refunds. Director Karen Hawkins stated: "It is an absolute violation of Circular 230, and it's something that I take really quite seriously, so we have actually been pursuing some of those."

Preparers who choose to break the rules can take part of a client's refund either by setting up a split direct deposit using Form 8888, *Allocation of Refund* or by using a bank product through which the refund is deposited into a joint account in the name of both the preparer and the client. "I see way too many return preparers who do self-help to get themselves paid," Hawkins said, adding that even if the preparer has the client's permission to split the refund, it is still a violation of Circular 230.

Taking a preparer fee out of a refund violates not only conflict of interest rules, but also Circular 230 §10.31. That section provides that "a practitioner who prepares tax returns may not endorse or otherwise negotiate any check issued to a client by the government in respect of a Federal tax liability."

4. Circular 230 implications of issuing Form 1099-C to nonpaying clients

Most businesses periodically write-off balance-due amounts as uncollectible based on established criteria. In a two-pronged effort, first to encourage the client to pay and secondly as an alternative to pursuing collection, professional firms have requested guidance for filing a Form 1099-C, *Cancellation of Debt*, reporting the amount of the client's unpaid bill as a discharged debt.

The provisions of law in the Internal Revenue Code (Title 26) relating to discharge of indebtedness and reporting discharges on federal tax or information returns are separate and distinct from the provisions governing practice before the IRS. If a tax professional repeatedly uses Forms 1099-C, as a business strategy to collect unpaid fees, when the tax professional knows, or should know, that the facts and circumstances do not provide a basis for doing so, the conduct calls into question the tax professional's fitness to practice before the IRS. A pattern of issuing Form 1099-C with a reckless disregard as to the existence of a debt (because, for example, the former client does not have a fixed contractual liability to repay a sum previously received), or the absence of an "identifiable event" triggering[482] a reporting requirement, is inconsistent with the standards of competency and professionalism embodied in the rules of practice.

IRC §6050P, which establishes the requirement to file an information return reporting a discharge of debt (Form 1099-C), is directed only at "applicable entities" and excludes from such reporting any discharge below $600. An "applicable entity" is defined as an "executive, judicial, or legislative agency" of the United States or an "applicable financial entity," such as a bank, savings and loan association, credit union, the FDIC, or "any organization a significant trade or business of which is the lending of money."

It is difficult to conceive of a situation in which a tax professional, principally engaged in providing tax services will be an "applicable entity" justifying the use of Form 1099-C to attribute income to an arguably scofflaw client for the nonpayment. However, every case will depend on its own particular facts and circumstances, including the existence (or not) of "debt," with the crux of the analysis turning on whether the client can be said to have received previously untaxed funds from an applicable entity for which there is an obligation for repayment.

C. Get transcript

1. Conduit between taxpayers and the IRS

Taxpayer's can get a transcript online or by mail to view their tax account transactions, line-by-line tax return information, or wage and income reported for a specific tax year. The method you used to file the return and whether a refund or balance is due affects current year transcript availability.

Practice note -- Copy of a return:

For a photocopy of a tax return, taxpayers must continue to use Form 4506.

- To use Get Transcript Online (when available), one must have a Social Security Number (SSN) and immediate access to an e-mail account to confirm the e-mail address. Taxpayers will answer personal, financial, and tax related questions to verify their identity.[483]
- To use Get Transcript by Mail, one must have a SSN or an Individual Tax Identification Number (ITIN), date of birth, and address from the latest tax return.

Practice note -- Identity theft concerns:

The IRS never sends e-mail requesting a taxpayer to obtain, upload, or access transcripts. If someone receives such an e-mail, please forward it to the IRS fraud group at phishing@irs.gov.

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482 Regulations under §6050P enumerate certain "identifiable events" that are deemed a discharge of indebtedness.
483 If previously registered, taxpayer's may log in with an established user ID and password.

