AFTR – Annual Federal Tax Refresher – Tax Year 2026

Course Material Export – Generated for IRS Continuing Education Review

1.1 Annual inflation and cost of living adjustments

Official 2026 Federal Income Tax Brackets (Rev. Proc. 2025-32)

Tax Rate	Single Filers	Married Filing Jointly (or Qualifying Surviving Spouse)	Married Filing Separately	Head of Household
10%	$0 to $12,400	$0 to $24,800	$0 to $12,400	$0 to $17,700
12%	$12,401 to $50,400	$24,801 to $100,800	$12,401 to $50,400	$17,701 to $67,450
22%	$50,401 to $105,700	$100,801 to $211,400	$50,401 to $105,700	$67,451 to $105,700
24%	$105,701 to $201,775	$211,401 to $403,550	$105,701 to $201,775	$105,701 to $201,750
32%	$201,776 to $256,225	$403,551 to $512,450	$201,776 to $256,225	$201,751 to $256,200
35%	$256,226 to $640,600	$512,451 to $768,700	$256,226 to $384,350	$256,201 to $640,600
37%	Over $640,600	Over $768,700	Over $384,350	Over $640,600

Estates and Trusts Tax Rate Schedule

[Image: Estate-and-Trust.webp]

Tax Rate	Taxable Income Range	The Tax Owed Formula Is:
10%	$0 to $3,300	10% of taxable income
24%	$3,301 to $11,700	$330 plus 24% of the excess over $3,300
35%	$11,701 to $16,000	**$2,346** plus 35% of the excess over $11,700
37%	Over $16,000	**$3,851** plus 37% of the excess over $16,000

1.1.1 — Certain Expenses of Elementary & Secondary School Teachers

IRC §62(a)(2)(D) · Rev. Proc. 2025-32(.12)

Eligible K–12 educators may deduct unreimbursed classroom expenses as an **above-the-line deduction** on Schedule 1. This deduction reduces AGI whether or not the taxpayer itemizes.

TY2026 Educator Deduction · Rev. Proc. 2025-32(.12)

Maximum deduction per eligible educator	$350
MFJ — both spouses are eligible educators	$700 ($350 each)
TY2025 amount	$350 (unchanged)

Who Qualifies — All Must Apply

- Works as a teacher, instructor, counselor, principal, or aide in a K–12 school
- Works at least **900 hours** during the school year
- Expenses are **unreimbursed** and paid out of pocket

What Expenses Qualify

- Books, supplies, and materials used in the classroom
- Computer equipment and software used in the classroom
- Professional development courses related to the curriculum taught
- PPE and COVID-19 prevention supplies used in the classroom qualify
- Home schooling expenses do **not** qualify — must be a regular K–12 school

1.1.2 — Interest on Education Loans

IRC §221 · Rev. Proc. 2025-32(.29)

Taxpayers who paid interest on a qualified student loan may deduct up to $2,500 as an **above-the-line deduction** on Schedule 1. The deduction phases out based on modified AGI and is completely eliminated at the upper threshold. It is not available to taxpayers who are claimed as dependents or who are MFS.

TY2026 Student Loan Interest · Rev. Proc. 2025-32(.29)

Maximum deduction	$2,500
Phaseout begins — Single / HOH / QSS	$85,000 MAGI
Phaseout complete — Single / HOH / QSS	$100,000 MAGI
Phaseout begins — MFJ	$175,000 MAGI
Phaseout complete — MFJ	$205,000 MAGI
Available to MFS filers?	No — not available

Key Rules

- Interest must be on a **qualified student loan** — taken out solely to pay qualified higher education expenses for the taxpayer, spouse, or a dependent at the time the debt was incurred
- Not available if the taxpayer is claimed as a dependent on someone else's return
- Lenders report interest paid of $600+ on **Form 1098-E**

1.1.3 — Foreign Earned Income Exclusion

IRC §911 · Rev. Proc. 2025-32(.39) · Form 2555

U.S. citizens and resident aliens who live and work abroad may exclude a portion of their **foreign earned income** from U.S. gross income. The exclusion is claimed on **Form 2555**. The taxpayer must meet either the **bona fide residence test** or the **physical presence test**.

TY2026 FEIE Amounts · Rev. Proc. 2025-32(.39)

Foreign Earned Income Exclusion — TY2026	$132,900
Foreign Earned Income Exclusion — TY2025	$130,000
Housing exclusion base (16% of FEIE)	$21,264
Form used	Form 2555

Bona Fide Residence Test

- Must be a bona fide resident of a foreign country for an **uninterrupted period** that includes an entire tax year
- Based on intent, the nature of the residence, and its permanence — not merely physical presence

Physical Presence Test

- Must be physically present in a foreign country or countries for at least **330 full days** during any 12-consecutive-month period
- Does not have to coincide with the tax year — the 12-month period can span two calendar years

Important — FEIE Does Not Eliminate SE Tax

The FEIE excludes foreign earned income from **income tax** only. Self-employed taxpayers living abroad still owe **self-employment tax** on net self-employment income — the exclusion does not reduce the SE tax base. Additionally, the exclusion is a choice — if not elected on a timely return, the taxpayer must re-elect and may face a 5-year waiting period.

1.1.4 — Annual Exclusion for Gifts

IRC §2503(b) · Rev. Proc. 2025-32(.42) · Form 709

The annual gift tax exclusion allows a donor to give up to a specified amount to **any number of individuals** each year without filing Form 709 or reducing the unified lifetime exemption. Gifts above the annual exclusion per recipient require a Form 709 filing.

TY2026 Gift & Estate Figures · Rev. Proc. 2025-32(.42)

Annual gift exclusion per recipient — TY2026	$19,000
Annual gift exclusion — TY2025	$19,000 (unchanged)
Gift-splitting — married couple per recipient	$38,000
Gift to non-citizen spouse (annual exclusion)	$194,000
Unified lifetime gift & estate exemption — TY2026	$15,000,000

Unified lifetime exemption — TY2025	$13,990,000
Form required when gift exceeds annual exclusion per recipient	Form 709

Key Gift Tax Rules

- The exclusion is **per recipient** — a donor can give $19,000 to as many people as desired with no gift tax consequence
- **Gift splitting** — married couples may elect to treat a gift as made half by each spouse, effectively doubling the exclusion to $38,000 per recipient. Both spouses must consent on Form 709.
- **Direct payments** for tuition (to the school) or medical expenses (to the provider) are **excluded without limit** and do not count against the annual exclusion — IRC §2503(e)
- The **unified lifetime exemption** increased to $15,000,000 for TY2026 (up $1,010,000 from TY2025's $13,990,000) — gifts over the annual exclusion reduce this exemption

Worked Example — Gift Splitting

Victor and Linda want to give their son $38,000 in TY2026. Victor writes a check for $38,000. They elect gift splitting on Form 709 — each spouse is treated as having given $19,000. The entire $38,000 is covered by the annual exclusion. **No gift tax. No lifetime exemption used.**

Complete TY2026 Inflation Reference — All Numbers Verified from IRS.gov

Every Number Sourced Directly from IRS.gov · Rev. Proc. 2025-32

Item	TY2026	TY2025
Standard Deductions		
Single / MFS	$16,100	$15,750
MFJ / QSS	$32,200	$31,500
Head of Household	$24,150	$23,625
Age 65+ / Blind add-on — Single / HOH (each)	+$2,050	+$2,000
Age 65+ / Blind add-on — MFJ / MFS (each)	+$1,650	+$1,600
OBBBA §70103 senior bonus deduction (age 65+)	$6,000	$6,000
Dependent standard deduction floor	$1,350	$1,350
EITC Maximum Credits		
3 or more qualifying children	$8,231	$8,046
2 qualifying children	$7,316	$7,152
1 qualifying child	$4,427	$4,328
No qualifying children	$664	$649
Investment income cliff	$12,200	$11,950

Item	TY2026	TY2025
Child & Dependent Credits		
Child Tax Credit per qualifying child (CTC)	$2,200	$2,200
Additional Child Tax Credit (ACTC) refundable	$1,700	$1,700
Credit for Other Dependents (ODC)	$500	$500
Retirement Accounts · IR-2025-111 / Notice 2025-67		
IRA contribution limit (under age 50)	$7,500	$7,000
IRA limit age 50+ (base + $1,100 catch-up)	$8,600	$8,000
401(k) / 403(b) employee deferral	$24,500	$23,500
401(k) catch-up age 50–59 and 64+	+$8,000 = $32,500	+$7,500
401(k) super catch-up age 60–63 (SECURE 2.0)	+$11,250 = $35,750	+$11,250
SIMPLE IRA / SIMPLE 401(k) deferral	$17,000	$16,500
Health Accounts · Rev. Proc. 2025-19		
HSA — self-only coverage	$4,400	$4,300
HSA — family coverage	$8,750	$8,550
HSA catch-up (age 55+)	+$1,000	+$1,000
Health FSA salary reduction limit	$3,400	$3,300
FSA carryover maximum	$680	$660
Deductions / Exclusions / Estate		
Educator expense deduction (K–12)	$350	$350
Student loan interest deduction	$2,500	$2,500
Foreign Earned Income Exclusion (FEIE)	$132,900	$130,000
Annual gift tax exclusion per recipient	$19,000	$19,000
Unified lifetime gift & estate exemption	$15,000,000	$13,990,000
Transportation fringe benefit (monthly)	$340	$325
AMT exemption — Single / HOH	$90,100	$88,100
AMT exemption — MFJ / QSS	$140,200	$137,000
AMT exemption — MFS	$70,100	$68,500

1.2 New standard mileage rates

[Image: 2026 standard mileage rates]

Lesson 1.2 — 2026 Standard Mileage Rates · Notice 2026-10

In December 2025, the IRS released **Notice 2026-10**, setting the optional standard mileage rates taxpayers may use to compute deductible automobile operating costs for business, medical, charitable, and eligible moving purposes during calendar year 2026. The business rate **increased** to 72.5 cents per mile; the medical and moving rate is **20.5 cents**; and the charitable rate remains unchanged.

72.5¢Business Rate

20.5¢Medical / Moving Rate

14.0¢Charitable Rate

35¢Depreciation Component

$61,700FAVR Auto Ceiling

Background

Under **IRC §162**, taxpayers may deduct ordinary and necessary business expenses, including the cost of operating a vehicle used in a trade or business. **IRC §170(i)** permits a deduction for unreimbursed automobile use in service of a qualifying charitable organization. **IRC §213** permits a deduction for transportation costs primarily for and essential to medical care.

Rather than tracking actual operating costs, taxpayers may elect to use an **optional standard mileage rate** announced annually by the IRS. The charitable rate is statutory and remains fixed at 14¢ per mile unless Congress changes it.

The 2026 Rates at a Glance

Use of Vehicle	2026 Rate	2025 Rate	Change
Business (IRC §162)	72.5¢ / mile	70.0¢ / mile	+2.5¢
Medical (IRC §213)	20.5¢ / mile	21.0¢ / mile	−0.5¢
Moving eligible Armed Forces and intelligence community members	20.5¢ / mile	21.0¢ / mile	−0.5¢
Charitable (IRC §170(i))	14.0¢ / mile	14.0¢ / mile	no change

Moving Mileage Exception

Most taxpayers may not deduct moving expenses. However, qualified members of the Armed Forces and, under recent legislation, eligible members of the intelligence community may deduct qualified moving expenses and use the moving mileage rate when the move meets the applicable rules.

[Image: Moving mileage exception for eligible intelligence community members]

Business Rate — What Changed

TY2025

70.0¢

Per mile · IRC §162

→

TY2026 New Rate

72.5¢

Per mile · IRC §162

Notice 2026-10

Key Facts — Notice 2026-10

The business rate rose **2.5 cents** from 70.0¢ in 2025 to **72.5¢** per mile for 2026. Of that amount, **35¢ per mile** is treated as depreciation. The **FAVR plan ceiling** for standard automobile cost is **$61,700** for 2026.

Eligibility — Who May Use the Business Standard Mileage Rate

To use the business rate, a taxpayer must elect it in the *first year* the automobile is placed in service for business. After using standard mileage in year one, the taxpayer may switch to actual expenses in later years. If actual expenses, MACRS depreciation, or §179 expensing are used in year one, the taxpayer is generally locked into actual expenses for that vehicle.

Cannot Use Standard Mileage Rate

The standard mileage rate is **not available** for fleet operators using five or more automobiles simultaneously, vehicles where §179 expensing was claimed, vehicles where depreciation other than straight-line was claimed, or vehicles where the rural mail carrier rate was previously claimed.

1.3 Third-Party Network Transaction reporting requirement

[Image: Third-party network transaction reporting]

Lesson 1.3 — Third-Party Network Transactions & Information Returns · TY2026

For tax year 2026, two major changes affect information reporting. **OBBBA §70432** reinstates the dual 200-transaction / $20,000 threshold for Form 1099-K. Separately, payers of interest and dividends continue to report on **Forms 1099-INT** and **1099-DIV**.

$20,000 1099-K Amount

200 Transactions

$10 1099-INT

$10 1099-DIV

Form 1099-K — Payment Card & Third-Party Network Transactions

Form 1099-K is issued by **payment settlement entities**, including payment card processors and third-party network organizations such as PayPal, Venmo, Etsy, eBay, and similar platforms, to report gross payments made to payees in the course of business.

Old Interim Rule

$600

Any number of transactions

TY2026 Reinstated

$20,000

AND more than 200 transactions

Both Required

200+

Transaction-count test

New Law — OBBBA §70432

Effective for TY2026, a TPSO must issue Form 1099-K only when a payee's aggregate transactions **both** exceed 200 transactions **and** exceed $20,000 in gross payments during the calendar year.

Item	Rule
Who issues	Payment settlement entities, payment card processors, and TPSOs
What is reported	Gross reportable payment transactions, not net income
TPSO threshold	More than 200 transactions AND more than $20,000
Payment card threshold	No transaction-count test
Due to payee	January 31, 2027

Gross vs. Taxable

Receiving a Form 1099-K does *not* automatically create taxable income. The form reports gross payments. Taxpayers must still determine whether the underlying transactions are taxable, partially taxable, or non-taxable.

Form 1099-INT — Interest Income

Form 1099-INT is issued by payers of interest, including banks, credit unions, brokerage firms, corporations, and the U.S. Treasury, to report interest income paid to a recipient during the calendar year.

1099-INT

Reporting Threshold

Payers generally issue Form 1099-INT when total interest paid is **$10 or more**. Backup withholding requires reporting regardless of amount.

1099-INT

Common Boxes

Box 1 taxable interest, **Box 3** Treasury interest, **Box 8** tax-exempt interest.

1099-INT

Due Dates

Recipient: January 31, 2027.
IRS electronic filing: March 31, 2027.

Form 1099-DIV — Dividends and Distributions

Form 1099-DIV is issued by corporations, mutual funds, ETFs, money market funds, and REITs to report dividends, capital gain distributions, and other shareholder distributions.

1099-DIV

Reporting Threshold

Payers generally issue Form 1099-DIV when dividends and distributions total **$10 or more**.

1099-DIV

Ordinary vs. Qualified

Box 1a reports ordinary dividends. **Box 1b** reports qualified dividends eligible for preferential rates if holding-period rules are met.

1099-DIV

Due Dates

Recipient: January 31, 2027.
IRS electronic filing: March 31, 2027.

Qualified Dividend Requirements

Qualified dividend treatment depends on the payer type, dividend type, and the taxpayer's own holding period. Box 1b identifies the amount the payer believes qualifies, but the taxpayer's holding period determines final treatment.

Quick Comparison — Three Forms at a Glance

Feature	Form 1099-K	Form 1099-INT	Form 1099-DIV
What it covers	Payment card & TPSO transactions	Interest paid	Dividends & distributions
TY2026 threshold	More than 200 transactions AND more than $20,000	$10	$10
Primary issuer	PSEs / TPSOs	Banks, brokers, Treasury	Corporations, funds, REITs
Recipient due date	Jan. 31, 2027	Jan. 31, 2027	Jan. 31, 2027

1.4 Information Reporting Threshold

OBBBA §70433 · TY2026

Form 1099 Reporting Threshold Increase

The One Big Beautiful Budget Act raises the general information reporting threshold from **$600** to **$2,000** beginning in Tax Year 2026 for many reportable payments.

[Image: 1099 NEC reporting threshold increased from $600 to $2,000]

$600

Prior Threshold

$2,000

New TY2026 Threshold

§70433

OBBBA Authority

1099-NEC
1099-MISC

Affected Forms

The Threshold Change — OBBBA §70433

TY2025 & Prior

$600

General reporting threshold

TY2026 New Law

$2,000

New threshold for most reportable payments

OBBBA §70433

New Law

Effective for payments made on or after January 1, 2026, the general information reporting threshold under IRC §6041 and §6041A is increased from $600 to **$2,000**. The threshold applies on a **per-payee, per-calendar-year** basis.

TY2026 Reporting Thresholds — Key Forms

Form	TY2025 Threshold	TY2026 Threshold	Status	What It Reports
1099-NEC	$600+	**$2,000+**	Changed	Nonemployee compensation
1099-MISC	$600+ common categories; $10+ royalties	**$2,000+** common categories; $10+ royalties	Changed	Rents, prizes, awards, medical payments, other income
1099-K	$5,000 phased threshold	200+ transactions & $20,000+	Changed	Payment settlement entities
1099-INT	$10+	$10+	Unchanged	Interest income
1099-DIV	$10+	$10+	Unchanged	Dividends and distributions
1099-R	Any amount	Any amount	Unchanged	Retirement and IRA distributions

Important — 1099-K Is Different

Form 1099-K is not affected by the new $2,000 reporting threshold under OBBBA §70433. Beginning in TY2026, payment settlement entities generally issue Form 1099-K only when a payee has more than 200 transactions and more than $20,000 in gross payments during the calendar year under OBBBA §70432.

Form 1099-NEC — Nonemployee Compensation

Form 1099-NEC reports payments of **$2,000 or more** made in the course of a trade or business to a single non-corporate payee during the calendar year.

Who Must File

Any trade or business that pays $2,000+ in nonemployee compensation to a single payee during the year.

Who Receives It

Independent contractors, freelancers, sole proprietors, and most partnerships. Corporate payees are generally exempt, except attorneys and medical providers.

Due Date

January 31 to both the payee and the IRS. The due date is not changed by the new threshold.

Backup Withholding

If the payee fails to provide a valid TIN, backup withholding at 24% can apply from the first dollar paid.

Form 1099-MISC — Miscellaneous Information

Form 1099-MISC covers several types of payments. The new **$2,000** threshold applies to many common categories, but royalties and substitute payments keep their separate $10 threshold.

Payment Type	TY2026 Threshold	Box
Rents	**$2,000+**	Box 1
Prizes and awards	**$2,000+**	Box 3
Medical and health care payments	**$2,000+**	Box 6
Other income	**$2,000+**	Box 3
Royalties	$10+ Unchanged	Box 2
Substitute payments in lieu of dividends	$10+ Unchanged	Box 8

Who Is Exempt from 1099-NEC & 1099-MISC Reporting

Even when the $2,000 threshold is met, some payees do not require a 1099. Always confirm payee status with a signed Form W-9.

Generally Exempt

C Corporations & S Corporations

Payments to incorporated entities are generally exempt from 1099-NEC and 1099-MISC, but status must be verified.

Exception

Attorneys

Payments to attorneys are reportable even when the law firm is incorporated, once the reporting threshold is met.

Exception

Medical & Health Care Providers

Medical and health care payments are reportable on Form 1099-MISC even when the provider is incorporated.

Depends on Election

LLCs

A disregarded LLC or partnership LLC is generally reportable. An LLC taxed as a C corporation or S corporation may be exempt.

Penalties for Failure to File — TY2026

Timing of Correction	Penalty Per Return	Annual Cap — Small Filers
Filed within 30 days of due date	$60	$232,500
Filed by August 1	$130	$664,500
Filed after August 1 or not filed	$330	$1,329,000
Intentional disregard	**$660 minimum**	No cap

Penalties apply under IRC §§6721–6724. Small filers generally means businesses with average annual gross receipts of $5 million or less for the three most recent tax years.

Practitioner Takeaway: Beginning with TY2026 payments, many vendors who previously triggered a 1099 at $600 will no longer require one unless total annual payments reach $2,000. However, practitioners must still verify payee classification, Form W-9 status, backup withholding exposure, attorney exceptions, medical payment exceptions, and separate rules such as Form 1099-K.

1.5 Child and Dependent Care Credit

Learning Objectives

[Image: Child and Dependent Care Credit]

IRC §21

Child and Dependent Care Credit

- The Child and Dependent Care Credit under **IRC §21** allows taxpayers who pay for the care of a qualifying person while they work or look for work to claim a **nonrefundable credit**.
- If married filing jointly, both spouses generally must work or look for work for the expenses to qualify.

Qualifying Person

The care must be for a qualifying child or dependent who meets the credit rules.

Expense Limits

The expense limits and applicable credit percentage are critical for accurate computation.

TY2026 Update

For TY2026, the OBBBA made modest enhancements to the credit.

Commonly Missed Credit

This credit is frequently missed for **single parents**, **dual-income households**, and taxpayers paying for **eldercare expenses** so they can work or look for work.

Practitioner Tip: Always ask working taxpayers whether they paid for child care, adult day care, or dependent care so they could work. Clients often do not recognize eldercare or summer day camp as potentially qualifying expenses.

Four Requirements to Claim the Credit

1. Qualifying Person

The care must be for a child under age 13 who is a dependent, OR for a spouse or dependent of any age who is physically or mentally incapable of self-care.

2. Work-Related Purpose

The care expense must allow the taxpayer (and spouse, if married) to work or actively look for work. Care during vacation or personal time does not qualify.

3. Earned Income

The taxpayer must have earned income. If married filing jointly, both spouses generally must have earned income unless one spouse is a student or disabled.

4. Provider Identification

The taxpayer must provide the care provider's name, address, and TIN on Form 2441. Payments to a spouse or dependent do not qualify.

TY2026 Credit Limits and Percentages

Item	TY2026 Amount
Maximum eligible expenses — 1 qualifying person	$3,000
Maximum eligible expenses — 2 or more qualifying persons	$6,000
Credit percentage — AGI $15,000 or less	35%
Credit percentage — AGI over $43,000	20% (minimum)
Maximum credit — 1 qualifying person (35%)	$1,050
Maximum credit — 2 or more qualifying persons (35%)	$2,100

Earned Income Limit — The Lesser-of Rule

Earned Income Limit — The Lesser-of Rule

Eligible expenses for the Child and Dependent Care Credit are limited to the taxpayer's earned income — or, if married filing jointly, the lesser of the taxpayer's or spouse's earned income for the year.

The Lesser-of Rule

If married filing jointly, eligible expenses cannot exceed the lower earned income of either spouse.

This rule prevents a stay-at-home spouse situation from generating a credit when one spouse has little or no earned income.

Common Limitation

Even if daycare expenses are high, the allowable credit may be reduced when one spouse has very low earned income during the year.

Important Exception

Student & Disabled Spouses

A spouse who is a full-time student or physically or mentally incapable of self-care is treated as having deemed earned income.

One Qualifying Person

$250

Deemed earned income per month

Two or More Qualifying Persons

$500

Deemed earned income per month

Practitioner Tip

Always verify earned income for both spouses before computing the credit. When one spouse is a student or disabled, remember to apply the deemed income rules — many taxpayers incorrectly lose the credit because this exception is overlooked.

Interaction with Dependent Care FSA (Form W-2 Box 10)

IRC §21 & §129 Coordination Rules

Interaction with Dependent Care FSA (Form W-2 Box 10)

If an employer provides dependent care benefits through a **§129 Flexible Spending Account (FSA)**, reported in **Box 10 of Form W-2**, those benefits reduce the maximum eligible expenses for the Child and Dependent Care Credit dollar for dollar.

FSA Benefits Reduce Eligible Expenses

Employer-provided dependent care benefits reduce the maximum expenses eligible for the credit on a dollar-for-dollar basis.

One Child Limitation

A taxpayer with one qualifying child who receives $5,000 in dependent care FSA benefits has fully used the $3,000 credit expense limit — leaving no additional credit available.

[Image: Worked Example]

Worked Example

Melissa & Jason — FSA Coordination

Facts

- Two qualifying children
- $9,000 paid for daycare during 2026
- $5,000 dependent care FSA benefits reported in Box 10
- AGI = $62,000

Credit Calculation

Maximum eligible expenses:

$6,000 – $5,000 FSA = $1,000

Credit percentage at AGI $62,000:

20%

Final credit:

$1,000 × 20% = $200

Practitioner Tip

The dependent care FSA often provides greater tax savings than the credit because the FSA avoids both income tax and payroll tax. Always coordinate Form 2441 with Box 10 of the W-2 before computing the credit.

1.6 Adoption Credit

[Image: Adoption Credit]

Track Expenses from Day One

Document all expenses from the beginning of the adoption process. Expenses paid across multiple years before finalization may still qualify — but only if properly tracked and documented.

Special Needs = Full Credit

For a special needs adoption, the full **$17,280** credit is available in the year the adoption becomes final — even if actual out-of-pocket adoption expenses were minimal.

Employer Reimbursements Reduce Credit

Adoption Credit & Exclusion Table (TY2026)

Tax Provision	TY2026 Threshold	Statutory Authority	Core Application / Rules
Maximum Credit / Exclusion	**$17,670**	Rev. Proc. 2025-32 §3.04	Available per eligible child for qualified adoption expenses. Fully excludable if employer-provided.
Phase-out Threshold (Begins)	**$259,190**	Rev. Proc. 2025-32 §3.04	The credit or exclusion begins to scale down proportionally once the taxpayer's MAGI crosses this limit.
Phase-out Completion (Ends)	**$299,190**	Rev. Proc. 2025-32 §3.04	The credit or exclusion is **completely eliminated** for taxpayers with a MAGI at or above this amount.

Qualified Adoption Expenses

Qualified Adoption Expenses

Qualified expenses include reasonable and necessary adoption fees, court costs, attorney fees, travel expenses, meals and lodging away from home, and other direct costs of legally adopting an eligible child.

They do **not** include illegal expenses, costs to adopt a spouse’s child, or amounts paid or reimbursed by an employer or government program.

Special Needs Adoption

For a child with special needs, the taxpayer may claim the full maximum credit in the year the adoption becomes final, regardless of actual qualified adoption expenses paid.

This is a major exception to the general rule that the credit is limited to actual expenses.

Timing of the Credit

For domestic adoptions, expenses paid before finalization are claimed in the year after payment. Expenses paid in the final year or later are claimed in the year paid.

For foreign adoptions, no credit is available until the adoption becomes final. All qualifying expenses are claimed in the finalization year.

Carryforward Rule

The adoption credit is nonrefundable. It cannot reduce tax below zero or generate a refund.

Any unused credit may be carried forward for up to **five years**. Practitioners should track carryforwards carefully.

1.7 American Opportunity and Lifetime Learning Credit

[Image: Education Credit]

IRC §25A — TY2026

Education Credits — AOTC vs. Lifetime Learning Credit

Two education credits are available for post-secondary education expenses: the **American Opportunity Tax Credit (AOTC)** under IRC §25A(b) and the **Lifetime Learning Credit (LLC)** under IRC §25A(c).

American Opportunity Tax Credit (AOTC)

The AOTC applies only to the first four years of post-secondary education and is partially refundable.

40%

Refundable Portion

Lifetime Learning Credit (LLC)

The LLC is nonrefundable but may be claimed for unlimited years of higher education, graduate programs, and job-skill improvement courses.

No Limit

Years Eligible

TY2026 Phase-Out Ranges

The income phase-out ranges for both education credits were inflation-adjusted for TY2026 under Rev. Proc. 2025-32.

Practitioners should verify modified AGI before calculating either credit.

One Credit Per Student

A taxpayer cannot claim both the AOTC and LLC for the same student in the same tax year.

Practitioners must compare both credits and determine which produces the better overall tax result.

TY2026 Credit Comparison

Feature	American Opportunity Credit	Lifetime Learning Credit
Maximum credit	$2,500 per eligible student	$2,000 per return
Refundable portion	40% ($1,000 maximum refundable)	None — nonrefundable only
Credit calculation	100% of first $2,000 + 25% of next $2,000	20% of up to $10,000 of expenses
Year limit	First 4 years of post-secondary only	No limit — any year of higher education
Enrollment requirement	At least half-time in a degree program	Any enrollment; any course to acquire job skills
MAGI phase-out (Single)	$80,000 – $90,000	$80,000 – $90,000
MAGI phase-out (MFJ)	$160,000 – $180,000	$160,000 – $180,000
Felony drug conviction	Disqualifies the student	No disqualification

Qualifying Expenses & Coordination Rules

529 Plan

Qualified Expenses

Qualifies

Tuition & Required Enrollment Fees

AOTC Materials

Books, Supplies & Required Equipment

Do Not Qualify

Room, Board, Transportation & Personal Expenses

Reduce Credit

Scholarships, Grants & Tax-Free Assistance

§529 Coordination

Credits & §529 Plans May Be Used Together

Planning Strategy

Use First $2,500 of Tuition for the AOTC

Qualifying Expenses & Coordination with §529 Plans

[Image: Anita]

Education Credits — TY2026

Qualifying Expenses & §529 Coordination

Qualifying Expenses

Tuition and required enrollment fees paid to an eligible educational institution qualify for education credits.

For the AOTC, required books, supplies, and equipment also qualify when required as a condition of enrollment or attendance.

Expenses That Do Not Qualify

Room and board, insurance, medical expenses, transportation, personal living expenses, and most sports or hobby courses do not qualify.

Expenses paid with tax-free scholarships, grants, or other tax-free educational assistance cannot also be used for the credit.

Coordination with §529 Plans

A taxpayer may claim an education credit and use §529 plan distributions in the same year — but not for the same expenses.

Qualified expenses used for the credit must be reduced by scholarships, grants, and tax-free §529 distributions.

Planning Opportunity

If a student receives $10,000 in §529 distributions and has $14,500 in qualified expenses, the first $2,500 of tuition may support the AOTC.

The remaining $12,000 may then be covered by the §529 distribution tax-free.

1.8 Alternative Fuel Vehicle Refueling Property Credit

Lesson at a Glance

[Image: Alternative Fuel Vehicle Refueling Property Credit]

The **Alternative Fuel Vehicle Refueling Property Credit** under IRC §30C provides a tax credit for qualified refueling property placed in service during the tax year. This includes

EV charging equipment, hydrogen refueling property, and other qualifying alternative fuel infrastructure. :contentReference[oaicite:0]{index=0}

The credit can apply to equipment installed at a taxpayer's principal residence or at qualifying business property. Residential and business installations follow different rules, limits, and reporting requirements. :contentReference[oaicite:1]{index=1}

The OBBBA modified and accelerated the phaseout of the §30C credit. Property generally must be placed in service before July 1, 2026 to qualify under the current rules. :contentReference[oaicite:2]{index=2}

What Qualifies as Refueling Property

Qualified alternative fuel vehicle refueling property includes equipment used to **store, dispense, or recharge alternative-fuel vehicles**. Traditional gasoline and diesel fueling equipment does not qualify for the credit.

EV Charging Stations

Includes Level 1, Level 2, and DC Fast Charging equipment installed at qualifying residential or business locations.

Hydrogen Fueling Stations

Equipment used to store and dispense hydrogen fuel for qualifying vehicles may qualify for the credit.

CNG & LNG Equipment

Compressed Natural Gas (CNG) and Liquefied Natural Gas (LNG) storage and dispensing systems qualify when used for alternative-fuel vehicles.

Propane Fueling Equipment

Propane storage tanks, dispensing pumps, and related refueling infrastructure may qualify.

Biodiesel & E85 Equipment

Equipment used to dispense biodiesel and ethanol-based fuels such as E85 may qualify as refueling property.

Key Concept

The credit applies to the **refueling or recharging infrastructure**, not the vehicle itself. Vehicle purchase credits and refueling property credits are separate tax incentives with different qualification requirements.

The Amendment — IRC §30C(i) as Changed by OBBBA §70433

OBBBA §70433 Amendment

IRC §30C(i) Termination Date Change

Before OBBBA

IRC §30C originally provided:

"This section shall not apply to any property placed in service after December 31, 2032."

After OBBBA §70433

Effective July 4, 2025, the statute now provides:

"This section shall not apply to any property placed in service after June 30, 2026."

What Changed?

OBBBA §70433 changed only the termination date of the credit.

- Credit percentages remain unchanged.
- Credit caps remain unchanged.
- Eligible property rules remain unchanged.
- Census tract requirements remain unchanged.

Practitioner Alert

The practical effect of OBBBA is significant. Taxpayers planning EV charging or alternative fuel infrastructure projects must place the property in service by **June 30, 2026** to qualify for the federal §30C credit.

Legislative Timeline

2005

Credit Created — Energy Policy Act of 2005

Original §30C credit created. Covered limited fuels; lower caps applied. Extended multiple times by Congress over subsequent years.

Aug 2022

Inflation Reduction Act — Major Expansion

Business cap raised to $100,000 per item; PWA enhanced rate added (6% → 30%); eligible census tract requirement added; credit extended to December 31, 2032.

Jan 2023

Current Credit Rules Take Effect

IRA-amended §30C begins. IRS issues Notice 2024-20 defining eligible census tracts for the geographic requirement.

Jul 4, 2025

OBBBA §70433 — Sunset Accelerated

Termination date changed from December 31, 2032 to June 30, 2026. Credit window shortened by over 6 years.

Jun 30, 2026

Last Day to Place Property in Service

Property must be installed and ready for use by June 30, 2026. Equipment placed in service on or after July 1, 2026 is ineligible for the §30C credit.

Jul 1, 2026

Credit Terminates — No Exceptions

IRC §30C ceases to apply to any property placed in service on this date or later. No grandfathering for contracts signed earlier. No transition rule for partially installed equipment.

TY2026 Credit Amounts

Property Type	Credit Percentage	Maximum Credit
Personal residence property (EV charger at home)	30%	$1,000 per item
Business/investment property — in eligible census tract	30%	$100,000 per item
Business/investment property — NOT in eligible census tract	6%	$100,000 per item

The Census Tract Rule — Location Matters

[Image: Alternative Fuel Infrastructure]

Census Tract Rule — Location Matters

The IRA and OBBBA expanded the §30C credit for business installations, but eligibility for the higher credit rate depends on location. Property generally must be installed in an eligible census tract to qualify.

- Eligible census tract = **30% credit rate**
- Low-income community census tract qualifies

- Non-urban census tract qualifies

Urban locations outside qualifying census tracts generally receive only the lower credit rate.

Basis Reduction Rule

The basis of qualifying refueling property must be reduced by the amount of the §30C credit claimed. This affects future depreciation calculations for business property.

- Credit claimed
- Property basis reduced
- Depreciable basis decreases

Practitioner Tips

- **Verify census tract eligibility** before calculating the credit.
- **Retain installation invoices** and placed-in-service documentation.
- **Screen every client who installed EV charging equipment.** Homeowners who installed a Level 2 charger for a personal EV may qualify for up to a $1,000 credit.
- **Form 8911 reporting:** calculate the credit on Form 8911 and carry it to Schedule 3, Line 6b.
- **Combined incentives may be available.** State, local, and utility rebates may stack with the federal credit, but rebates that reduce actual cost generally reduce the credit base.

1.9.1 Itemized Deduction Limitations

Lesson 1.9.1 — Itemized Deduction Limitations · TY2026

For TY2026, **OBBBA §70111** permanently repeals the old Pease limitation and replaces it with a new rule that limits the tax benefit of itemized deductions for certain high-income taxpayers in the 37% bracket. Most miscellaneous itemized deductions formerly subject to the 2% AGI floor remain unavailable for most individual taxpayers under current law.

§70111 OBBBA New Limit

No 2% Misc. Return

0.5% Charitable AGI Floor

$40,000 SALT Cap

7.5% Medical AGI Floor

New Itemized Deduction Limit — OBBBA §70111

The Pease limitation under IRC §68 was a former itemized deduction phaseout for certain high-income taxpayers. It was commonly known as the "Pease limitation." The Pease limitation was suspended by TCJA through 2025. For TY2026, OBBBA §70111 permanently repeals Pease and replaces it with a new calculation that limits the tax benefit of itemized deductions for certain high-income taxpayers in the 37% bracket.

AFTR Key Point

The old Pease 3%-of-excess-AGI phaseout is **not** reinstated. It is permanently repealed and replaced by a different limitation that reduces the tax benefit of itemized deductions for certain taxpayers in the 37% bracket.

2% Miscellaneous Itemized Deductions — Not Reinstated for Most Taxpayers

Do Not Teach This as Reinstated

For TY2026 AFTR purposes, most miscellaneous itemized deductions formerly subject to the 2% AGI floor remain suspended or unavailable for most individual taxpayers. Do not tell students that unreimbursed employee expenses, tax preparation fees, investment advisory fees, or safe deposit box fees generally returned as Schedule A deductions.

Before TCJA

2% Floor

Certain miscellaneous deductions were allowed only above 2% of AGI

TY2026 Rule

Generally Unavailable

Do not treat the old 2% miscellaneous deduction category as generally restored

Examples Generally Not Deductible as 2% Miscellaneous Itemized Deductions

- Unreimbursed employee business expenses
- Tax preparation fees
- Investment advisory fees
- Safe deposit box rental and similar personal investment expenses

Schedule A — Itemized Deduction Rules for TY2026

Deduction	TY2026 Rule	Status
Medical & dental	Deductible only to the extent expenses exceed 7.5% of AGI	Unchanged
SALT	Capped at $40,000, with phase-down rules for high-income taxpayers	Changed — cap raised
Mortgage interest	Generally limited to interest on up to $750,000 of qualified acquisition debt	Unchanged

Deduction	TY2026 Rule	Status
Charitable contributions	For itemizers, charitable deductions are reduced by the new 0.5% of AGI floor	Changed — new floor
Personal casualty losses	Generally limited to federally declared disasters and qualifying state-declared disasters under current law	Changed — state-declared disasters added
Miscellaneous itemized deductions formerly subject to 2% floor	Generally suspended or unavailable for most individual taxpayers	Not reinstated
Overall Pease limitation	Permanently repealed; replaced by OBBBA §70111 limitation for certain 37% bracket taxpayers	Repealed / replaced

Charitable Contribution Floor for Itemizers

Worked Example — 0.5% Charitable Floor

Taxpayer AGI: **$100,000**. Cash donated to qualifying charity: $800.