2. *Transcript types and available delivery methods*

Transcript Types	Get Transcript Online (When Available)	Get Transcript By Mail
Tax Return Transcript – Shows most line items from tax return as originally filed, including any accompanying forms and schedules. This transcript does not show account changes made after the return is processed. A return transcript usually meets the requirements of lending institutions offering mortgages and student loans.	Yes	Yes
Tax Account Transcript – Shows basic data including return type, marital status, adjusted gross income, taxable income, credits, and payments. It also shows adjustments made after the return was filed.[484]	Yes	Yes
Record of Account Transcript – Combines the information from both the tax account and tax return transcripts.	Yes	No
Wage and Income Transcript – Shows data from information returns reported to the IRS, such as W-2s, 1099s, and 1098s. Current tax year information may not be complete until July.	Yes	No
Verification of Non-filing Letter – Proof from the IRS that an individual did not file a return. Current year requests are not available until after June 15. This letter does not address whether a taxpayer is required to file a tax return for a given tax year. A taxpayer may fail to file a tax return even though he/she is required to do so.	Yes	No

3. *Circular 230 practitioner e-Services Transcript Delivery System Access*

Generally, a practitioner with a Power of Attorney **may not use** “Get Transcript Online” to request a transcript for the other taxpayer. However, they may submit by mail Form 4506T. Practitioners can use e-Services Transcript Delivery System if their power of attorney already exists in the IRS Centralized Authorization File.

Circular 230 attorneys, certified public accountants, and enrolled agents are eligible to access the e-Services Transcript Delivery System (TDS) even if they are not an Electronic Return Originator (ERO). To do so, they must complete an online IRS e-file application and pass the same suitability check required of EROs.

Practice note:

> The IRS has stopped processing transcript requests through the Transcript Delivery System (TDS) if an Identity Theft Indicator is on the taxpayer's account. As described by the agency, under the new procedure, a taxpayer will receive a notice regarding any request for a transcript and instruct the taxpayer to contact the Identity Protection Specialized Unit at 1-800-908-4490. “Once proper authentication has been performed, the IRS will issue a transcript directly to the taxpayer,” the IRS stated.

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484 If estimated tax payments were made and/or an overpayment applied from a prior year tax return, this transcript confirms these payments or credits a few weeks after the beginning of the calendar year prior to filing a current year return.

D. The Marriage Tax -- Partially eliminated

1. Taxpayers in the 37% bracket

The marriage penalty is still with us, but it is better than it was. The TCJA sets all of the tax brackets for married filing joint as double the corresponding bracket for single, except for the top bracket. The 37% bracket kicks in at $600,000 for married filing joint ($751,600 indexed for inflation for tax year 2025), and $500,000 for single ($626,350 indexed for inflation for tax year 2025).

Other notable marriage penalties that survive in the tax code:

a. The debt limit for the mortgage interest deduction was reduced to $750,000 for all taxpayers. So, a married couple filing joint has the same debt limit as a single person, and two single people living together who both have ownership and share the payments have double the limit of a married couple.

b. The phase out of the $25,000 small landlord exception from the passive loss rules starts at $100,000 for all taxpayers.

c. Two unmarried people living together who file single have no impact on each other's taxable Social Security. A married couple filing separately has to pay tax on 85% of Social Security income.

d. The thresholds for the additional .9% Medicare tax on wages and 3.8% net investment income tax still have severe marriage penalties. Both kick in at $200,000 for single and $250,000 for married filing joint.

Practice point:

> Up to thirty years ago the long-running and highly credible television production "60 Minutes" ran an article based upon a strategy that gained some popularity in the 1970s and 1980s, that being annual or frequent divorce and remarriage (wrapped around a vacation to Las Vegas or Mexico). A taxpayer's tax status is determined at the end of the year, so a married individual would achieve single status for the entire year by a divorce at the end of the year. A couple could remarry early in the next year.
>
> However, today the principles apply more importantly to a couple that has chosen not to marry or has not yet decided whether to marry. It may be to the couple's tax advantage to remain unmarried to provide higher aggregate thresholds given the change in tax rates and threshold levels that would apply to their aggregate assets and income upon marriage.

Example: John and Marcia are single and contemplating marriage. John has $200,000 of wages and Marcia has $200,000 of investment income for 2025.

If married and filing a joint return, John and Marcia are subject to a 3.8-percent tax on $150,000 (the lesser of $150,000 net investment income and the $150,000 excess AGI [$200,000 wages + $200,000 investment income - $250,000 threshold]), or $5,700. Each is assumed to have $10,000 in Itemized deductions, therefore they would take the standard deduction of $30,000.

If single and filing as such, with Marcia owning the investments this would give each a $200,000 threshold; as a result, Marcia does not have enough AGI to be subject to the additional net investment income tax and John does not have any investment income that could be subject to the tax. Total savings is calculated below. There are other risks to be considered.

John and Marcia 2025			
Married Filing Jointly		**Filing as Single Taxpayers**	
John - Wages	**$200,000**	**$200,000**	**$0**
Marcia – Investment Income	**$200,000**	**$0**	**$200,000**
Subtotal	**400,000**	**$200,000**	**$200,000**
Deductions	**($-30,000)**	**($-15,000)**	**($-15,000)**
Taxable Income	**$370,000**	**$185,000**	**$185,000**
Regular Tax	**$74,494**	**$37,343**	**$37,343**
Tax On NII	**$5,700**	**$0**	**$0**

E. Changes to the lifetime estate tax exemption by the TCJA

1. The increased estate tax lifetime limit

The Tax Cuts and Jobs Act increased the estate, gift, and generation-skipping transfer tax exemption amounts to $11,180,000 for 2018.[485] The increase was accomplished by doubling the 2011 amount from $5,000,000 to $10,000,000 for years 2018 through 2025. The amount is indexed for inflation as follows:

- **2018 -** $11,180,000
- **2019 -** $11,400,000
- **2020 -** $11,580,000
- **2021 -** $11,700,000
- **2022 -** $12,060,000
- **2023 -** $12,920,000
- **2024 -** $13,610,000
- **2025 -** $13,990,000

Therefore, a couple has $27,980,000 of exemption to use in estate planning in 2025.

2. The increase is temporary

The temporary nature of the increased limit makes planning a necessity. Some considerations:

a. Contrary to what you may have heard, credit-shelter trusts are not dead! Even though portability can still be used by many couples to shelter all of their assets under current law without the first-to-die using their lifetime exclusion, what if the law changes? When the increased exemption expires, how will they treat portability?

b. We have to be aware that the estate can increase greatly due to inflation.

485 I.R.C. §2010(c)(3)(C)

c. The Biden administration has been vocal about its intent to increase taxes on the wealthy, including eliminating stepped-up basis for gains of $1 million or more.

The TCJA doubled the Basic Exclusion Amount (BEA) from $5 million to $10 million (adjusted annually for inflation) for decedents dying and gifts made after December 31, 2017, and before January 1, 2026. On January 1, 2026, absent any legislation, the BEA will revert to $5 million.

On November 19, 2019, the IRS issued final regulations that implemented a special rule applicable in cases where the credit against the estate tax that is attributable to the BEA is less at the date of death than the sum of the credits attributable to the BEA allowable in computing gift tax payable with regard to the decedent's lifetime gifts. Under this special rule, the portion of the credit taken against the net tentative estate tax attributable to the BEA is based on the sum of credits attributable to the BEA allowable in computing gift tax payable regarding the decedent's lifetime gifts. In other words, this special rule ensures that donors are not taxed on completed gifts that were free of tax when made due to the increased BEA. This special rule was often referred to as the "anti-clawback" rule, as taxpayers would not have to worry about the IRS clawing back into the estate any gifts that were made when the higher BEA was in effect if the BEA later decreased. The final regulations also allowed taxpayers to claim the increased BEA without making a true gift by still having sufficient interest or income from the "gifted" property.

Although the IRC distinguishes between taxable gifts not included in the donor's gross estate and includable gifts treated as testamentary transfers, the special rule in the final regulations did not distinguish between:

- Completed gifts that are treated as adjusted taxable gifts for estate tax purposes and that, by definition, are not included in the donor's gross estate; and
- Completed gifts that are treated as testamentary transfers for estate tax purposes and are included in the donor's gross estate (includible gift).