0.5% floor: $100,000 × 0.5% = **$500**

Deductible on Schedule A: $800 – $500 = $300

The non-itemizer charitable deduction is separate and is not subject to this itemized charitable floor.

Standard vs. Itemized — TY2026 Break-Even

Filing Status	2026 Standard Deduction	Must Itemize More Than
Single / MFS	$16,100	$16,100
Married Filing Jointly	$32,200	$32,200
Head of Household	$24,150	$24,150

AFTR Practice Point

Do not increase Schedule A deductions by adding back old 2% miscellaneous itemized deductions. For TY2026, compare the standard deduction to allowable itemized deductions after applying the current SALT cap, charitable floor, medical floor, casualty loss rules, and the new high-income limitation where applicable.

1.9.2 Mortgage Interest Deduction

Lesson at a Glance

[Image: Mortgage Interest Deduction]

Schedule A Itemized Deduction

Mortgage Interest Deduction

The mortgage interest deduction allows taxpayers who itemize to deduct qualified interest paid on acquisition debt secured by a qualified residence.

Qualified Mortgage Interest

- Interest must be paid on acquisition debt.
- The debt must be secured by a qualified residence.
- The deduction is claimed on Schedule A by taxpayers who itemize.

TY2026 Debt Limit

- For TY2026, the acquisition debt limit is $750,000.
- The TCJA limit is now permanent under OBBBA.
- The limit applies to acquisition debt secured by a qualified residence.

Home Equity Loan Interest

Home equity loan interest is deductible only when the loan proceeds are used to buy, build, or substantially improve the qualifying residence securing the loan.

Deductible when used to improve the qualified residence.

Not deductible when used for personal expenses unrelated to the home.

Practitioners should document how the loan proceeds were used.

Key Takeaway

With high interest rates and large mortgage balances, qualified mortgage interest remains one of the largest itemized deductions for many homeowners. The preparer must verify the type of debt, the loan balance, the secured residence, and the use of any home equity proceeds before claiming the deduction.

TY2026 Acquisition Debt Limits

Loan Category	Maximum Deductible Debt	Notes
Acquisition debt — loans originated after Dec. 15, 2017	$750,000 ($375,000 MFS)	TCJA limit made permanent by OBBBA
Grandfathered debt — originated on or before Dec. 15, 2017	$1,000,000 ($500,000 MFS)	Original pre-TCJA limit still applies to pre-2018 loans
Home equity debt (proceeds used for home improvement)	Subject to overall $750,000/$1,000,000 limit	Deductible only if proceeds used to buy, build, or improve the securing residence
Home equity debt	$0 — not deductible	Personal loan proceeds =

Loan Category	Maximum Deductible Debt	Notes
(proceeds used for other purposes)		personal interest = not deductible

What Counts as Acquisition Debt

What Counts as Acquisition Debt?

Acquisition debt is debt used to **buy, build, or substantially improve** a qualified residence and must be secured by that residence.

A cash-out refinance creates a split:

- Original acquisition balance = acquisition debt
- Additional cash-out = home equity debt

Only the acquisition debt portion qualifies for the mortgage interest deduction (subject to the $750,000 limitation).

Qualified Residences

The mortgage interest deduction is available for:

- Principal residence
- One second or vacation residence

If a second home is rented fewer than 15 days, rental income is excluded and expenses remain personal.

If rented more extensively, the property becomes a mixed-use vacation home subject to Schedule E rules.

Worked Example

Cash-Out Refinance

Facts

Paul purchased his home using a **$600,000 mortgage**.

By 2026, the outstanding balance is **$540,000**.

He refinances for **$700,000**:

- $540,000 pays off the original mortgage
- $160,000 cash-out is used for a vacation

Tax Result

Acquisition Debt: $540,000

Home Equity Debt: $160,000

Interest attributable to the **$540,000 acquisition debt** is deductible.

Interest attributable to the **$160,000 vacation cash-out** is personal interest and is **not deductible**.

1.9.3 Casualty Loss Deduction

Lesson 1.9.3 — Casualty Loss Deduction · TY2026

OBBBA §70109 expands the personal casualty loss deduction for TY2026 to include losses in both **federally declared** and **state-declared disaster areas —** a significant expansion from the TCJA rule that limited the deduction to federally declared disasters only. The $100 per-casualty and 10% AGI floors still apply.

§70109 OBBBA Authority

Federal + State Qualifying Declarations

$100 Per-Casualty Floor

10% AGI Floor

Sch. A Reported On

The Expansion — OBBBA §70109

TY2018–2025 · TCJA

Federally Declared
Disasters Only

State disasters not eligible

TY2026 · OBBBA §70109

Federal or State Declared
Disaster Areas

Both declarations now qualify

OBBBA §70109

New Law — OBBBA §70109

Effective for TY2026, individuals may deduct personal casualty losses arising in a **state-declared disaster area** even if no federal disaster declaration has been issued for that event. The loss must still result from a sudden, unexpected, or unusual event. The $100 per-event floor and the 10% AGI floor continue to apply. Losses are reported on Schedule A and may not exceed the lesser of the property's adjusted basis or the decrease in fair market value.

Eligibility Requirements — TY2026

Requirement	TY2026 Rule
Disaster declaration required	Federal **or** state disaster declaration — both qualify under OBBBA §70109
Type of loss	Sudden, unexpected, or unusual event such as fire, flood, hurricane, tornado, or earthquake
Per-event floor	Reduce each casualty loss by **$100** before applying the AGI floor
AGI floor	Only losses exceeding **10% of AGI**, after the $100 reduction, are deductible
Loss measurement	Lesser of decrease in FMV or adjusted basis of property, reduced by insurance reimbursement
Insurance offset	Must reduce loss by any insurance or other reimbursement received or reasonably expected
Personal use property	Deductible on Schedule A. Business or income-producing property follows different rules on Form 4684, Section B
IRC authority	IRC §165(h); OBBBA §70109; Form 4684

Worked Example — State-Declared Disaster

Example — Flood Damage in State-Declared Area

Rachel's home is damaged by flooding. The Governor declares a state disaster; no federal declaration is issued. AGI: **$60,000**.

Decrease in FMV	$28,000
Less: insurance reimbursement	($12,000)
Net casualty loss	$16,000
Less: $100 per-event floor	($100)
After $100 floor	$15,900
Less: 10% of AGI	($6,000)
Deductible casualty loss on Schedule A	$9,900

Note: Under TY2025 and prior TCJA rules, this deduction would have been zero because no federal declaration was issued. Under OBBBA §70109, the state declaration qualifies Rachel for the deduction in TY2026.

Federal vs. State Declaration — What Changes

Item	Federal Declaration	State Declaration TY2026 New
Qualifies for	Yes	Yes — new for TY2026

Item	Federal Declaration	State Declaration TY2026 New
deduction?		
$100 per-event floor	Applies	Applies
10% AGI floor	Applies	Applies
Insurance offset required	Yes	Yes
Form 4684 required	Yes — Section A for personal losses	Yes — Section A for personal losses
Election to claim in prior year	May elect to deduct in year preceding the disaster	IRS guidance pending — confirm applicability

What Does Not Qualify

These Losses Remain Non-Deductible for Personal Property

- Losses from progressive deterioration, including termite damage, rust, rot, dry rot, or disease
- Losses not in a federal or state declared disaster area
- Losses fully covered by insurance
- Loss of future profits or business income
- Losses from willful acts or negligence of the taxpayer

Business & Income-Producing Property

The TCJA suspension of personal casualty losses never applied to business or income-producing property. Losses to business property are reported on Form 4684, Section B and flow to Schedule C, E, or F depending on the activity. The OBBBA §70109 expansion applies specifically to **personal use property** on Schedule A.

1.9.4 Gambling Losses

Learning Objectives

[Image: Gambling winnings and losses]

Gambling winnings are fully taxable income.

Gambling losses are deductible on **Schedule A**, but only to the extent of gambling winnings.

Winnings**$5,000**

Losses**$8,000**

Deductible**$5,000 only**

The excess **$3,000** is permanently lost and cannot be carried forward.

Key Point: Gambling losses never create a net loss deduction. The maximum Schedule A deduction is limited to gambling winnings reported as income.

The Basic Rule — IRC §165(d)

W-2G Reporting Thresholds

Type of Gambling	W-2G Required When	Withholding Required When
Bingo or slot machines	Winnings $1,200+	Winnings minus wager exceeds $5,000
Keno	Winnings $1,500+ (reduced by wager)	Winnings minus wager exceeds $5,000
Poker tournaments	Winnings $5,000+ (net of buy-in)	Same
Horse racing, dog racing, jai alai	Winnings 300× or more of wager AND $600+	Winnings minus wager exceeds $5,000
Sports betting / fantasy sports	Winnings 300× or more of wager AND $600+	Winnings minus wager exceeds $5,000
State lottery	Winnings $600+ (or 300× wager)	Winnings minus wager exceeds $5,000

Casual Gambler

Most recreational gamblers are treated as casual gamblers. Winnings are reported as taxable income, and losses are deducted on Schedule A only up to the amount of gambling winnings.

Losses do not offset wages, interest, retirement income, or other non-gambling income.

Professional Gambler

A taxpayer who gambles as a trade or business may report gambling activity on Schedule C and deduct ordinary and necessary gambling expenses.

Net gambling income is generally subject to self-employment tax.

IRS Business Activity Test

The IRS applies stringent tests. Gambling must be the taxpayer's primary source of income, conducted in a businesslike manner, and performed with regularity and continuity. Most recreational gamblers do not qualify.

[Image: phantom_money.svg]

The "Phantom Income" Problem

Because only 90% of losses are deductible, a taxpayer who breaks even — say $100,000 in winnings and $100,000 in losses — will report $10,000 of net taxable income from gambling. This is a meaningful change for high-volume gamblers, online sportsbook bettors, and table-game players who often "break even" gross but face significant federal tax exposure.

1.9.5 State and Local Tax (SALT) Deduction

[Image: State and Local Tax SALT Deduction TY2026]

SALT Deduction · TY2026 (Filed 2027)

OBBBA §70120 increases the State and Local Tax deduction cap to **$40,400** ($20,200 for Married Filing Separately) for TY2026. A phaseout applies for higher-income taxpayers, reducing the cap but not below a **$10,000 floor**. This replaces the flat $10,000 TCJA cap that applied through TY2025.

$40,400 New Cap (Most Filers)

$20,200 MFS Cap

$10,000 Phaseout Floor

§70120 OBBBA Authority

Sch. A Reported On

The Cap Change — OBBBA §70120

TY2018–2025 · TCJA

$10,000

Flat cap — all filing statuses
($5,000 for MFS)

TY2026 · OBBBA §70120

$40,400

With phaseout — floor of $10,000
($20,200 for MFS)

OBBBA §70120

New Law — OBBBA §70120

Effective for TY2026, the SALT deduction cap is raised from $10,000 to **$40,400** for most filers and **$20,200** for Married Filing Separately. A phaseout reduces the cap for higher-income taxpayers, but the cap cannot fall below the **$10,000 floor**. The deduction covers state and local income taxes (or sales taxes in lieu of income taxes) plus real property taxes — the same categories as under TCJA.

SALT Caps by Filing Status — TY2026

Filing Status	TY2025 Cap (TCJA)	TY2026 Cap (OBBBA)	Phaseout Floor
Single	$10,000	$40,400	$10,000
Married Filing Jointly	$10,000	$40,400	$10,000
Head of Household	$10,000	$40,400	$10,000
Married Filing Separately	$5,000	$20,200	$10,000*

* IRS guidance pending on whether the $10,000 floor applies at the MFS level or the joint level. Confirm with IRS instructions for TY2026 Schedule A before filing.

The Phaseout — How It Works

Phaseout Mechanics

The $40,400 cap phases out as AGI rises above the threshold. The phaseout reduces the available cap dollar-for-dollar (or at a set rate — per OBBBA §70120) until the cap reaches the **$10,000 floor**, at which point no further reduction applies. Even the highest-income taxpayers retain the $10,000 SALT deduction.

The IRS will publish the exact phaseout thresholds and rate in the TY2026 Schedule A instructions. Confirm the applicable AGI threshold before filing.

AGI Range	Available SALT Cap	Note
Below phaseout threshold	$40,400 (full cap)	No reduction
Within phaseout range	Between $10,000 and $40,400	Cap reduced per §70120 formula
Above phaseout ceiling	$10,000 (floor — minimum)	Cap cannot go below $10,000

Worked Examples — TY2026

Example 1 — Below Phaseout (Full Cap Available)

David and Sarah file MFJ. AGI: **$180,000**. They paid $22,000 in state income tax and $14,000 in real property tax. Total SALT paid = $36,000.

Total SALT paid	$36,000
TY2026 cap (below phaseout threshold)	$40,400
SALT deduction on Schedule A	$36,000

Full amount deducted — SALT paid ($36,000) is less than the $40,400 cap. Under TY2025 TCJA rules, only $10,000 would have been deductible — a **$26,000 improvement**.

Example 2 — Exceeds Cap (Capped at $40,400)

Lisa files Single. AGI: **$120,000**. She paid $18,000 in state income tax and $27,000 in real property tax. Total SALT paid = $45,000.

Total SALT paid	$45,000
TY2026 cap (below phaseout threshold)	$40,400
SALT deduction on Schedule A	$40,400

Capped at $40,400 — $4,600 of SALT paid is not deductible. Still a **$30,400 improvement** over the $10,000 TY2025 cap.

Example 3 — Above Phaseout Ceiling (Floor of $10,000)

Michael files Single. AGI: **$900,000** (well above the phaseout ceiling). He paid $55,000 in SALT. The phaseout has fully reduced his cap to the $10,000 floor.

Total SALT paid	$55,000
Cap after full phaseout (floor)	$10,000
SALT deduction on Schedule A	$10,000

Same result as TY2025 — the phaseout fully erodes the expanded cap back to the $10,000 floor for very high earners.

What Counts as SALT — Eligible Taxes

Eligible — Counts Toward Cap	Not Eligible — Does Not Count
State and local income taxes paid	Foreign taxes (go to Form 1116)
State and local general sales taxes (in lieu of income tax)	Federal income taxes
Real property taxes on personal residence	Transfer taxes (real estate sales)
Personal property taxes (e.g., vehicle registration based on value)	Assessments for local improvements (sidewalks, sewers)
State estimated tax payments made in TY2026	Taxes on business income (go to Schedule C/E/F)

Pass-Through Entity Tax (PTET) Workaround

Many states offer a Pass-Through Entity Tax (PTET) election allowing S corporations and partnerships to pay state income tax at the entity level. This allows the business to deduct the state tax on its federal return (Schedule K-1) — bypassing the individual SALT cap entirely. OBBBA §70120 does not eliminate the PTET workaround. Taxpayers with pass-through income in high-SALT states should evaluate whether the PTET election remains advantageous given the higher $40,400 cap for TY2026.

Year of Payment Rule

SALT is deductible in the **year paid**, not the year assessed. A taxpayer who pays their 2025 state income tax balance in April 2026 deducts it under the TY2026 $40,400 cap — not the

TY2025 $10,000 cap. Conversely, prepaying 2027 property taxes in December 2026 counts toward the TY2026 cap only if the tax has been **assessed** by the taxing authority before December 31, 2026.

1.10.1 Deduction for Tip Income

Learning Objectives

[Image: No tax on tips]

The **OBBBA** created a new above-the-line deduction for qualified tip income under new **IRC §224**.

Eligible taxpayers may deduct up to **$25,000** of qualified tips received in **TY2025 through TY2028**.

The deduction is available to both **itemizers and non-itemizers**. It is claimed on the new **Schedule 1-A (Form 1040)** and reduces **AGI**.

Key Point: This is one of the most frequently asked-about TY2026 provisions for service industry workers.

Key Parameters

Parameter	TY2026 Rule
Maximum deduction	$25,000 of qualified tip income
Available to	Both itemizers and non-itemizers (above-the-line)
AGI phase-out begins	MAGI over $150,000 (single) / $300,000 (MFJ)
Phase-out rate	$25,000 reduced by $100 for each $1,000 (or fraction) over threshold
Years available	TY2025 through TY2028 only
Reported on	Schedule 1-A, Form 1040 (new form for TY2026)
W-2 documentation	Box 12, Code TP on TY2026 W-2; separate documentation required for TY2025

Qualifying Occupations — "Customarily and Regularly Tipped"

Qualifying Occupations

The deduction applies to employees and independent contractors who worked in occupations that customarily and regularly received tips before 2025.

Waitstaff, bartenders, and food service workers
Hairdressers, barbers, and cosmetologists
Bellhops, valets, and hotel service staff
Taxi, rideshare, and limousine drivers

Casino dealers and gaming workers
Delivery drivers receiving tips

Important: The deduction generally does not apply to management, supervisors, or highly compensated employees.

Only the Tip Portion Qualifies

The deduction covers only the voluntary gratuity paid by the customer.

It does **not** include base wages, mandatory service charges, commissions, bonuses, or other compensation.

TY2026 W-2 Reporting

Box 12 Code **TP** reports qualified tip income.

For TY2025, employers must provide a separate breakdown because the 2025 Form W-2 did not contain a TP box.

Treasury Guidance: The preliminary occupation list is advisory. Practitioners should consult final IRS and Treasury guidance when determining whether a taxpayer's occupation qualifies for the deduction.

1.10.2 Deduction for Overtime Pay

Lesson at a Glance

[Image: Overtime Deduction]

TY2026 New Deduction

Qualified Overtime Premium Deduction

The OBBBA created a new above-the-line deduction for the premium portion of qualified overtime compensation under new IRC §225. For TY2026, eligible employees may deduct up to **$12,500 — or $25,000 for MFJ —** of the overtime premium.

The deduction applies only to the **premium portion** — the extra amount paid above the employee's regular rate for overtime hours.

The deduction is reported on **Schedule 1-A** and is available to both itemizers and non-itemizers.

Practitioner Tip: This deduction does **not** cover all overtime pay. Only the overtime premium — the amount above the regular hourly rate — qualifies. The deduction is temporary for **TY2025 through TY2028**.

it is *not* a true exclusion

[Image: Busy.webp]

"No tax on overtime" was the second of two campaign-trail promises delivered through OBBBA's Schedule 1-A above-the-line deductions. Like the tip deduction (Lesson 1.10.1), it is *not* a true exclusion — wages remain reportable and FICA/Medicare apply. It is a temporary income-tax-only deduction designed to deliver tax relief specifically to hourly workers paid overtime under the FLSA.