On April 26, 2022, the IRS issued proposed regulations regarding the increased estate and gift tax exclusion amount provided by the TCJA.[486] The proposed regulations provide an exception to the special rule for includible transfers, or transfers treated as includible, in a grantor's gross estate. The proposed regulations exception to the special rule would apply to transfers described above 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.

486 REG-118913-21.

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

> ***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 §2001(b). Thus, the $9 million gift is excluded from adjusted taxable gifts in computing the tentative estate tax under §2001(b)(1). Nonetheless, if the donor dies after a 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 needed 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).

While President Trump and Congress have proposed extending the higher exclusion amounts, legislation is not guaranteed. High-net-worth individuals may consider using their higher exclusion before it sunsets in 2026. As discussed, the IRS has confirmed (via regulations) that gifts made under the higher exemption amount before 2026 won’t be “clawed back” if the exclusion drops later. This provides an incentive to use the higher limits now.

F. Basis of property transfers to beneficiaries of estates

1. Ownership interest acquired by inheritance -- General rule

In a much publicized matter, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) eliminated the estate tax for decedents dying in 2010. However, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 reinstates the estate and generation-skipping transfer taxes effective for decedents dying and transfers made after December 31, 2009.

The estate tax applicable exclusion amount is $13,990,000[487] for decedents dying in calendar year 2025 (increased from $5,490,000 in 2017, $11,180,000 in 2018, $11,400,000 in 2019, $11,580,000 in 2020, $11,700,000 in 2021, $12,060,000 in 2022, $12,920,000 in 2023, $13,610,000 in 2024, and $13,990,000 in 2025); the maximum estate tax rate is 40 percent.

The basis of property acquired from a decedent is the fair market value at the date of death, the alternative valuation date, or the distribution date if earlier than the valuation date.[488] The alternative date is six months after death, but may only be elected if both the gross estate and the estate tax are reduced.

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487 Rev. Proc. 2024-40.
488 I.R.C. §1014(a).

2. *Communicating basis to beneficiaries of an estate*

The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015[489] created §6035, which requires the executor of an estate required to file an estate tax return to also provide certain statements to the IRS and to beneficiaries receiving inherited property. ***Fewer estates will be subject to the reporting requirement due to the increase in the estate tax limit by TCJA.*** Filing a return to elect portability does not trigger the reporting requirement. Reporting is only triggered when the estate return is required (a taxable estate).

To accomplish the required reporting, the IRS has developed **Form 8971, *Information Regarding Beneficiaries Acquiring Property From a Decedent***. Executors of estates filing Form 8971 are required to complete a Schedule A for each beneficiary that acquired (or is expected to acquire) property from the estate.

Practitioner's note:

> Each beneficiary receives only a copy of that beneficiary's own Schedule A, and does not receive a copy of the Form 8971.

The law also adds §1014(f), which requires consistent basis reporting between an estate and the beneficiary receiving certain property from a decedent. In such cases, a beneficiary cannot use a value higher than the value reported as the beneficiary's initial basis in the property.

3. *Holding period of property received by beneficiaries of an estate*

If the property is capital-gain property, the holding period will be considered more than 12 months regardless of the length of time the decedent held the property.[490] If the date of death is used, the property cannot be distributed earlier and this rule cannot apply. However, if the alternate valuation date is properly elected and any property is distributed prior to that date, the fair market value at the date of distribution is used for any property distributed.

The above rule does not apply to **appreciated property received from a decedent if the recipient originally gave the property to the decedent within one year before the decedent's death**. In this case, the basis in the property is the same as the decedent's adjusted basis in the property immediately before his or her death, rather than its FMV. Appreciated property is any property whose FMV on the day it was given to the decedent is more than its adjusted basis.

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489 July 31, 2015.
490 I.R.C. §1223(9).

Form **8971** (January 2016) Department of the Treasury Internal Revenue Service

Information Regarding Beneficiaries Acquiring Property From a Decedent

► Information about Form 8971 and its separate instructions is at *www.irs.gov/form8971*.

OMB No. 1545-2264

Check box if this is a supplemental filing ☐

Part I Decedent and Executor Information

1 Decedent's name	2 Decedent's date of death	3 Decedent's SSN
4 Executor's name (see instructions)	5 Executor's phone no.	6 Executor's TIN

7 Executor's address (number and street including apartment or suite no.; city, town, or post office; state or province; country; and ZIP or foreign postal code)

8 If there are multiple executors, check here ☐ and attach a statement showing the names, addresses, telephone numbers, and TINs of the additional executors.

9 If the estate elected alternate valuation, indicate the alternate valuation date: ____________

Part II Beneficiary Information

How many beneficiaries received (or are expected to receive) property from the estate? ________ For each beneficiary, provide the information requested below. If more space is needed, attach a statement showing the requested information for the additional beneficiaries.

A Name of Beneficiary	B TIN	C Address, City, State, ZIP	D Date Provided

Notice to Executors:

Submit Form 8971 with a copy of each completed Schedule A to the IRS. To protect privacy, Form 8971 should not be provided to any beneficiary. Only Schedule A of Form 8971 should be provided to the beneficiary. Retain copies of all forms for the estate's records.

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, all information reported herein is true, correct, and complete.

Signature of executor | Date

May the IRS discuss this return with the preparer shown below? See instructions . . . . ☐ Yes ☐ No

Paid Preparer Use Only	Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
	Firm's name ►			Firm's EIN ►	
	Firm's address ►			Phone no.	

For Privacy Act and Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 37794V Form **8971** (1-2016)

SCHEDULE A—Information Regarding Beneficiaries Acquiring Property From a Decedent

► **Information about Form 8971 (including Schedule A) and its separate instructions is at *www.irs.gov/form8971*.**

Check box if this is a supplemental filing ☐

Part 1. General Information

1 Decedent's name	2 Decedent's SSN	3 Beneficiary's name	4 Beneficiary's TIN
5 Executor's name			6 Executor's phone no.
7 Executor's address			

Part 2. Information on Property Acquired

A Item No.	B Description of property acquired from the decedent and the Schedule and item number where reported on the decedent's Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return. If the beneficiary acquired a partial interest in the property, indicate the interest acquired here.	C Did this asset increase estate tax liability? *(Y/N)*	D Valuation Date	E Estate Tax Value *(in U.S. dollars)*
1	Form 706, Schedule ______ , Item ______ Description —			

Notice to Beneficiaries:

You have received this schedule to inform you of the value of property you received from the estate of the decedent named above. **Retain this schedule for tax reporting purposes.** If the property increased the estate tax liability, Internal Revenue Code section 1014(f) applies, requiring the consistent reporting of basis information. For more information on determining basis, see IRC section 1014 and/or consult a tax professional.

G. Basis of property transfers to beneficiaries of trusts

1. Ownership interest acquired by trust property distribution -- Blending of gift and inheritance rules[491]

Discussion note: No equivalent form for trust property distributions (yet!)

> With Form 8971, The Surface Transportation and Veterans Health Care Choice Improvement Act requires certain executors of estates to provide consistent basis reporting of property distributions. However, trust property distributions do not fall into the reporting requirement.
>
> Many trusts are established prior to, or outside and independent, of the estate. The basis of property distributions is a function of the type of trust. See the following discussion.

The basis of any property received by a beneficiary in a distribution from a trust shall be the adjusted basis of such property in the hands of the trust immediately before the distribution, adjusted for any gain or loss recognized to the trust on the distribution.

The question therefore is: Was the property subject to a step up in basis or not?

a. **Trusts in which there is not a basis step up:**

(1) Generally, assets NOT included in a decedent's estate do not receive a step up in basis. Whatever the cost was inside the trust is the cost that will be passed to the beneficiary. These may generally include:

- Bypass, credit shelter, exemption, or second-to-die trusts;
- Generation-skipping trusts; and
- Irrevocable grantor trusts.

b. **Trusts in which there is a step up:**

(1) Generally assets that ARE included in a decedent's estate receive a step up in basis. These may generally include:

- Marital, residual, or survivor trusts; and
- Living or revocable grantor trusts.