Key Parameters

Parameter	TY2026 Rule
Maximum deduction — Single / MFS	$12,500 of qualified overtime premium
Maximum deduction — MFJ	$25,000 (combined for both spouses)
AGI phase-out begins	MAGI over $150,000 (single) / $300,000 (MFJ)
Years available	TY2025 through TY2028 only
Reported on	Schedule 1-A, Form 1040
W-2 documentation	Box 12, Code TT on TY2026 W-2

What Is the "Overtime Premium"? and example

TY2026 Overtime Deduction

What Is the “Overtime Premium”?

Under the Fair Labor Standards Act (FLSA), employees working more than 40 hours in a week generally receive overtime compensation equal to **1.5× their regular hourly rate**. The new overtime deduction does not apply to the entire overtime payment. Instead, it applies only to the **overtime premium** — the additional amount paid above the employee’s normal rate of pay.

Regular Pay

Employee’s normal rate:
$20 per hour

Overtime Pay

Overtime rate:
$30 per hour

Premium Portion

$30 overtime rate − $20 regular rate =
$10 overtime premium

Practitioner Tips

[Image: Form W-2]

Form W-2 — Wage and Tax Statement

Practitioner Tips

Overtime Deduction Planning

Review Box 12 Carefully

Check **Box 12, Code TT** on every TY2026 Form W-2. Employers are required to report qualifying overtime compensation. If Code TT appears, the client may qualify for the overtime premium deduction.

Married Filing Jointly

Both spouses' qualifying overtime premiums count toward the **$25,000 MFJ limitation**. Couples where both spouses earn overtime may combine eligible amounts up to the joint return cap.

Not Available to Self-Employed

Sole proprietors, gig workers, and independent contractors do not qualify. The deduction applies only to employees receiving qualifying overtime compensation under the Fair Labor Standards Act (FLSA).

Exam Tip: The overtime deduction is based on the **premium portion of overtime pay**, not total overtime wages. Always verify Form W-2 reporting and confirm that the taxpayer is an employee rather than self-employed before calculating the deduction.

1.10.3 Auto Interest Loan Deduction

Lesson at a Glance

[Image: U.S.-assembled vehicle]

Qualified Vehicle Interest Deduction — IRC §226

TY2025–TY2028 Temporary Deduction

Qualified Vehicle Loan Interest

What Is the Vehicle Interest Deduction?

The OBBBA created a new temporary deduction for interest paid on loans used to purchase a new, U.S.-assembled personal vehicle. Under new **IRC §226**, taxpayers may deduct up to **$10,000** of qualifying auto loan interest for TY2025 through TY2028. The deduction is claimed above-the-line on **Schedule 1-A** and is available to both itemizers and non-itemizers.

Up to $10,000

Taxpayers may deduct up to **$10,000** of qualifying interest paid on an eligible vehicle loan.

Schedule 1-A

The deduction is claimed **above-the-line** and is available to both itemizers and non-itemizers.

U.S. Assembly Required

The vehicle must be **assembled in the United States** to qualify for the deduction.

Refinancing Does Not Qualify

The loan must be the original financing used to purchase the vehicle. Refinanced vehicle loans do **not** qualify.

Practitioner Tip: Before calculating the deduction, verify three items: the vehicle was assembled in the United States, the loan is the original financing arrangement, and the interest was actually paid during the tax year.

Key Parameters

Parameter	TY2026 Rule
Maximum deduction	$10,000 of qualifying interest paid
Vehicle requirement	New automobile assembled in the United States
Loan requirement	New loan used to purchase the qualifying vehicle; refinancing does not qualify
Personal use requirement	Vehicle must be used for personal (not business) purposes; business vehicles use existing IRC §163 business interest rules
AGI phase-out begins	MAGI over $100,000 (single) / $200,000 (MFJ)
Years available	TY2025 through TY2028 only
Reported on	Schedule 1-A, Form 1040
Lender form	Form 1098-VLI (new) — Vehicle Loan Interest

[Image: U.S.-assembled vehicle]

The "Assembled in the United States" Requirement

Vehicle Interest Deduction

“Assembled in the United States” Requirement

Final Assembly Location Matters

Only vehicles with final assembly in the United States qualify. The VIN can be used to determine assembly location. Vehicles with a VIN beginning with **1, 4, or 5** are generally assembled in the United States. The IRS and DOE jointly maintain a list of qualifying vehicles, and the dealer must provide documentation of U.S. assembly at the time of purchase.

Worked Example — Jennifer's Pickup Truck

In March 2026, Jennifer purchases a new U.S.-assembled pickup truck for **$52,000** with a 5-year auto loan at **7.5%** interest. She receives Form **1098-VLI** showing **$3,640** in qualifying interest paid during 2026.

Her MAGI is **$85,000**, so no phase-out applies. Her deduction is **$3,640** because the amount is below the $10,000 cap. She reports the $3,640 deduction on **Schedule 1-A** as an above-the-line deduction.

Look for Form 1098-VLI

Qualifying lenders will issue this new form for TY2026. If a client bought a new U.S.-assembled car in 2025 or 2026 and financed it, ask for Form **1098-VLI**.

Refinancing Does Not Qualify

If a client refinanced an existing auto loan to get a lower rate, the new loan is not a purchase money loan. The interest does **not** qualify for the §226 deduction.

Business Vehicles Are Different

The §226 deduction applies to personal-use vehicles. Business vehicle interest is already deductible as a business expense through **Schedule C** or **Form 4562**.

1.10.4 Enhanced Deduction for Seniors

Lesson at a Glance

[Image: Enhanced Senior Deduction]

Enhanced Senior Deduction

TY2025–TY2028 Temporary Deduction

Enhanced Senior Deduction

New Above-the-Line Senior Deduction

The OBBBA created a new enhanced standard deduction for qualifying seniors. Taxpayers who are age **65 or older as of December 31, 2026** may claim an additional above-the-line deduction of **$6,000** per qualifying individual, or **$12,000** for a qualifying married couple.

$6,000 / $12,000

Eligible seniors may deduct **$6,000** per qualifying individual. A qualifying married couple may deduct up to **$12,000**.

Above-the-Line

The deduction is available to both itemizers and non-itemizers and is claimed separately from the regular standard deduction rules.

In Addition to Age Deduction

This deduction is separate from and in addition to the existing additional standard deduction for age: **$1,600 for MFJ** and **$2,000 for single**.

Temporary & Phased Out

The enhanced senior deduction is available for **TY2025 through TY2028 only** and is phased out at higher income levels.

Practitioner Tip: Do not confuse the new enhanced senior deduction with the existing additional standard deduction for age. Qualifying seniors may receive both, but the new deduction is temporary and subject to income-based phase-out rules.

Key Parameters

Parameter	TY2026 Rule
Deduction — individual (65+ as of Dec. 31, 2026)	$6,000
Deduction — MFJ (both spouses are 65+)	$12,000
Deduction — MFJ (one spouse is 65+)	$6,000
AGI phase-out begins	MAGI over $75,000 (single) / $150,000 (MFJ)
Phase-out rate	Deduction reduced until fully phased out
Available to	Above-the-line — both itemizers and non-itemizers
Years available	TY2025 through TY2028 only
Reported on	Schedule 1-A, Form 1040

Two Separate Age-Based Deductions in TY2026

It is important to distinguish the new enhanced deduction from the existing additional standard deduction for age under IRC §63(f):

Provision	Amount	Type	Availability
Additional standard deduction for age (existing, permanent)	$1,650 (MFJ/QSS) or $2,050 (Single/HoH)	Increases standard deduction	Permanent; only for those who take standard deduction
Enhanced senior deduction (new OBBBA provision)	$6,000 per qualifying senior	Above-the-line; reduces AGI	Temporary 2025–2028; available to all including itemizers

1.11 Charitable Contributions

Lesson at a Glance

[Image: Charitable Contributions]

TY2026 Charitable Contribution Changes

TY2026 Charitable Contributions

Two Different Deduction Tracks

Major TY2026 Changes

The OBBBA made two significant changes to charitable contribution rules for TY2026. First, it permanently restored the non-itemizer charitable deduction at a higher amount. Second, it created a new 0.5% AGI floor for itemizers. Practitioners must understand both deduction tracks and the substantiation requirements that continue to apply.

Non-Itemizers

Taxpayers who do not itemize may claim an above-the-line charitable deduction of up to **$1,000 Single** or **$2,000 MFJ**.

Itemizers

Itemizers continue claiming charitable contributions on Schedule A but must now apply the new **0.5% AGI floor**.

Documentation Still Required

The deduction rules changed, but substantiation rules did not. Receipts, acknowledgments, and written records remain essential.

Two Different Calculations

Do not assume every client follows the same charitable deduction rules. Non-itemizers and itemizers now have different calculation methods.

Two Tracks for TY2026 Charitable Deductions

Track	Who Uses It	TY2026 Rules	Where Reported
Non-itemizer deduction	Taxpayers taking standard deduction	Up to $1,000 (single) / $2,000 (MFJ); cash only; no floor; permanent under OBBBA	Schedule 1, Line 12 (or similar)
Itemizer deduction	Taxpayers who itemize on Schedule A	Limited to contributions exceeding 0.5% of AGI; standard AGI percentage limits apply	Schedule A, Line 12

The New 0.5% AGI Floor for Itemizers

TY2026 Schedule A Rule

New 0.5% AGI Floor for Itemizers

Itemizers Must Reduce the Deduction First

Itemizers who deduct charitable contributions on **Schedule A** must first reduce their total contributions by **0.5% of AGI**. Only the excess amount is deductible. This floor applies to the itemized deduction track only.

AGI

Taxpayer AGI:
$100,000

Charitable Gift

Total contribution:
$800

0.5% Floor

$100,000 × 0.5%
= **$500 floor**

Deductible Amount

Deductible charitable contribution:
$800 contribution – $500 AGI floor = $300 deductible

Practitioner Tip: The 0.5% AGI floor does **not** apply to the non-itemizer charitable deduction claimed on Schedule 1. It applies only to charitable contributions deducted by itemizers on Schedule A.

Two Tracks for TY2026 Charitable Deductions

Type of Contribution	AGI Limit
Cash to public charities and certain private foundations	60% of AGI
Capital gain property to public charities (long-term)	30% of AGI
Cash and property to private foundations	30% of AGI
Capital gain property to private foundations	20% of AGI

Substantiation Requirements — Unchanged

Documentation Requirements

Substantiation Rules Remain Unchanged

The Deduction Rules Changed — Documentation Rules Did Not

Although TY2026 introduced new charitable contribution rules, the substantiation requirements remain unchanged. Practitioners must continue verifying receipts, acknowledgments, Forms 8283, and qualified appraisals when required.

Cash Contributions

Any cash contribution requires a bank record, receipt, or written acknowledgment.

Contributions of **$250 or more** require a contemporaneous written acknowledgment (CWA).

Non-Cash Contributions

Non-cash contributions over **$250** require a CWA.

Non-cash contributions over **$500** require **Form 8283**.

Qualified Appraisal

Non-cash contributions exceeding **$5,000** generally require a qualified appraisal and additional reporting requirements.

Missing Documentation

A valid charitable deduction can be completely disallowed if the required documentation is missing, incomplete, or obtained after the filing deadline.

Non-Itemizers

Most non-itemizers can deduct up to **$1,000 Single** or **$2,000 MFJ** in cash donations. Make sure this permanent above-the-line deduction is claimed whenever available.

Bunching Strategy

Bunching two years of charitable contributions into one year may help taxpayers exceed both the standard deduction threshold and the new 0.5% AGI floor.

Goodwill & Salvation Army

Non-cash donation receipts should describe each item and document condition. For items over $500, retain records showing the property was in **good** or **excellent** condition.

1.12 529 Plan Account Disbursements

[Image: 529 Plan Distribution]

529 Plan Disbursements · TY2026 Filed 2027

Two OBBBA changes expand 529 plan benefits for TY2026. **OBBBA §70413** doubles the annual aggregate per-beneficiary distribution limit from **$10,000 to $20,000** for K–12 tuition and certain other uses. **OBBBA §70414** expands the definition of qualified higher education expenses to include **postsecondary credentialing expenses** — opening 529 funds to trade certifications, licensure programs, and workforce credentials.

$20,000 New Annual Limit

§70413 Limit Increase

§70414 Credentialing Added

Per Beneficiary Limit Basis

Form 1099-Q Reported On

Annual Distribution Limit Doubled — OBBBA §70413

Prior Law · Through TY2025

$10,000

Per beneficiary · per year

TY2026 · OBBBA §70413

$20,000

Per beneficiary · per year

OBBBA §70413

OBBBA §70413 — What Changed

The annual aggregate per-beneficiary limit on tax-free 529 distributions for K–12 tuition and other non-higher-education qualified uses is increased from **$10,000 to $20,000** effective for distributions made in TY2026. The limit applies **per beneficiary, per calendar year** across all 529 accounts for that beneficiary. Distributions within this limit from a qualified 529 plan are excluded from gross income to the extent used for qualified expenses.

Worked Example — K–12 Tuition Distribution

The Thompson family has two children enrolled in private elementary school. Each child has a separate 529 account. Annual private school tuition is **$18,000 per child**.

	TY2025 Prior Law	TY2026 OBBBA
Annual limit per child	$10,000	$20,000
Tax-free distributions for 2 children	$20,000	$36,000
Additional tax-free benefit in TY2026	—	+$16,000

Each child's tuition of $18,000 is now fully within the $20,000 limit. Under prior law, $8,000 per child, or $16,000 total, would have been taxable earnings on a non-qualified distribution.

Postsecondary Credentialing Added — OBBBA §70414

OBBBA §70414 — New Qualified Expense Category

The definition of **qualified higher education expenses** under IRC §529 is amended to include **postsecondary credentialing expenses.** This covers costs associated with recognized postsecondary credentials — including workforce certifications, trade licensure programs, apprenticeship-related coursework, and professional credentialing programs — even when offered outside a traditional degree-granting institution. Distributions used for these expenses are excluded from gross income.

Qualified Expenses — TY2026	Status
Tuition and fees at eligible higher education institutions	Always qualified
Books, supplies, and equipment required for enrollment	Always qualified
Room and board, if at least half-time enrollment is required	Always qualified
Special needs services for a special needs beneficiary	Always qualified
K–12 tuition at public, private, or religious school	Qualified up to $20,000/year under §70413
Postsecondary credentialing expenses — trade certifications, workforce credentials, licensure programs, apprenticeship coursework	New for TY2026 — OBBBA §70414
Computers and technology required by the institution	Always qualified
Transportation, health insurance, personal expenses	Not qualified
Student loan repayments, lifetime cap $10,000 per beneficiary	Qualified — separate lifetime limit

Worked Example — Postsecondary Credentialing

Marcus has a 529 account. His son enrolls in a **licensed electrician apprenticeship program** at a trade school — not a degree-granting college. Costs: $8,500 in program fees and $1,200 in required tools and materials.

Under prior law through TY2025: This program would likely not qualify as a higher education expense — distributions would be non-qualified, triggering income tax plus a 10% penalty on the earnings portion.

Under TY2026 OBBBA §70414: The $9,700 in program fees and required materials qualifies as a postsecondary credentialing expense. The 529 distribution is **tax-free** — no income tax, no penalty.

The program must meet the IRS definition of a recognized postsecondary credential program. Confirm eligibility with the plan administrator before distributing.

529 to Roth IRA Rollover — Still Available for TY2026

[Image: 529 to Roth IRA Rollover]

529 to Roth IRA Rollover Rules — SECURE 2.0

Beginning in 2024 and continuing for TY2026, beneficiaries may roll unused 529 funds into a Roth IRA for the same beneficiary. Key conditions:

- The 529 account must have been open for **at least 15 years**.
- Annual rollover is limited to the **Roth IRA contribution limit** for the year.
- **Lifetime cap: $35,000** per beneficiary across all rollovers.
- Contributions and earnings from the **last 5 years** are not eligible to roll over.
- The beneficiary must have **earned income** at least equal to the rollover amount for the year.
- The rollover is not subject to the usual Roth IRA income limits.

Non-Qualified Distributions — Tax Consequences

Non-Qualified Distributions — Two Hits

When a 529 distribution exceeds qualified expenses or is used for a non-qualified purpose, the **earnings portion** of the excess distribution is:

- Included in the recipient's **gross income** at ordinary income rates.
- Subject to an additional **10% penalty tax** on the earnings portion.

The return of contributions, or basis portion, is always tax- and penalty-free. Form 1099-Q reports all distributions; the recipient must track qualified vs. non-qualified use.

No Double Dipping — Education Credits & 529 Distributions

[Image: No double dipping with education credits and 529 distributions]

Coordination Rule — No Double Benefit on Same Expenses

The same qualified education expenses **cannot** be used to justify both a tax-free 529 distribution **and** an education tax credit in the same year. Taxpayers must allocate expenses — expenses used to support the education credit must be **reduced** from the amount counted as qualified expenses for 529 purposes.

Strategy: If the AOTC provides a $2,500 credit, the taxpayer should ensure $4,000 of tuition is allocated to the credit. The remaining tuition and other qualified expenses can then be covered by tax-free 529 distributions.

Worked Example — Coordination with AOTC

Sofia is a college freshman. Tuition and fees: **$22,000**. Room and board: **$10,000**. Her parents claim the American Opportunity Credit and have a 529 plan.

Total qualified expenses available	$32,000
Allocated to AOTC	($4,000)
Remaining expenses eligible for 529 distribution	$28,000

Tax-free 529 distribution allowed	$28,000

The family receives the $2,500 AOTC credit **and** $28,000 in tax-free 529 distributions by properly allocating expenses and avoiding double dipping on the same $4,000.

529 Plan — TY2026 Quick Reference

Item	TY2026 Rule
Annual K–12 / limited-use limit	$20,000 per beneficiary per year under OBBBA §70413
Postsecondary credentialing	Now a qualified expense under OBBBA §70414
Higher education distributions	No annual dollar cap — limited by actual qualified expenses
529 to Roth IRA rollover	Up to annual Roth IRA contribution limit; $35,000 lifetime cap; 15-year account age required
Non-qualified distribution — earnings	Ordinary income plus 10% penalty on earnings portion
Education credit coordination	Same expenses cannot support both a tax-free 529 distribution and an education credit
Form 1099-Q	Issued by plan administrator for all distributions; recipient tracks qualified use
IRC authority	IRC §529; OBBBA §70413; OBBBA §70414

1.13 — Trump Accounts (MAGA Savings Accounts) for TY2026

Key Account Features

Feature	**TY2026 Rule**
Eligible beneficiaries	U.S. citizen children; account established for a child at or after birth
Federal seed contribution	$1,000 one-time federal contribution for children born January 1, 2025 – December 31, 2028
Annual contribution limit	$5,000 per year per child (individuals); employer contributions also permitted
Who may contribute	Parents, grandparents, other individuals, and employers
Tax treatment of contributions	After-tax (non-deductible) — similar to a Roth account structure
Tax treatment of growth	Tax-deferred while in the account
Qualified distributions	Tax-free when used for qualified purposes (education, first home purchase, business startup) after age 18
Non-qualified	Earnings includible in gross income plus 10% additional tax

Feature	TY2026 Rule
distributions	
Investments permitted	Index funds tracking broad U.S. stock market indices (investment options are limited under the statute)
Access to funds	No withdrawals until age 18 (except qualified disability distributions)
Form to establish	Form 4547 (new) — filed to establish and register the account
W-2 reporting	Employer contributions reported in Box 12, Code TA on the 2026 W-2

The $1,000 Federal Seed Contribution

Scan for IRS Trump Account Information

Trump Accounts give the next generation a jump start on saving.