Example 1: **Part 1** -- Mike and Carol have total assets of $28,000,000. They divide the assets so that each has $14,000,000 in their respective name. Mike passes away in 2025.

Mike's estate plan requires $13,990,000 to be placed in a trust (called the By-Pass or B trust). The trust has Carol and Alice as income beneficiaries and remains intact until both Carol and Alice's demise.

The remainder beneficiaries in equal proportion are Greg, Peter, Bobby, Marcia, Jan, and Cindy.

Alice passes away in 2026 and Carol passes away in 2028. At the time of Carol's passing, the trust holds a stock portfolio with FMV of $18,000,000 and basis of $12,000,000. The trustee distributes the portfolio pro-rata in-kind by transferring one-sixth of the underlying stocks ($3,000,000 FMV) to each of the six children.

Conclusion and Analysis -- The trust assets are not included in the estates of either Alice or Carol.

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491 §643(c) of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010; and I.R.C. §1022.

The basis of the stock portfolio for each of the children shall be the adjusted basis of such property in the hands of the trust immediately before the distribution, or $2,000,000.

Being outside the estate, the executor would not include them on a Form 8971 for Carol's estate. The trustee should inform the beneficiaries of the basis, perhaps via a trustee's letter.

Part 2 -- Also in 2025, the remaining $390,000 of Mike's estate is placed in a portfolio in another trust (called the Marital or A trust). To meet the unlimited marital deduction requirements, this trust can only be used for the benefit of Carol and requires her to receive all of the income. At the time of Carol's death, after paying any estate tax, assume the trust portfolio has a fair value of $420,000, with a basis of $300,000.

The trust assets are distributed pro-rata in-kind by transferring one-sixth of the underlying stocks ($70,000 FMV) to each of the remainder beneficiaries, the six children.

Conclusion and Analysis -- The assets remaining will be taxed as part of Carol's estate and therefore available for a step-up in basis.

The basis of $70,000 each in the underlying portfolio must be communicated to the beneficiaries.

Example 2: In 1986 Grandma Ester Walton established a generation-skipping trust at her death. The trust was funded with 100 shares of Microsoft stock with a basis of $2,500.

Income of the trust is payable to "Pa" John Walton over his life.

After "Pa's" death, the trust assets are to be distributed evenly between the seven Walton children, John-Boy, Jason, Mary Ellen, Erin, Ben, Jim-Bob, and Elizabeth.

Pa passes away in 2025, when the original 100 shares have split nine times into 28,800 shares, with a fair value of $1,400,000. The trustee distributes the assets pro-rata in-kind by transferring one-seventh (4,114.29 shares) of the Microsoft shares ($200,000 FMV) to each of the remainder beneficiaries, the seven children.

Conclusion and Analysis -- The basis of the Microsoft shares shall be the adjusted basis of such property in the hands of the trust immediately before the distribution, $2,500, or $357.14 each.

As it is outside Pa's estate, the executor would not include this information on a Form 8971. The trustee should inform the beneficiaries of the basis, perhaps via a trustee's letter.

As noted above, under §643(e)(3) a trust may elect to recognize gain or loss in the same manner as if such property had been sold to the distributee at its fair market value. The distribution deduction is the property's FMV. This election applies to all distributions made by the trust during the tax year. Once the election is made, it may only be revoked with IRS consent. **Proper planning must be incorporated into this strategy**, as income tax rates and the additional tax on net investment income for a trust or estate **accelerate very quickly**.

Practitioner's note

The treatment as a sale will cause a step up in basis to the beneficiary to the value at date of distribution.

The trustee should report to the beneficiary tax basis and the date the holding period begins.

Practitioner's note: Related party sales rules apply

Section 267 does not allow a trust or a decedent's estate to claim a deduction for any loss on property to which a §643(e)(3) election applies. In addition, when a trust or a decedent's estate distributes depreciable property, §1239 applies to deny capital gains treatment for any gain on property to which a §643(e)(3) election applies.