New Savings Program

$1,000 Federal Seed Contribution

Federal Contribution for Newborn Children

The federal government contributes **$1,000** to a Trump Account established for every U.S. citizen child born between **January 1, 2025** and **December 31, 2028**. The contribution is available regardless of family income.

Practitioner Tip: Ask every client with a newborn child whether a Trump Account has been established. The filing window for birth-year accounts is limited, and delaying Form 4547 could jeopardize receipt of the federal seed contribution.

Qualified Uses for Tax-Free Distribution

Trump Accounts

Qualified Uses for Tax-Free Distribution

Higher Education

Tuition, fees, books, and room and board at eligible educational institutions may qualify for tax-free distributions.

First Home Purchase

Funds may be used for the down payment and closing costs on a first principal residence.

Starting a Business

Qualified startup costs, as defined under OBBBA regulations, may be eligible for tax-free distributions.

Roth IRA Rollover

After age 18, the account may be rolled over to a Roth IRA, subject to annual contribution limits.

Worked Example — Sophia

Sophia is born in March 2026. Her parents file **Form 4547** to establish a Trump Account. The federal government deposits **$1,000**, and her grandparents contribute **$5,000** in 2026. Her total account value at the end of 2026 is **$6,000**.

If the $6,000 grows at a 7% average annual return for 18 years, the account would grow to approximately **$20,500**, available tax-free for qualified purposes.

Tax Treatment: Contributions are made with after-tax dollars, and the federal seed contribution is not income to the parents. Properly used qualified distributions may be received tax-free.

Employer Contributions — Box 12, Code TA

[Image: Form W-2 Box 12 Code TA]

Form W-2 — Box 12 Code TA

Trump Accounts

Employer Contributions — Box 12 Code TA

New Employee Benefit

Employers may contribute to employee Trump Accounts. Contributions are reported on Form W-2 using **Box 12 Code TA**. Qualified employer contributions are excluded from employee gross income up to the annual limit and may become a valuable recruiting and retention tool.

Common Red Flags

Missing Form 4547

The federal $1,000 seed contribution is not automatic. Failure to establish the account may result in losing the contribution.

Confusing Trump Accounts with 529 Plans

Trump Accounts and 529 plans have different contribution limits, investment rules, and qualified uses.

Excess Contributions

Contributions exceeding the $5,000 annual limit may be subject to a **6% excise tax** similar to excess IRA contributions.

1.14 Health Savings Accounts

TY2026 HSA Contribution Limits

Coverage Type	TY2026 Limit	TY2025 Limit	Change
Self-only HDHP coverage	$4,400	$4,300	+$100
Family HDHP coverage	$8,750	$8,550	+$200
Catch-up contribution (age 55+)	$1,000	$1,000	No change

TY2026 HDHP Thresholds

HDHP Requirement	Self-Only	Family
	$1,650	$3,300
Maximum annual out-of-pocket	$8,300	$16,600

Health Savings Accounts

OBBBA Expansion — Who Can Now Contribute to an HSA

Expanded HSA Eligibility Beginning TY2026

Beginning in TY2026, some taxpayers who were previously blocked from HSA contributions may now qualify. The key rule is simple: the taxpayer still needs a **qualifying High Deductible Health Plan (HDHP)**, but certain added arrangements — such as Direct Primary Care or a qualifying health care sharing ministry — no longer automatically disqualify them.

Easy AFTR Rule

Coverage Situation	HSA Result
Qualifying HDHP only	HSA allowed if all other requirements are met
Qualifying HDHP + DPC	HSA allowed
Qualifying HDHP + health care sharing ministry	HSA may be allowed
DPC only, no qualifying HDHP	Not HSA eligible

Practitioner Tip: Do not tell clients that DPC alone creates HSA eligibility. The easy rule is: **qualifying HDHP + DPC = HSA allowed.** Review clients who have an eligible HDHP and also pay for Direct Primary Care or belong to a qualifying health care sharing ministry.

OBBBA Expansion — Who Can Now Contribute to an HSA

The Triple Tax Benefit

Tax Event	Tax Treatment
Contributions made	Tax-deductible above-the-line on Schedule 1 (Form 8889)

Tax Event	Tax Treatment
Investment growth inside the account	Tax-deferred — no tax on interest, dividends, or capital gains while in the account
Distributions for qualified medical expenses	Tax-free — no income tax when used for qualified medical expenses
Non-qualified distributions (age under 65)	Includible in gross income plus 20% additional tax
Non-qualified distributions (age 65+)	Includible in gross income only — no 20% additional tax (acts like a traditional IRA)

Qualified Medical Expenses

Health Savings Accounts

Qualified Medical Expenses

Same Definition as IRC §213(d)

HSA distributions are tax-free when used for qualified medical expenses under **IRC §213(d)**. This is the same definition used for the medical expense deduction and includes many common health care costs.

Common Non-Qualified Expenses

Cosmetic procedures, gym memberships, health club dues, and similar personal expenses generally do not qualify unless specifically prescribed as treatment for a diagnosed medical condition.

Worked Example — Family HSA Maximum

Tom and Linda (both under age 55) are covered by a family HDHP.

Tom contributes: **$6,000** through payroll deductions.

Linda contributes: **$2,750** directly to her HSA.

Combined contribution: **$8,750**

This equals the TY2026 family HSA contribution limit.

Triple Tax Benefit: Qualified HSA contributions are deductible, earnings grow tax-free, and distributions used for qualified medical expenses are also tax-free.

Catch-Up Contributions — Age 55 and Older

[Image: W-2 Box 12 Code W]

Form W-2 — Box 12 Code W

Health Savings Accounts

Catch-Up Contributions — Age 55 and Older

Additional $1,000 Catch-Up Contribution

Taxpayers who are **age 55 or older by December 31, 2026** may contribute an additional **$1,000** catch-up contribution beyond the standard HSA limit. If both spouses are 55 or older, both may make catch-up contributions, but each spouse must have a separate HSA.

Age 55 by Year-End

The taxpayer must be age **55 or older by December 31, 2026** to make the additional catch-up contribution.

Each Spouse Needs Own HSA

A single HSA cannot receive more than one person's catch-up contribution. If both spouses are 55+, each spouse must contribute the catch-up amount to their own separate HSA.

Check W-2 Box 12 Code W

Employer HSA contributions are excluded from wages and reduce the employee's remaining deductible HSA contribution limit. Missing Code W can cause excess contribution errors.

Contributions Until April 15

TY2026 HSA contributions may be made up to **April 15, 2027**, without extension. This creates a planning opportunity for clients who did not maximize during the year.

Last-Month Rule

If an individual is HSA-eligible on December 1, they may contribute the full annual amount, but they must remain eligible through the following December 31 testing period.

Medicare Stops HSA Contributions

Once a taxpayer enrolls in Medicare, they may no longer contribute to an HSA. Retroactive Medicare Part A enrollment can create unexpected excess contribution issues.

Common Red Flags

Medicare Enrollment

Contributing to an HSA while enrolled in Medicare is a common error for clients turning 65.

Missing Code W

Always reduce the taxpayer's remaining contribution limit by employer contributions shown in W-2 Box 12, Code W.

Non-Qualified Distributions

Non-qualified HSA distributions before age 65 are subject to income tax plus a **20% penalty**.

Spousal Catch-Up Error

Both spouses cannot put their catch-up contributions into the same HSA. Each spouse must use their own HSA.

2.1 Filing Status Review

Lesson at a Glance

Form 1040 Fundamentals

Filing Status Drives the Return

The Most Consequential Box on the Return

Filing status determines the standard deduction amount, tax bracket thresholds, eligibility for many credits, and the gross income limit for a qualifying relative. Selecting the most favorable status for which the client actually qualifies is one of the highest-value services a practitioner can provide.

Five Filing Statuses

There are five filing statuses: **Single**, **Married Filing Jointly**, **Married Filing Separately**, **Head of Household**, and **Qualifying Surviving Spouse**.

Standard Deduction & Brackets

Filing status controls the standard deduction and tax bracket thresholds. Choosing the wrong status can change taxable income and tax liability throughout the return.

Qualifying Relative Limit

For TY2025, the gross income limit for a qualifying relative is **$5,300** under Rev. Proc. 2025-32(.23).

Practitioner Value

The goal is not simply to choose a status that seems convenient. The practitioner must select the most favorable filing status the client legally qualifies to use.

Exam Tip: Filing status affects more than the standard deduction. It can change tax brackets, credit eligibility, dependency outcomes, and the gross income test for qualifying relatives.

The Five Filing Statuses

Form 1040 Fundamentals

The Five Filing Statuses

Single

A taxpayer is Single if they are unmarried (or legally separated under a final decree) on December 31 and do not qualify for Head of Household or Qualifying Surviving Spouse status.

Single is the **default fallback status**. Any taxpayer who does not qualify for a more favorable filing status files as Single.

Married Filing Jointly (MFJ)

Available to legally married couples, including same-sex married couples recognized under Obergefell v. Hodges.

A couple may also file jointly in the year one spouse dies.

MFJ usually produces the most favorable result because of wider tax brackets and a larger standard deduction.

Married Filing Separately (MFS)

MFS generally carries the least favorable tax treatment.

Many credits are reduced or eliminated, including:
• Earned Income Credit
• Education Credits
• Child & Dependent Care Credit
• Premium Tax Credit

If one spouse itemizes, both spouses must itemize.

Head of Household (HoH)

Available to unmarried taxpayers (or taxpayers treated as unmarried) who:

• Pay more than half the cost of maintaining a home
• Have a qualifying person
• Meet residency requirements

HoH provides a larger standard deduction and more favorable tax brackets than Single.

Qualifying Surviving Spouse (QSS)
Formerly Qualifying Widow(er)

Provides the same tax brackets and standard deduction as MFJ.

Available for the two tax years following the year a spouse dies if the taxpayer:

• Has not remarried

• Maintains a home for a dependent child
• Pays more than half the household costs

MFS May Still Be Beneficial: Despite its disadvantages, MFS can help clients with high medical expenses, taxpayers seeking separate liability from a spouse, or borrowers on income-driven student loan repayment plans where a lower AGI may reduce monthly payments.

Common Exam Trap

Many taxpayers who qualify for Head of Household incorrectly file as Single. Always test for Head of Household and Qualifying Surviving Spouse before defaulting to Single status.

Key HoH requirements:

Filing Status Rules

Head of Household & Qualifying Surviving Spouse

Head of Household Requirements

Unmarried

Taxpayer must be unmarried on December 31 or qualify as a taxpayer treated as unmarried under the abandoned spouse rules.

More Than Half

Must pay more than half the cost of maintaining the home, including rent, mortgage interest, utilities, repairs, and insurance.

Qualifying Child

A qualifying child generally must live in the taxpayer's home for more than half the year.

Parent Exception

A qualifying parent does not need to live with the taxpayer if the taxpayer pays more than half the cost of the parent's principal residence.

Qualifying Surviving Spouse (QSS)

Same Benefits as MFJ

Qualifying Surviving Spouse provides the same standard deduction and tax brackets as Married Filing Jointly. It is available for the two tax years following the year of a spouse's death if all eligibility requirements are met.

No Remarriage

Taxpayer must not have remarried by December 31 of the current tax year.

Dependent Child

Must have a qualifying child who lived in the taxpayer's home all year.

Home Costs

Taxpayer must pay more than half the cost of maintaining the household.

Prior MFJ Eligibility

Taxpayer must have been eligible to file MFJ in the year the spouse died.

Timeline Rule: In the year of death, the surviving spouse may file Married Filing Jointly with the deceased spouse. QSS status is then available for the next two tax years if eligibility requirements continue to be met. After that period, the taxpayer generally files as Single or Head of Household if qualified.

Common Exam Trap

Many students incorrectly believe a qualifying parent must live with the taxpayer to qualify for Head of Household. The parent residency requirement is waived if the taxpayer pays more than half the cost of maintaining the parent's principal residence.

Qualifying Relative — Gross Income Limitation

Dependency Rules

Qualifying Relative — Gross Income Limitation

$5,050 Gross Income Limit for TY2025

A qualifying relative is one of the dependency categories used throughout Form 1040 preparation and directly affects filing status determinations, especially Head of Household. For TY2025, Rev. Proc. 2025-32(.23) sets the qualifying relative gross income limit at **$5,050**.

Four Tests for a Qualifying Relative

Test #1

Not a Qualifying Child

The person cannot be anyone's qualifying child for the tax year.

Test #2

Relationship Test

The person must either live with the taxpayer all year or be a qualifying relative by relationship.

Test #3

Gross Income Test

Gross income must be less than **$5,050 for TY2025**. This amount is indexed annually and should always be verified for the current tax year.

Test #4

Support Test

The taxpayer must provide more than half of the person's total support during the year.

Common Qualifying Relative Relationships

Child • Parent • Grandparent • Brother • Sister • Aunt • Uncle • Niece • Nephew • Mother-in-Law • Father-in-Law • Brother-in-Law • Sister-in-Law • Stepchild • Stepparent • Stepsibling

Practitioner Tip: Most dependency errors occur because preparers focus only on the relationship test and forget the gross income and support tests. Always verify all four tests before claiming a qualifying relative.

Common Exam Trap

A parent may qualify as a dependent even if the parent does not live with the taxpayer. Students often incorrectly assume all qualifying relatives must live in the taxpayer's home.

Tax Year	Qualifying Relative Gross Income Limit	Authority
2023	$4,700	Rev. Proc. 2022-38
2024	$5,050	Rev. Proc. 2023-34
2025	$5,050	Rev. Proc. 2025-32(.23)

Filing Status Comparison — Tax Year 2025

Filing Status	2025 Standard Deduction	EITC Eligible?	Key Requirement
Single	$15,000	Yes (no qualifying child version)	Unmarried or legally separated on Dec. 31
Married Filing Jointly	$30,000	Yes	Legally married as of Dec. 31
Married Filing Separately	$15,000	No	Legally married; both must itemize or both take standard deduction
Head of Household	$22,500	Yes	Unmarried; paid > 50% home costs; qualifying person resided in home > 6 months
Qualifying Surviving Spouse	$30,000	Yes	Spouse died in prior 2 years; dependent child in home; not remarried

Worked Examples

Filing Status Applications

Worked Examples

Example 1 — Head of Household

Maria is unmarried and has an 8-year-old daughter who lived with her all year.

Maria paid all household costs including rent and utilities.

The child's father claims the child under a written agreement.

Result

Maria qualifies for **Head of Household**.

Releasing the dependency claim to the noncustodial parent does not transfer Head of Household status.

Dependency and HoH are determined separately.

Example 2 — Qualifying Relative

Tom supports his 22-year-old brother James.

James earned $4,800 during 2025.

Tom provided 70% of James's support.

Result

James passes the gross income test because **$4,800 is below the $5,050 limit**.

Tom also passes the support test.

James qualifies as Tom's dependent and may support a Head of Household claim if all other requirements are met.

Example 3 — Qualifying Surviving Spouse

Sandra's husband died in 2023.

Sandra has a 10-year-old son who lived with her all year.

Sandra has not remarried.

Current year: 2025.

Result

Sandra qualifies for **Qualifying Surviving Spouse** in 2024 and 2025.

QSS provides the same tax brackets and standard deduction as MFJ.

Beginning in 2026, she must qualify for Head of Household or file Single.

Example 4 — MFS May Be Better

Kevin earns $120,000.

Lisa earns $28,000 and has $22,000 of medical expenses.

Joint AGI = $148,000.

Result

Filing separately increases Lisa's deductible medical expenses because the 7.5% AGI threshold is based on her separate AGI.

Practitioners should always compare MFJ and MFS before making a recommendation.

Example 5 — Abandoned Spouse

Patricia is legally married.

Her husband moved out in March.

Their daughter lived with Patricia all year.

Patricia paid all home costs.

Result

Patricia qualifies under the **abandoned spouse rule**.

She may file as Head of Household because:
• She files separately
• Paid more than half the home costs
• Spouse was absent during the last 6 months of the year
• Her qualifying child lived with her all year

2.2 Taxability of earnings (such as wages, salaries, tips)

[Image: Taxability of Earnings TY2026]

Lesson 2.2 — Taxability of Earnings · TY2026

Wages, salaries, and tips are all **includible in gross income** under IRC §61 unless a specific exclusion applies. Form W-2 reports compensation paid by employers. Employees who receive tips must report all tips to their employer and on their return — unreported tips require **Form 4137** to compute the Social Security and Medicare tax owed.

IRC §61 Gross Income Authority

Form W-2 Wage Reporting

$20 / Month Tip Reporting Threshold

Form 4137 Unreported Tip Tax

Jan 31 W-2 Due to Employee

What Is Includible in Gross Income — IRC §61

IRC §61 defines gross income as **all income from whatever source derived** unless a specific exclusion applies. For employees, this means the full value of all compensation received — in cash, property, or services — is taxable.

Wages & Salaries

Fully taxable

All regular pay, overtime, bonuses, commissions, and severance pay — reported in W-2 Box 1

Tips & Gratuities

All tips taxable

Cash tips, charged tips, tip pooling shares — all gross income regardless of amount

Fringe Benefits

Taxable unless excluded

Non-cash compensation included in Box 1 unless a statutory exclusion applies — IRC §132

Back Pay & Awards

Fully taxable

Back pay, settlement awards for lost wages, employee achievement awards over statutory limits

Form W-2 — Wage and Tax Statement

Employers must furnish Form W-2 to each employee by **January 31, 2027** for TY2026. The form reports wages paid and taxes withheld and is filed with the Social Security Administration (SSA). Employees use it to prepare their Form 1040.

Form W-2 — Key Boxes Explained

Box	What It Reports	Where on Form 1040
Box 1	Wages, tips, other compensation (total taxable wages)	Form 1040, Line 1a
Box 2	Federal income tax withheld	Form 1040, Line 25a
Box 3	Social Security wages (capped at SS wage base)	Used for SS tax computation
Box 4	Social Security tax withheld (6.2%)	Schedule 3 — excess SS credit if over-withheld
Box 5	Medicare wages and tips (no cap)	Used for Medicare / NIIT computation
Box 6	Medicare tax withheld (1.45%)	Form 1040, Line 25a
Box 7	Social Security tips	Included in SS wage base — Box 3 + Box 7
Box 8	Allocated tips (large food/beverage employer)	Form 1040, Line 1b — taxable unless employee proves actual tips less
Box 12	Various codes — 401(k) deferrals (D), HSA contributions (W), dependent care (E), moving reimbursements (P), etc.	Varies by code — reduces Box 1 or flows to specific lines
Box 14	Other items — state SDI, union dues, employer-paid PFML premiums, educational assistance	Informational — may affect Schedule A or other deductions

Form W-2 Due Dates — TY2026

Recipient	Due Date	Filed With
Employee (Copy B, C, 2)	January 31, 2027	Furnished to employee
SSA (Copy A) — paper	January 31, 2027	Social Security Administration with Form W-3
SSA — electronic (250+ W-2s)	January 31, 2027	SSA Business Services Online

Tip Income — Reporting Rules

All tip income is taxable under IRC §61 regardless of the amount. However, the reporting obligations — to the employer and to the IRS — differ based on the amount received and the type of tip.

Cash Tips

- Received directly from customers
- Must report to employer if **$20 or more** in a calendar month
- Report by the **10th day** of the following month
- Use **Form 4070** or employer-provided form
- Included in employer's payroll tax withholding

Charged Tips

- Added to credit/debit card payments
- Employer collects and distributes to employees
- Reported by employer in **W-2 Box 1** and **Box 7**
- Subject to regular income and payroll tax withholding
- Employer may deduct card processing fees from tips

Allocated Tips

- Apply to large food/beverage establishments
- Employer allocates tips if reported tips are less than **8% of gross receipts**
- Shown in **W-2 Box 8** — not included in Box 1
- Taxable — employee includes in income on Form 1040, Line 1b
- Employee may prove actual tips were less — use **Form 4137**

Tip Reporting — Under $20 Rule

If an employee receives less than **$20 in tips in a calendar month from a single employer**, they are not required to report those tips to the employer. However, the tips are still **taxable income** and must be reported on the employee's own tax return. The $20 threshold affects only the employer-reporting obligation — not the taxability of the tips.

Form 4137 — Social Security & Medicare Tax on Unreported Tips

When an employee does not report tips to their employer — or when allocated tips from W-2 Box 8 are included in income — the employee must use **Form 4137** to compute and pay the employee share of Social Security (6.2%) and Medicare (1.45%) taxes on those unreported tips. The employer's share is not owed by the employee.

Item	Detail
Form used	Form 4137 — Social Security and Medicare Tax on Unreported Tip Income
Flows to	Schedule 2, Line 5 — added to total tax on Form 1040
Rates applied	Employee share only — 6.2% SS + 1.45% Medicare = 7.65% on unreported tips
Deductibility of SS tax paid	One-half of self-employment taxes do not apply here — but the unreported tip amount increases Box 1 wages and may affect earned income calculations
Employer	The IRS notifies the employer of unreported tips so the employer can

Item	Detail
notification	collect its share of FICA — the employee is not responsible for the employer's 6.2% and 1.45%
Also use for	Allocated tips from W-2 Box 8 that the employee is including in income but for which no FICA was withheld

Worked Example — Unreported Tips

Sofia works as a server. During TY2026 she received **$4,800 in cash tips** that she did not report to her employer. Her W-2 Box 1 does not include these tips.

Unreported tips	$4,800
Added to Form 1040, Line 1 (total wages + tips)	+$4,800 taxable
SS tax on Form 4137: $4,800 × 6.2%	$297.60
Medicare tax on Form 4137: $4,800 × 1.45%	$69.60
Total FICA tax on Form 4137 — flows to Schedule 2, Line 5	$367.20

Sofia also owes regular income tax on the $4,800 at her marginal rate — the Form 4137 covers only the FICA portion.

Special Wage Items — Taxable vs. Excludable

Item	Treatment	W-2 Reporting
Bonuses & commissions	Fully taxable	Included in Box 1
Severance pay	Fully taxable	Included in Box 1
Group term life insurance over $50,000	Excess taxable	Box 1 + Box 12, Code C
Health insurance premiums (employer-paid)	Excluded — IRC §106	Not in Box 1
401(k) / 403(b) deferrals	Excluded from Box 1	Box 12, Code D — included in Box 3 & 5
Dependent care FSA (up to $5,000)	Excluded — IRC §129	Box 10 and Box 12, Code E
Employee achievement awards	Excluded up to $400 / $1,600	Excess over limit in Box 1
Sick pay (employer-paid)	Fully taxable	Box 1; third-party sick pay in Box 12, Code J

Constructive Receipt Doctrine

Under the **constructive receipt doctrine** (Treas. Reg. §1.451-2), income is taxable in the year it is made available to the taxpayer — even if not actually received. A paycheck issued on December 31, 2026 is taxable in TY2026 even if the employee does not cash it until

January 2027. Similarly, year-end bonuses credited to an employee's account are taxable when credited, not when withdrawn.

Tip Reporting Requirements

[Image: Tip Reporting on Form W-2]

Tip Reporting — Form W-2 and Form 4137

Employee Tip Income

Tip Reporting Requirements

$20 Monthly Tip Reporting Threshold

An employee who receives **$20 or more in tips** during any calendar month must report those tips to the employer by the **10th day of the following month**. The employer includes reported tips in Boxes 1, 5, and 7 of the Form W-2 and withholds the appropriate taxes.

Practitioner Tip: Always ask service-industry clients whether all tips were reported to their employer. If cash tips were omitted from payroll reporting, Form 4137 is required to report the income and calculate the employee's Social Security and Medicare tax.

Worked Examples

Wages, Tips, and Fringe Benefits

Worked Examples

Example 1 — Unreported Tips

Carlos is a restaurant server. His W-2 Box 1 shows **$28,000**, including **$8,000** in reported tips.

Carlos discloses he received an additional **$3,200** in cash tips that were never reported to his employer.

Action Required

Add **$3,200** to gross income on Form 1040 Line 1.

Form 4137 computes:
SS tax: **6.2% × $3,200 = $198.40**
Medicare tax: **1.45% × $3,200 = $46.40**

Total additional employment tax: **$244.80**, plus income tax at Carlos's marginal rate.

Example 2 — Allocated Tips

Sandra's W-2 shows:

Box 1 wages: **$22,000**
Box 7 Social Security tips: **$1,500**
Box 8 allocated tips: **$900**

Sandra did not keep a tip diary.

Result

Without tip diary records, Sandra cannot prove actual tips were lower.

The **$900** Box 8 allocated tip amount is taxable.

Sandra uses Form 4137 to compute Social Security and Medicare tax on the **$900**.

Example 3 — Transportation Fringe

In TY2026, an employer provides an employee with **$400 per month** in transit passes.

Result

Excluded amount: **$340/month**

Taxable excess: **$60/month**

Annual taxable amount: **$720**

The $720 excess must appear in Box 1 wages on Form W-2.

Example 4 — Moving Expense Reimbursement

A civilian employee receives an **$8,000** moving expense reimbursement in 2026.

An active-duty military member also receives an **$8,000** moving reimbursement.

Result

The civilian employee's reimbursement is fully taxable and included in Box 1 wages.

The active-duty military member's reimbursement is excluded from income.

The same exclusion also extends to qualifying members of the intelligence community under OBBBA §70113.

Example 5 — Non-Cash Tip

A hotel guest leaves a **$150 gift card** as a tip for a housekeeper.

The housekeeper does not report it to the employer.

Result

The **$150 fair market value** is taxable tip income.

It must be added to gross income and reported on Form 4137 as unreported tip income because it was not disclosed to the employer.

2.3 Interest, dividends, foreign accounts and trusts

Lesson at a Glance

[Image: money-bill-trend-up.svg]

Schedule B Reporting Rules

Interest & Dividend Income

```
Interest and dividend income must be reported by every taxpayer who receives them. Schedule B becomes required when reporting thresholds are exceeded or when foreign financial accounts or trusts are involved.
```

[Image: percent.svg]

Interest Income

```
Taxable interest is generally reported on Form 1099-INT. Schedule B is required when taxable interest exceeds $1,500.
```

[Image: chart-line.svg]

Dividend Income

```
Dividends are reported on Form 1099-DIV. Schedule B is required when ordinary dividends exceed $1,500.
```

[Image: scale-balanced.svg]

Qualified Dividends

```
Qualified dividends receive preferential long-term capital gains tax rates of 0%, 15%, or 20%
```

[Image: building-columns.svg]

Tax-Exempt Interest

Tax-exempt interest must still be entered on the return because it affects Social Security taxation and certain credit calculations.

[Image: triangle-exclamation.svg]

Foreign Financial Accounts & FBAR

Taxpayers with foreign financial accounts exceeding $10,000 may have a separate FBAR filing requirement. Schedule B also asks direct questions regarding foreign accounts and foreign trusts.

[Image: Learning_objective.svg]

Practitioner Reminder

Tax-exempt interest is not ignored on the return. Even though it is excluded from federal taxable income, it still affects multiple downstream tax calculations and disclosure requirements.

Interest Income — Form 1099-INT

Form 1099-INT

Interest Income

General Rule

All interest income is taxable unless a specific exclusion applies. Most taxable interest is reported to the taxpayer on **Form 1099-INT** and reported on Form 1040.

Common Taxable Sources of Interest

Bank Accounts

Savings accounts, checking accounts, CDs, and money market accounts.

Corporate Bonds

Interest from corporate debt obligations is fully taxable.

U.S. Treasury Interest

Federally taxable but generally exempt from state and local income tax.

Original Issue Discount

OID is taxable annually even if the taxpayer receives no cash during the year.

Additional Taxable Interest Sources

- Interest paid on federal or state income tax refunds
- Interest on insurance proceeds held by the insurer
- Interest from private notes and loans
- Interest from installment sales

Tax-Exempt Municipal Bond Interest

Reported But Not Taxed

Interest from state and municipal bonds is generally excluded from federal taxable income.

However, it is **not omitted from the tax return**.

Tax-exempt interest is reported on **Form 1040 Line 2a**.

Social Security Taxation

Tax-exempt interest is included in the **provisional income formula** used to determine whether Social Security benefits become taxable under IRC §86.

Credit Phaseouts

Tax-exempt interest is included in various Modified AGI calculations used for credit eligibility and phaseout determinations.

Common Exam Trap

Students often think municipal bond interest is ignored because it is tax-exempt. That is incorrect. Tax-exempt interest must still be reported on Form 1040 Line 2a and can affect Social Security taxation and numerous income-based calculations.

Practitioner Tip: When a retired client owns municipal bonds and receives Social Security benefits, always include tax-exempt interest in your Social Security worksheet calculations. Many taxpayers assume tax-free means it has no effect elsewhere on the return.

Tax-exempt is not "ignored":

Every practitioner must enter tax-exempt interest on Line 2a of Form 1040 even though it does not enter taxable income. Omitting it causes an incorrect Social Security taxability calculation and can affect credit eligibility.

Key Form 1099-INT Boxes

Box	Contents	Where Reported on Return
Box 1	Interest income	Schedule B Part I; Form 1040 Line 2b
Box 3	U.S. Savings Bond / Treasury interest	Schedule B; state tax exempt — enter as subtraction on state return

Box	Contents	Where Reported on Return
Box 4	Federal income tax withheld (backup withholding)	Credit on Form 1040 — not income
Box 8	Tax-exempt interest	Form 1040 Line 2a; not in taxable income
Box 11	Bond premium	Election to amortize reduces taxable interest
Box 13	Bond premium on tax-exempt bond	Reduces tax-exempt interest amount

Dividend Income — Form 1099-DIV

Form 1099-DIV

Dividend Income

Every Dividend Starts as an Ordinary Dividend

All dividends begin as **ordinary dividends** and are reported in **Box 1a of Form 1099-DIV**. Ordinary dividends are generally taxed at ordinary income tax rates unless they qualify for preferential treatment.

Ordinary Dividends

Reported in **Box 1a**.

Taxed at the taxpayer's ordinary income tax rates.

All dividends are initially classified as ordinary dividends.

Qualified Dividends

Reported in **Box 1b**.

Eligible for the preferential long-term capital gain tax rates of:
• 0%
• 15%
• 20%

Requirements for Qualified Dividend Treatment

Requirement #1

Qualified Corporation

Dividend must be paid by a U.S. corporation or a qualifying foreign corporation.

Requirement #2

Holding Period

Stock must be held for more than 60 days during the 121-day period surrounding the ex-dividend date.

Requirement #3

Not an Excluded Source

Dividends from money market funds, tax-exempt organizations, and certain other excluded entities generally do not qualify.

Common Exam Trap

Students frequently add Box 1a and Box 1b together when calculating dividend income. This is incorrect. Box 1b is already included within Box 1a and merely identifies the portion eligible for reduced tax rates.

Box	Contents	Tax Treatment
Box 1a	Total ordinary dividends	Ordinary income; Schedule B Part II
Box 1b	Qualified dividends	0%/15%/20% rates per Rev. Proc. 2025-32(.03); Form 1040 Line 3a
Box 2a	Total capital gain distributions	Long-term; Schedule D or Form 1040 Line 7 if Sch D not otherwise required
Box 3	Non-dividend distributions (return of capital)	Reduces basis; not currently taxable
Box 4	Federal income tax withheld	Credit against tax — not income
Box 5	Section 199A dividends (REIT/PTP)	May qualify for QBI deduction; pull to Form 8995 per Rev. Proc. 2025-32(.26)
Box 12	Exempt-interest dividends	Tax-exempt; still enters provisional income for SS

Schedule B — When Required for TY2026

Form 1040 Attachment

When Is Schedule B Required?

Schedule B Is More Than an Interest Schedule

Many preparers think Schedule B is required only when interest or dividend income exceeds certain thresholds. While that is true, Schedule B is also triggered by foreign accounts, foreign trusts, and certain seller-financed mortgages.

Trigger #1

Interest Income

Schedule B is required when taxable interest income exceeds **$1,500**.

Trigger #2

Dividend Income

Schedule B is required when ordinary dividend income exceeds **$1,500**.

Trigger #3

Foreign Accounts

The taxpayer had a financial interest in or signature authority over a foreign financial account and must answer Schedule B Part III, Line 7a.

Trigger #4

Foreign Trusts

The taxpayer received a distribution from, or was a grantor of, a foreign trust and must answer Schedule B Part III, Line 8.

Additional Trigger — Seller-Financed Mortgage

Schedule B is also required when the taxpayer received interest from a seller-financed mortgage and the buyer used the property as a personal residence. The IRS requires disclosure of the buyer's identifying information on Schedule B.

Common Exam Trap

Students often believe Schedule B is required only when interest or dividends exceed $1,500. Foreign accounts, foreign trusts, and seller-financed mortgage interest can require Schedule B even when interest and dividends are minimal.

Part III of Schedule B is required regardless of income amounts

whenever the taxpayer had any foreign account. Check this box even if the account produced zero income. Failure to check Part III is a separate compliance violation from FBAR non-filing.

Foreign Accounts — FBAR and FATCA

International Reporting

Foreign Accounts — FBAR and FATCA

Two Different Reporting Systems

Taxpayers with foreign financial accounts may have reporting obligations under both the **FBAR rules** and the **FATCA rules**. These are separate filings with different thresholds, forms, and filing locations.

FBAR (FinCEN Form 114)

Filed With: FinCEN (not the IRS)

Due Date: April 15
Automatic extension to October 15

Threshold: Aggregate value of all foreign financial accounts exceeded **$10,000** at any time during the year.

Examples: Foreign bank accounts, brokerage accounts, foreign mutual funds, and certain foreign retirement accounts.

FATCA (Form 8938)

Filed With: IRS
Attached to Form 1040

Purpose: Reports specified foreign financial assets.

Threshold: Based on filing status and whether the taxpayer lives in the United States or abroad.

FATCA thresholds are generally much higher than FBAR thresholds.

Common FATCA Thresholds (Form 8938)

Single (U.S.)

More than **$50,000** at year-end

OR

More than **$75,000** at any time during the year.

MFJ (U.S.)

More than **$100,000** at year-end

OR

More than **$150,000** at any time during the year.

Living Abroad

Higher FATCA thresholds apply to taxpayers who qualify as foreign residents.

Severe FBAR Penalties

Willful failure to file an FBAR can result in penalties of the greater of:

$100,000 OR
50% of the account balance per violation.

International reporting penalties are among the most severe penalties in the Internal Revenue Code system.

Common Exam Trap

Students often confuse FBAR and FATCA reporting. FBAR uses a **$10,000 aggregate account threshold** and is filed electronically with FinCEN. FATCA uses much higher thresholds and is reported on **Form 8938 attached to the tax return**.

Filing Status / Location	Year-End Value	Any Time During Year
Single / MFS (U.S. resident)	>$50,000	>$75,000
MFJ (U.S. resident)	>$100,000	>$150,000
Single living abroad	>$200,000	>$300,000
MFJ living abroad	>$400,000	>$600,000

2.4 Reporting and taxability of retirement income (SS benefits, pensions, annuities, 401(k) dist)

Part 1 — Social Security Benefits

[Image: Social Security Benefits]

Form SSA-1099 — Social Security Benefit Reporting

Form SSA-1099

Social Security Benefits

Up to 85% May Be Taxable

Social Security benefits are reported on **Form SSA-1099**. Depending on the taxpayer's income, up to **85%** of Social Security benefits may become taxable.

The Social Security taxation thresholds have not been inflation-adjusted since 1984, causing more retirees to become subject to taxation each year as benefit amounts increase.

Combined Income (Provisional Income)

AGI (excluding Social Security)
+
Tax-Exempt Interest
+
50% of Social Security Benefits

Components of Combined Income

AGI (Excluding SS)

Includes wages, pensions, IRA distributions, interest, dividends, business income, and other taxable income.

Tax-Exempt Interest

Municipal bond interest is added back into the calculation even though it is not taxable.

50% of Benefits

One-half of the taxpayer's annual Social Security benefits is included in the combined income formula.

Why Municipal Bond Interest Matters

Many retirees believe municipal bond interest is completely ignored because it is tax-exempt. While it is not taxable itself, it is included in the combined income calculation and can cause Social Security benefits to become taxable.

Common Exam Trap

Students frequently assume Social Security benefits are either completely taxable or completely tax-free. The actual calculation depends on combined income, and tax-exempt municipal bond interest is included in that calculation even though it is not taxable income.

Practitioner Tip: Whenever a retired client receives Social Security benefits, review all Forms 1099-INT, 1099-DIV, 1099-R, and SSA-1099 together. Small increases in interest income, IRA withdrawals, or municipal bond interest can unexpectedly increase the taxable portion of Social Security benefits.

Filing Status	Combined Income	Taxable SS
Single / HoH / MFS	Under $25,000	$0 — no SS taxable
Single / HoH / MFS	$25,000 – $34,000	Up to 50% of SS benefits taxable
Single / HoH / MFS	Over $34,000	Up to 85% of SS benefits taxable
MFJ	Under $32,000	$0 — no SS taxable
MFJ	$32,000 – $44,000	Up to 50% of SS benefits taxable
MFJ	Over $44,000	Up to 85% of SS benefits taxable

Part 2 — Pensions and Annuities (Form 1099-R)
Form 1099-R Form 1040 (Line 5 a & b)

Form 1099-R

Pension and Annuity Income

Form 1099-R Reports Retirement Distributions

Pension and annuity income is reported on **Form 1099-R**. The taxable amount is generally reported in **Box 2a**.