H. Disposition of an auto which utilized the standard mileage rate

1. Calculating adjusted basis

If a taxpayer disposes of a trade or business automobile, taxable gain or a deductible loss may be incurred. The portion of any gain that is due to depreciation (including any §179 deduction, clean-fuel vehicle deduction, and special depreciation allowance) claimed on the auto will be treated as ordinary income, as calculated on Form 4797.

If the standard mileage rate for the business car has been utilized, depreciation was included in that rate. Taxpayers must reduce the basis in the car (but not below zero) by the amount of depreciation. The rate of depreciation that was allowed in the standard mileage rate is listed in the following chart:

Year	Depreciation Per mile
2025	$.30
2024	.28
2023	.26
2022	.26
2021	.27
2020	.26
2019	.25
2018	.25
2017	.24
2016	.24
2015	.22
2014	.23
2013	.23
2012	.22

Practice note:

These rates do not apply for any year in which the actual expenses method was used.

Example: In 2020 Jesse paid $30,000 to purchase an auto utilized exclusively in his business. From 2020 through 2025 Jesse used the standard mileage rate to figure his car expense deduction.

Jesse drove the car 14,600 miles in 2020; 14,500 miles in 2021; 14,900 miles in 2022; 16,100 miles in 2023; 15,200 miles in 2024; and 15,500 miles in 2025.

At the end of 2025, Jesse's adjusted basis in the car is $5,323 ($30,000 - $24,677 depreciation calculated as follows):

Year	Depreciation Per mile	Mileage	Depreciation
2025	**$.30**	**15,500**	$4,650
2024	**.28**	**15,200**	$4,256
2023	**.26**	**16,100**	$4,186
2022	**.26**	**14,900**	$3,874
2021	**.27**	**14,500**	$3,915
2020	**.26**	**14,600**	$3,796
Total			$24,677

2. If the auto is fully depreciated, yet still in use

If the basis is reduced to zero (but not below zero) through the use of the standard mileage rate, and the auto continues to be utilized for business, no adjustment (reduction) to the standard mileage rate is necessary. Use the full standard mileage rate (70 cents per mile for 2025) for business miles driven.

I. Special tax benefits for Armed Forces Personnel

Each year, the IRS publishes Publication 3, *Armed Forces' Tax Guide*, a free booklet with valuable information and tips designed to help service members and their families take advantage of all tax benefits allowed by law. This year's edition is posted on IRS.gov. Available tax benefits include:

1. Combat pay is partly or fully tax-free.
2. Reservists whose reserve-related duties take them more than 100 miles from home can deduct their unreimbursed travel expenses on Form 2106 as an above-the-line deduction.
3. Eligible unreimbursed moving expenses are deductible on Form 3903.
4. Low-and moderate-income service members often qualify for such family-friendly tax benefits as the Earned Income Tax Credit and a special computation method is available for those who receive combat pay.
5. Low-and moderate-income service members who contribute to an IRA or 401(k)-type retirement plan, such as the federal government's Thrift Savings Plan, can often claim the saver's credit, also known as the retirement savings contributions credit, on Form 8880.
6. Service members stationed abroad have extra time, until June 15, to file a federal income tax return. Those serving in a combat zone have even longer, typically until 180 days after they leave the combat zone.
7. Service members may qualify to delay payment of income tax due before or during their period of service. See Publication 3 for details including how to request relief.

Service members who prepare their own return qualify to electronically file their federal return for free using IRS Free File. In addition, the IRS partners with the military through the Volunteer Income Tax Assistance program to provide free tax preparation to service members and their families at bases in the United States and around the world.

Military OneSource is a program is offered by the Department of Defense and provides free resources for military members, veterans, and their families. MilTax, Military OneSource's tax service, provides online software to electronically file a federal and up to three state tax returns for free, regardless of income. This resource is made available at MilitaryOneSource.mil or by calling 800-342-9647.

Practitioner's note:

See Publication 3, *Armed Forces' Tax Guide*, for more information on tax benefits available to service members. The booklet is available on IRS.gov or can be ordered by calling 1-800-TAX-FORM (800-829-3676). Additionally, refer to FS-2020-03 (Fact sheet listing tax filing tips for military service members and veterans), available on IRS.gov.