If Box 2a is blank or marked **"Taxable Amount Not Determined"**, the preparer must calculate the taxable portion using either the **General Rule** or the **Simplified Method**.

General Rule

Generally applies to older annuities and certain nonqualified contracts.

Uses actuarial calculations to determine the tax-free return of investment.

Simplified Method

Applies to most qualified retirement plans, including pensions, 401(k)s, and 403(b)s that began after November 18, 1996.

Simplified Method — Three Steps

Step 1

Determine Basis

Divide the employee's investment in the contract (after-tax contributions) by the IRS life expectancy factor.

Step 2

Monthly Exclusion

The result becomes the tax-free portion of each pension or annuity payment.

Step 3

Taxable Portion

The remainder of each payment is taxable as ordinary income.

Recovery of Investment (Basis)

The Simplified Method allows taxpayers to recover their after-tax contributions tax-free over time.

Once the taxpayer has recovered their entire investment in the contract, all future pension or annuity payments become **100% taxable**.

When the Entire Distribution Is Taxable

If the taxpayer made **no after-tax contributions** to the plan, there is no basis to recover.

In that situation, the entire pension distribution is taxable as ordinary income.

This is common for:
• Employer-funded pension plans
• Most private pension plans
• Government pensions funded entirely with pre-tax contributions

Box 2a Shortcut

When the payer has correctly calculated the taxable amount, Box 2a will show the taxable portion of the distribution.

In many cases, the preparer simply transfers the Box 2a amount to the return.

Additional calculations are needed only when Box 2a is blank or marked as not determined.

Common Exam Trap

Students often assume every pension payment is fully taxable. If the employee made after-tax contributions to the plan, part of each payment may be a tax-free return of basis under the Simplified Method.

Part 3 — 401(k), 403(b), and Traditional IRA Distributions

Form 1099-R

Traditional Retirement Account Distributions

General Rule

Distributions from traditional **401(k)**, **403(b)**, and **traditional IRA** accounts are generally fully taxable as ordinary income.

These plans were funded with pre-tax contributions, and investment earnings grew tax-deferred while inside the account.

Why Are These Distributions Taxable?

Step 1

Pre-Tax Contributions

Contributions reduced taxable income when originally made.

Step 2

Tax-Deferred Growth

Interest, dividends, and gains accumulated without current taxation.

Step 3

Distribution

The entire amount becomes taxable when withdrawn unless an exception applies.

Common Taxable Retirement Accounts

Traditional IRA

Usually fully taxable when distributed because contributions were deducted.

Traditional 401(k)

Employee salary deferrals and employer contributions are generally fully taxable upon withdrawal.

Traditional 403(b)

Common for teachers, hospitals, and nonprofits. Generally taxable when distributed.

Reporting on Form 1099-R

Retirement plan distributions are reported on Form 1099-R.

In most situations:
• Box 1 shows the gross distribution
• Box 2a shows the taxable amount
• The taxable amount is reported as ordinary income on Form 1040

Important Exception

Some retirement plans contain after-tax employee contributions. In those situations, part of the distribution may represent a tax-free recovery of basis.

The Simplified Method or Form 8606 may be required to determine the taxable portion.

Common Exam Trap

Students often confuse traditional retirement accounts with Roth accounts. Traditional IRA, 401(k), and 403(b) distributions are generally taxable because the taxpayer received a deduction when contributions were made. Roth distributions follow different rules.

Account Type	**Tax Treatment of Distributions**	**Form**
Traditional IRA	Fully taxable (if all deductible contributions); pro-rata if basis exists (Form 8606)	1099-R
Traditional 401(k) / 403(b)	Fully taxable as ordinary income	1099-R
Roth IRA (qualified distribution)	Tax-free — account open 5+ years and age 59½ or other qualifying event	1099-R (Code Q)
Roth 401(k) / 403(b)	Qualified distributions tax-free; same 5-year / age 59½ rules apply	1099-R
Social Security	0% to 85% taxable based on combined income	SSA-1099

Account Type	Tax Treatment of Distributions	Form
	formula	

Part 4 — Required Minimum Distributions (RMDs) Under SECURE 2.0

The SECURE 2.0 Act (P.L. 117-328, signed December 2022) changed the RMD starting age in two steps. For TY2026, the applicable RMD age depends on the taxpayer's birth year:

Birth Year	RMD Starting Age	Notes
Born before July 1, 1949	70½	Pre-SECURE Act rules applied; already taking RMDs
Born July 1, 1949 – Dec. 31, 1950	72	SECURE Act 1.0 applied; already taking RMDs
Born Jan. 1, 1951 – Dec. 31, 1959	73	SECURE 2.0 — RMDs begin at age 73
Born Jan. 1, 1960 or later	75	SECURE 2.0 — RMDs begin at age 75 (effective 2033)

Part 5 — The 10% Early Distribution Penalty

Form 5329

The 10% Early Distribution Penalty

General Rule

Distributions from traditional **IRAs**, **401(k)** plans, and **403(b)** plans taken before age **59½** are generally subject to a **10% additional tax** on the taxable portion of the distribution.

This penalty is in addition to ordinary income tax and is reported on **Form 5329**.

Penalty Formula

Taxable Distribution
×
10%
=
Early Distribution Penalty

Common Penalty Exceptions

Death or Disability

Distributions made after the account owner's death or disability avoid the 10% penalty.

SEPP / 72(t)

Substantially Equal Periodic Payments qualify for an exception when IRS rules are followed.

Medical Expenses

Unreimbursed medical expenses exceeding 7.5% of AGI qualify for penalty relief.

IRA-Only Exceptions

Health Insurance

Health insurance premiums paid while unemployed.

First Home Purchase

Up to **$10,000 lifetime** for a qualified first-time home purchase.

Higher Education

Qualified higher education expenses for the taxpayer, spouse, child, or grandchild.

Additional Exceptions

IRS Levy

Distributions resulting from an IRS levy on the retirement account.

Qualified Reservists

Certain distributions to military reservists called to active duty.

Age 55 Rule

Separation from service after age 55 avoids the penalty for employer plans.

Does not apply to IRAs.

SECURE 2.0 New Exceptions

Additional exceptions created by SECURE 2.0 include:

• Terminal illness distributions
• Domestic abuse distributions (up to $10,000)
• Qualified disaster distributions

These exceptions may eliminate the 10% penalty while the distribution itself remains taxable.

Important Distinction

Most exceptions eliminate only the **10% penalty**.

The distribution is usually still subject to ordinary income tax unless another exclusion applies.

Common Exam Trap

Students often believe the age 55 exception applies to IRAs. It does not. The age 55 separation-from-service exception applies only to employer retirement plans such as 401(k) and 403(b) plans.

2.5 IRAs (contributions, deductions, distributions and 10% penalty)

IRAs — Contributions, Deductions, Distributions & 10% Penalty · TY2026

For TY2026, IRA contribution limits are updated per **IR-2025-111**. This lesson covers Traditional and Roth IRA contribution limits, deductibility rules, distribution taxation, the 10% early distribution penalty and its exceptions, and the reporting forms — **Form 1099-R** and **Form 5498**.

$7,500 IRA Limit Under 50

$8,600 Age 50+ Catch-Up

10% Early Penalty

Age 59½ Penalty-Free Age

Age 73 RMD Begins

IRA Contribution Limits for TY2026 — IR-2025-111

The annual IRA contribution limit for TY2026 is **$7,500** ($8,600 for taxpayers age 50 or older by December 31, 2026). The limit applies across *all* IRAs combined — Traditional and Roth combined contributions cannot exceed the limit.

Taxpayer	TY2026 Limit	Catch-Up Age 50+
Under age 50	$7,500	N/A
Age 50 or older	$8,600	+$1,100 catch-up
Spousal IRA	$7,500 / $8,600	Same limits — based on spouse's earned income

Contribution Limits — Key Rules

- Contributions cannot exceed the taxpayer's **taxable compensation** for the year.
- The deadline to contribute is **April 15, 2027**.
- Excess contributions are subject to a **6% excise tax** per year until corrected.
- Traditional IRA and Roth IRA contributions have no age limit if the taxpayer has taxable compensation.

Traditional IRA — Deductibility Rules

Whether a Traditional IRA contribution is deductible depends on whether the taxpayer or spouse is covered by a workplace retirement plan and their Modified Adjusted Gross Income (MAGI).

Situation	TY2026 Phaseout Range MAGI	Below Phaseout
Single / HOH — covered by workplace plan	$81,000 – $91,000	Fully deductible
MFJ — covered spouse	$129,000 – $149,000	Fully deductible
MFJ — non-covered spouse, covered spouse has plan	$242,000 – $252,000	Fully deductible
Not covered by any workplace plan	No phaseout	Always fully deductible

Non-Deductible Contributions — Form 8606

When a Traditional IRA contribution is not deductible because MAGI is too high, the taxpayer may still make the contribution — it becomes a **non-deductible contribution** tracked on **Form 8606**. This creates basis in the IRA, meaning that portion will not be taxed again on distribution. Failure to file Form 8606 can result in double taxation.

Roth IRA — Eligibility & Income Limits

Roth IRA contributions are never deductible, but qualified distributions are **completely tax-free**. Eligibility to contribute phases out at higher MAGI levels.

Filing Status	TY2026 Phaseout Range MAGI	Above Phaseout
Single / HOH	$153,000 – $168,000	No Roth contribution allowed
Married Filing Jointly	$242,000 – $252,000	No Roth contribution allowed
Married Filing Separately	$0 – $10,000	No Roth contribution allowed

Backdoor Roth IRA — Still Available TY2026

High-income taxpayers above the Roth income limits may use the **backdoor Roth strategy**: make a non-deductible Traditional IRA contribution, then convert it to a Roth IRA. The pro-rata rule applies if the taxpayer has other pre-tax IRA balances. The conversion is reported on Form 8606.

Traditional IRA Distributions — Taxation Rules

Traditional IRA distributions are generally included in gross income in the year received. The taxable amount depends on whether the account contains any non-deductible after-tax contributions.

Distribution Type	Tax Treatment
All pre-tax contributions and earnings	100% ordinary income in year of distribution

Distribution Type	Tax Treatment
Non-deductible after-tax contributions	Tax-free basis recovered pro-rata using Form 8606
Roth IRA qualified distribution	100% tax-free
Required Minimum Distribution age 73+	Ordinary income; 25% excise tax if not taken timely, reduced to 10% if corrected in 2-year window

Early Distributions — The 10% Additional Tax

[Image: Early Distribution Additional Tax]

A distribution from a Traditional IRA before age 59½ is subject to a **10% additional tax** on the taxable amount, in addition to ordinary income tax. The 10% penalty is reported on **Form 5329** and added to tax on Form 1040, Schedule 2.

How the 10% Early Distribution Tax Works

The 10% applies to the **taxable portion** of the distribution — not the total distribution. If the IRA includes non-deductible contributions tracked on Form 8606, only the earnings and pre-tax portion are subject to the penalty.

Example: Maria, age 45, takes a $20,000 distribution from her Traditional IRA, all pre-tax. She owes ordinary income tax on $20,000 **plus** a 10% penalty of **$2,000** — unless an exception applies.

Exceptions to the 10% Early Distribution Penalty

The following exceptions allow early distributions without the 10% penalty. Ordinary income tax still applies unless the distribution is otherwise exempt.

Exception	IRC §72(t) Code	Key Condition
Death of IRA owner	§72(t)(2)(A)(ii)	Distribution to beneficiary after owner's death
Disability	§72(t)(2)(A)(iii)	Total and permanent disability
Substantially Equal Periodic Payments	§72(t)(2)(A)(iv)	Must continue for 5 years or to age 59½, whichever is later
Unreimbursed medical expenses	§72(t)(2)(B)	Expenses exceed 7.5% of AGI; itemizing not required
Health insurance premiums while unemployed	§72(t)(2)(D)	Received unemployment compensation for 12+ consecutive weeks
§72(t)(2)(E)	Qualified expenses for taxpayer, spouse, child, or grandchild	
First-time home purchase	§72(t)(2)(F)	Lifetime limit $10,000; no

Exception	IRC §72(t) Code	Key Condition
		principal residence in prior 2 years
§72(t)(2)(A)(vii)	Due to IRS levy under IRC §6331	
Qualified reservist distribution	§72(t)(2)(G)	Active duty for 180+ days
Disaster distributions	Special rules	Up to $22,000; income spread over 3 years; repayable within 3 years
Terminal illness	§72(t)(2)(L)	Certified by physician; 84-month or less life expectancy
§72(t)(2)(M)	Up to $2,500/year for qualifying LTC premiums	

Form 1099-R — Reporting IRA Distributions

Form 1099-R is issued by the IRA custodian for any distribution of $10 or more. The form reports the gross distribution, the taxable amount, and a **distribution code** in Box 7 that identifies the type and tax treatment of the distribution.

Box 7 Code	Meaning	Penalty?
1	Early distribution — no known exception	10% penalty likely
2	Early distribution — exception applies	No penalty
3	Disability	No penalty
4	Death — distribution to beneficiary	No penalty
7	Normal distribution age 59½+	No penalty
8	Excess contribution returned before tax deadline	No penalty if timely
G	Direct rollover to another qualified plan or IRA	No penalty — not taxable
Q	Qualified Roth IRA distribution	No penalty — tax-free
J	Early Roth IRA distribution — no known exception	10% on earnings

Code 1 — Taxpayer Claims Exception on Form 5329

When the custodian issues a Code 1 but the taxpayer qualifies for an exception, the taxpayer files **Form 5329** to claim the exception. The form is not required if Code 2 is already shown on the 1099-R. Always verify the Box 7 code — an incorrect code can cause the IRS to assess penalties automatically.

Form 5498 — IRA Contribution Information

Form 5498 is issued by the IRA custodian to report contributions, rollovers, conversions, and the year-end fair market value of the account. It is informational — it does not need to be attached to the tax return.

Box	What It Reports
Box 1	IRA contributions for the year
Box 2	Rollover contributions
Box 3	Roth IRA conversion amount
Box 5	Fair market value at December 31
Box 10	Roth IRA contributions for the year
Box 11	RMD required checkbox
Box 12a	RMD date
Box 12b	RMD amount for the year

Form 5498 Due Date — Issued After Tax Deadline

Form 5498 for TY2026 contributions is due to the taxpayer by **June 1, 2027** — after the April 15 filing deadline. This is because contributions made between January 1 and April 15, 2027 can still be designated as TY2026 contributions. If a taxpayer files before receiving Form 5498, the deduction is based on the actual contribution made — the 5498 is confirmatory, not required to file.

Worked Examples

Traditional IRA Distributions

Early Distribution Rules & Worked Examples

Early Distribution Rule

- Distributions from a Traditional IRA before age **59½** are generally subject to a **10% additional tax** on the taxable portion.
- This additional tax is reported on **Form 5329**.
- The distribution is usually still taxable as ordinary income even when the 10% additional tax does not apply.

Example 1 — Deductible Traditional IRA

- Sarah is age 38, single, and earns **$60,000**.
- She is not covered by a workplace retirement plan.
- She contributes **$7,000** to a Traditional IRA for TY2026.

Result

- Sarah receives a full **$7,000 deduction**.
- No phase-out applies because neither Sarah nor a spouse participates in a workplace retirement plan.

- Her AGI is reduced by **$7,000**.

Example 2 — Non-Deductible Contribution

- Mark participates in his employer's 401(k).
- His MAGI exceeds the TY2026 phase-out range.
- He contributes **$7,000** to a Traditional IRA.

Result

- No deduction is allowed.
- The contribution becomes a **non-deductible IRA contribution**.
- Mark must file **Form 8606** to establish basis and prevent future double taxation.

Example 3 — Early Distribution

- Tom is age 45.
- He receives a **$15,000** IRA distribution.
- Form 1099-R shows **Code 1**, and Tom has no basis.

Result

- Entire distribution is taxable.
- Additional tax: **$15,000 × 10% = $1,500**.
- Tom also owes regular income tax on the distribution.
- Total federal tax cost could easily exceed **$5,000**.

Example 4 — First-Time Homebuyer Exception

- Lisa is age 34.
- She withdraws **$10,000** from her IRA for a first-home down payment.
- She has not owned a home during the prior two years.

Result

- The distribution remains taxable income.
- The 10% additional tax is waived under the first-time homebuyer exception.
- Lisa claims the exception on **Form 5329**.
- This exception has a **$10,000 lifetime limit**.

Example 5 — Direct Rollover

- Carol changes jobs and receives Form 1099-R reporting a distribution of **$120,000**.
- Box 7 contains **Code G**.

Result

- Code G indicates a direct rollover.
- The **$120,000** is not included in taxable income.

- No early distribution tax applies.
- If Carol had taken possession of the funds, mandatory 20% withholding and the 60-day rollover rules would have applied.

Practitioner Tip: Always review Box 7 on Form 1099-R before determining taxability. Distribution codes often identify rollovers, exceptions, disability distributions, Roth conversions, and other transactions that significantly affect both taxable income and the 10% additional tax calculation.

2.6 — Reporting and Taxability of Unemployment Compensation

[Image: Reporting and Taxability of Unemployment Compensation]

Taxable Income Reporting

Unemployment Compensation

Unemployment compensation is fully taxable as ordinary income at the federal level for TY2026 under IRC §85. There is no federal exclusion for unemployment benefits received during the year.

Federal Tax Treatment

- All unemployment compensation is included in federal gross income.
- The COVID-era $10,200 exclusion expired and was not extended or renewed.
- For TY2026, unemployment compensation remains taxable under IRC §85.

Form 1099-G Reporting

- Unemployment benefits are reported to the taxpayer on Form 1099-G, Certain Government Payments.
- The amount received must be included as ordinary income on the federal return.
- Practitioners should verify the 1099-G amount before filing, especially when clients received benefits from multiple states.

Voluntary Federal Withholding

Recipients may elect voluntary federal income tax withholding from unemployment compensation at a flat 10% rate by submitting Form W-4V to the paying state agency.

Use Form W-4V to request withholding from unemployment benefits.

The voluntary federal withholding rate is 10%.

The election is submitted to the state agency paying the benefits.

- **Common Client Surprise**
- Many taxpayers assume unemployment compensation is not taxable.
- A balance due often results when the taxpayer did not elect voluntary withholding.

- Clients should be counseled early so they can withhold or make estimated payments if needed.

Practitioner Tip

When a client receives unemployment compensation, ask whether federal tax was withheld. If no withholding was elected, review the potential balance due before filing and discuss Form W-4V or estimated payments for future benefit periods.

What Is Taxable Unemployment Compensation for TY2026?

The following payments are fully taxable under IRC §85:

- State unemployment insurance (UI) benefits
- Federal Unemployment Trust Fund benefits
- Railroad unemployment compensation
- Disability payments received under a state unemployment compensation law
- Trade Readjustment Allowances (TAA/TRA — for workers displaced by foreign trade)
- Disaster Unemployment Assistance (DUA)

[Image: DidUKnow.svg]

Supplemental unemployment from an employer trust fund

is also taxable but is reported on Form W-2 as wages — not on Form 1099-G. Do not treat it as regular unemployment compensation when reconciling the return.

Form 1099-G — Key Boxes

Box	Contents	Tax Treatment for TY2026
Box 1	Unemployment compensation	Fully taxable; Schedule 1, Line 7 of Form 1040
Box 4	Federal income tax withheld	Credit on Form 1040 — not income
Box 10a/10b	State / Payer state ID	State reporting — varies by state
Box 11	State income tax withheld	Credit on state return

Voluntary Withholding — Form W-4V

Recipients may elect to have **10% federal income tax withheld** by submitting Form W-4V to the state unemployment agency. This is the only available federal withholding rate — clients cannot request a higher percentage. Advise clients who expect significant total income in 2026 to elect withholding immediately upon beginning to receive benefits, or to make quarterly estimated tax payments via Form 1040-ES.

Fraudulent 1099-G — Identity Theft

A client who receives a Form 1099-G for unemployment benefits they never received should:

- Report the fraud immediately to the issuing state unemployment agency.
- Request a corrected 1099-G showing $0.
- Do NOT include the fraudulent amount on the return.
- File Form 14039 (Identity Theft Affidavit) with the IRS to flag the account.
- If a corrected 1099-G cannot be obtained before the filing deadline, attach a written statement explaining the fraud to the return.

2.7 Alimony (divorce agreements executed before 2019; executed or modified after 2018)

[Image: Alimony and divorce tax rules]

Alimony — Two Tax Regimes · TY2026

The tax treatment of alimony depends entirely on **when the divorce or separation agreement was executed**. Agreements executed **before January 1, 2019** follow the old deductible/includible regime. Agreements executed or **modified after December 31, 2018** follow the TCJA regime — no deduction for the payer, no income for the recipient.

Pre-2019 Deductible / Includible

Post-2018 No Deduction / No Income

Above-the-Line Pre-2019 Payer Deduction

IRC §71 Pre-2019 Authority

IRC §215 Pre-2019 Deduction

The Two Alimony Regimes — Side by Side

Regime 1 · Agreement Before Jan 1, 2019

Payer

Deductible

Above-the-line on Schedule 1 · IRC §215

Recipient

Includible in Gross Income

Schedule 1, Line 2a · IRC §71

SSN Requirement

Payer must report recipient's SSN on return — $50 penalty per failure

VS

Regime 2 · Agreement After Dec 31, 2018

Payer

No Deduction

TCJA repealed deduction for post-2018 agreements

Recipient

Not Includible

Not gross income — not reported on return

SSN Requirement

Not applicable — no deduction to claim

Regime 1 — Agreements Executed Before January 1, 2019

Under the pre-TCJA rules — which continue to apply to agreements executed before January 1, 2019 — alimony follows a **transferee tax system**: the payer deducts, the recipient includes. The tax burden shifts from the higher-bracket payer to the lower-bracket recipient, which was the legislative intent.

Requirements for Pre-2019 Alimony Treatment

All six conditions must be met for a payment to qualify as deductible/includible alimony:

- Payment is made in **cash**; property transfers do not qualify.
- Payment is made under a **divorce or separation instrument**.
- The instrument does **not designate** the payment as non-alimony.
- The parties are **not members of the same household** when the payment is made.
- There is **no liability to continue payments** after the recipient's death.
- The payment is **not child support**.

Item	Payer	Recipient
Tax treatment	Above-the-line deduction	Gross income
IRC authority	IRC §215	IRC §71
Itemizing required?	No — above-the-line deduction	N/A
SSN disclosure	Must include recipient's SSN on return — $50 penalty if omitted	N/A
IRA contribution eligibility	N/A	Alimony received counts as **earned income** for IRA

Item	Payer	Recipient
		contribution purposes
Child support mixed with alimony	If a payment is reduced on a child-related event, the IRS treats the reducible portion as child support — not deductible/includible.	

Alimony Recapture Rule — Pre-2019 Agreements

If alimony payments decrease by more than **$15,000** in the first three years, the **excess front-loading** is recaptured. In year 3, the payer must include the recaptured amount in gross income and the recipient may deduct it.

Recapture does not apply if payments end due to death of either party or remarriage of the recipient.

Worked Example — Pre-2019 Agreement

Robert and Linda divorced in **2016**. The decree requires Robert to pay Linda **$2,000/month** ($24,000/year). Robert earns $180,000; Linda earns $42,000.

Robert — deduction on Schedule 1	−$24,000
Linda — income on Schedule 1	+$24,000
Linda's IRA contribution eligibility from alimony	Up to $7,000

The $24,000 counts as Linda's earned income for IRA purposes — she can contribute up to $7,000, or $8,000 if age 50+, even if she has no other earned income.

Regime 2 — Agreements Executed or Modified After December 31, 2018

The Tax Cuts and Jobs Act permanently repealed the deductibility/includibility of alimony for divorce and separation agreements executed after December 31, 2018. Under Regime 2, alimony is treated like a gift — **no tax consequence on either side**.

Post-2018 Rules — TCJA

- Payer receives **no deduction** — alimony paid is not deductible.
- Recipient has **no gross income** — alimony received is not taxable.
- Alimony received does **not count as earned income** for IRA contribution purposes.
- No SSN disclosure required on the payer's return.
- The recapture rules of IRC §71(f) do **not apply**.
- Property settlements, child support rules, and non-cash transfer rules are unchanged.

Item	Payer	Recipient
Tax treatment	No deduction — not reported	Not gross income — not reported
IRC authority	§215 repealed for post-2018	§71 repealed for post-2018

Item	Payer	Recipient
IRA contribution eligibility	N/A	Alimony does not count as earned income
Recapture rules	Not applicable — no deduction was taken	

Worked Example — Post-2018 Agreement

Kevin and Amy divorced in **2022**. The decree requires Kevin to pay Amy **$2,000/month** ($24,000/year). Kevin earns $180,000; Amy earns $42,000 from her job.

Kevin — deduction on Schedule 1	$0 — no deduction
Amy — income from alimony	$0 — not taxable
Amy — IRA contribution limit from alimony	$0 — alimony not earned income
Amy's IRA eligibility — based on her $42,000 job income only	Up to $7,000

Amy can still contribute to an IRA — but only because she has $42,000 in wages. The $24,000 in alimony contributes nothing toward her IRA eligibility under the post-2018 regime.

The Modification Trap — Critical for TY2026

Modifying a Pre-2019 Agreement Can Change the Regime

A pre-2019 divorce agreement that is **modified after December 31, 2018** will be governed by the post-2018 TCJA rules *if the modification expressly states* that the TCJA alimony rules apply. If the modification does not include that language, the pre-2019 rules continue.

Key point: A modification that simply changes the payment amount — without expressly adopting the TCJA rules — does **not** automatically switch the agreement to the post-2018 regime.

Scenario	Applicable Regime
Original decree executed 2015 — never modified	Pre-2019 rules apply
Decree from 2015 — modified in 2023 with no TCJA election language	Pre-2019 rules continue to apply
Decree from 2015 — modified in 2023 with express statement adopting TCJA rules	Post-2018 rules apply from modification date
New decree executed 2021	Post-2018 rules apply

Child Support vs. Alimony — Never Confused

Child Support — Always Tax-Neutral

- Child support is **never deductible** by the payer under either regime.

- Child support is **never includible** in the recipient's gross income under either regime.
- If a payment is designated as both alimony and child support, any shortfall is allocated to child support first.
- Amounts that reduce upon a child-related contingency are treated as child support — not alimony.

Quick Reference — Two Regimes at a Glance

Feature	Regime 1 · Pre-2019	Regime 2 · Post-2018
Payer deduction	Yes — above-the-line	No
Recipient income	Yes — ordinary income	No
IRA earned income	Yes	No
Recapture rules apply	Yes — IRC §71(f)	No
SSN required on return	Yes — payer discloses recipient's SSN	No
Child support tax treatment	Same under both regimes — never deductible / never includible	
IRC authority	§71 income · §215 deduction	Both repealed for post-2018

2.8.1 Determination of gross income & deduction

Schedule C Overview — TY2026

Schedule C is used by sole proprietors and single-member LLCs treated as disregarded entities to report business income and deductible expenses. Net profit is subject to self-employment tax.

§179 Expensing

TY2026 limit: **$2,560,000**
Phase-out begins at **$4,090,000**.

NEW LAW

Bonus Depreciation

100% bonus depreciation reinstated for qualifying TY2026 property.

Luxury Auto Limits

Updated luxury automobile depreciation limits apply for TY2026.

Business Meals

Business meals remain **50% deductible**.

Entertainment

Entertainment expenses are **0% deductible**.

Self-Employment Tax

Net Schedule C profit is generally subject to self-employment tax.

[Image: Schedule C Gross Income and Deductions TY2026]

Determination of Gross Income & Deductions · Schedule C · TY2026

Schedule C, Profit or Loss from Business, is the form sole proprietors use to report all business income and deductions. Net profit flows to Form 1040 and is subject to both income tax and self-employment tax. Understanding **what counts as gross income**, **which deductions are allowed**, and **how the form flows** is the foundation of Schedule C preparation.

IRC §61 Gross Income

IRC §162 Business Deductions

SE Tax Applies to Net Profit

Sch. 1 Flows to Form 1040

O&N Test Ordinary & Necessary

How Schedule C Flows — The Big Picture

Schedule C — Top to Bottom

A

Part I — Income

Gross receipts or sales (Line 1) minus returns and allowances (Line 2) = **Net receipts (Line 3)**. Subtract cost of goods sold (Line 4) = **Gross profit (Line 5)**. Add other income (Line 6) = **Gross income (Line 7)**.

B

Part II — Expenses (Lines 8–27)

All ordinary and necessary business expenses — advertising, vehicle, depreciation, insurance, professional fees, rent, utilities, wages, and more. Total expenses entered on Line 28.

C

Tentative Profit or Loss (Line 29)

Gross income (Line 7) minus total expenses (Line 28) = tentative profit or loss before home office deduction.

D

Home Office (Line 30)

Deduction for business use of home (from Form 8829 or simplified method). Cannot exceed tentative profit — excess carried forward.

E

Net Profit or Loss (Line 31) → Schedule 1 & SE Tax

Net profit flows to Schedule 1, Line 3 (adds to AGI) **and** to Schedule SE to compute self-employment tax. A net loss may be subject to at-risk and passive activity rules.

Gross Income — What Is Included

Under IRC §61, gross income means **all income from whatever source derived** unless a specific exclusion applies. For a Schedule C sole proprietor, gross income includes all amounts received from the business — in cash, property, or services.

Includible in Gross Income — Schedule C Line 1 / Line 6

- Cash receipts from sales of goods or services — full amount before any expenses
- Credit card, check, and electronic payments received — amounts on Forms 1099-NEC and 1099-K are a subset, not the ceiling
- Bartering income — fair market value of goods or services received in exchange for your own goods or services
- Tips and gratuities received in the course of business — all tips are taxable (Schedule C Line 1)
- Insurance proceeds for lost business income (business interruption) — taxable as replacement income
- Recoveries of previously deducted amounts — if a bad debt or expense deducted in a prior year is recovered, the recovery is income in the year received (tax benefit rule)
- Rental income from business property — if incidental to the main business activity (otherwise Schedule E)

Not Included in Gross Income — Common Exclusions

- Loan proceeds received — borrowing money is not income (but keep records of the loan terms)
- Capital contributions from the owner — money put into the business by the sole proprietor is not income
- Insurance reimbursements for actual expense losses (casualty or theft of business property) — reduce the loss, not income, to the extent of the loss

- Sales tax collected for state/local governments — held in trust for the government, not the business owner's income

Three Key Income Figures on Schedule C

Term	Schedule C Line	Definition
Gross receipts	Line 1	Total amount received from all business sales and services — before any deductions
Gross profit	Line 5	Gross receipts minus returns and minus cost of goods sold (COGS)
Gross income	Line 7	Gross profit plus other business income — the starting point for the deduction calculation

The Ordinary & Necessary Test — IRC §162

Every expense claimed on Schedule C must meet the **ordinary and necessary (O&N) standard** of IRC §162. This is the gateway test — before applying any specific limitation (50% for meals, §274 strict substantiation for vehicles), the expense must first pass the O&N test.

Ordinary

Common and accepted in the taxpayer's trade or business. Would a taxpayer in the same business commonly incur this expense? It need not be frequent — just normal for that industry.

Necessary

Helpful and appropriate for the business. Does not have to be indispensable — but it must be reasonably expected to benefit the business. Purely personal expenses disguised as business fail this test.

Not Personal

IRC §262 disallows personal, living, and family expenses. When an expense serves both business and personal purposes, only the business portion qualifies. Mixed-use items require allocation.

Schedule C Part II — Deductions Line by Line

Line	Expense	Key Rules & Limitations
8	Advertising	Fully deductible — must be for the business, not personal promotion
9	Car and truck expenses	Standard mileage (72.5¢/mile TY2026) or actual expenses — §274 strict substantiation — no commuting
10	Commissions and fees	Sales commissions, referral fees, finder fees paid to others — issue 1099-NEC if $600+ to individuals

Line	Expense	Key Rules & Limitations
11	Contract labor	Payments to independent contractors — issue 1099-NEC if $600+ — W-9 on file
12	Depletion	Cost or percentage depletion for natural resources — timber, minerals, oil and gas
13	Depreciation and §179	From Form 4562 — §179 up to $1,220,000; 100% bonus depreciation reinstated TY2026 (Notice 2026-11)
14	Employee benefit programs	Health insurance, retirement plan contributions for employees — not for sole proprietor's own coverage
15	Insurance (other than health)	Business liability, property, and casualty insurance premiums — not life insurance where business is beneficiary
16a/b	Mortgage interest / Other interest	Interest on business loans — must be for business purposes. Personal mortgage interest goes on Schedule A.
17	Legal and professional services	Attorney, CPA, consultant fees for business matters — not legal fees for personal matters
18	Office expense	Postage, small office items, printer ink — distinct from supplies (Line 22) and equipment (Line 13)
19	Pension and profit-sharing	Employer contributions to qualified retirement plans for employees — owner's own contributions go on Schedule 1
20a/b	Rent or lease	20a: vehicles, machinery, equipment rental. 20b: office or business space rent. Cannot be paid to yourself.
21	Repairs and maintenance	Keep business assets in working condition — does not add to value or extend life (that would be a capital improvement)
22	Supplies	Consumable items used in the business — separate from inventory (COGS) and equipment (capitalized)
23	Taxes and licenses	State/local business taxes, payroll taxes (employer share), license fees, business permits — not federal income tax
24a	Travel	Business travel away from home overnight — §274 strict substantiation required — 100% deductible
24b	Meals (deductible)	Enter 50% of qualifying business meals — §274 strict substantiation — five conditions must be met
25	Utilities	Business phone, internet, electricity for a business location — home utilities go through Form 8829 (Line 30)
26	Wages	Wages paid to employees — not the owner's own draw. Must have Form W-2 issued. Include bonuses and commissions paid to employees.
27a	Other expenses	Any ordinary and necessary business expense not listed above — itemized on Part V. Examples: subscriptions, bank fees, professional memberships, continuing education.

Line	Expense	Key Rules & Limitations
30	Home office	From Form 8829 (regular method) or $5/sq ft simplified — cannot exceed tentative profit on Line 29

Capital Expenditures vs. Deductible Expenses

One of the most important distinctions in Schedule C preparation is whether a payment is a **currently deductible expense** or a **capital expenditure** that must be depreciated over time. Getting this wrong understates or overstates income.

Deductible in Current Year

- Repairs that restore to working condition but do not add value or extend useful life
- Supplies consumed during the year
- Prepaid expenses — deductible when economic benefit does not extend beyond 12 months
- Equipment under the de minimis safe harbor ($2,500 per item for businesses without an applicable financial statement)

Must Capitalize & Depreciate

- Machinery and equipment with useful life beyond one year (unless §179 or bonus depreciation elected)
- Improvements that add value, adapt property to a new use, or restore a major component (UNICAP rules)
- Separately purchased §197 intangibles — customer lists, patents, franchises, covenants not to compete (15-year amortization)

Net Profit — Where It Goes

The net profit (or loss) on Schedule C, Line 31 flows in two directions simultaneously — it adds to the taxpayer's AGI *and* is the base for self-employment tax.

Schedule 1, Line 3

Net profit adds to AGI. Net loss may offset other income subject to at-risk (IRC §465) and passive activity (IRC §469) rules.

Schedule SE

Net profit × 92.35% × 15.3% = SE tax. One-half of SE tax is deductible above-the-line on Schedule 1, Line 15.

Self-Employed Health Insurance

Deductible above-the-line on Schedule 1, Line 17 — limited to net profit from the business.

Net Loss — At-Risk and Passive Activity Rules

A Schedule C net loss is generally deductible against other income — but only to the extent the taxpayer is **at risk** for the loss (IRC §465). Losses from a business activity in which the taxpayer does not materially participate are **passive losses** and may only offset passive income (IRC §469). Most active sole proprietors are not affected by these limits, but they apply to certain rental activities and passive business investments.

A net loss also eliminates any SE tax obligation for that year — no profit means no SE tax base.

2.8.2 Business versus hobby

[Image: Business vs Hobby Tax Rules TY2026]

Business vs. Hobby · IRC §183 · TY2026

Whether an activity is a **for-profit business** or a **hobby** determines whether losses can offset other income. Under IRC §183, losses from an activity not engaged in for profit are **not deductible**. The IRS uses a nine-factor test to evaluate profit intent — no single factor is controlling. For TY2026, hobby income is still reportable but deductions are severely limited.

IRC §183 Hobby Loss Authority

9 Factors Profit Intent Test

3 of 5 Years Profit Presumption

$0 Hobby Loss Deduction

Sch. 1 Hobby Income Reported

The Core Distinction — Why It Matters

For-Profit Business

- All ordinary and necessary expenses deductible on Schedule C
- Net losses can offset wages, investment income, and other income
- Net profit subject to self-employment tax
- §179 expensing and bonus depreciation available

VS

Hobby Activity

- Income is reportable — included in gross income on Schedule 1, Line 8
- Expenses are **not deductible** — TCJA eliminated the 2% miscellaneous deduction; hobby expenses produce no tax benefit
- Losses cannot offset other income — limited to hobby income
- Not subject to SE tax — but income still subject to income tax

TY2026 — Hobby Expenses Are Completely Non-Deductible

Before TCJA (through TY2017), hobby expenses could be deducted as miscellaneous itemized deductions subject to the 2% AGI floor. TCJA suspended the 2% miscellaneous deduction, and OBBBA reinstated it for TY2026 — **but hobby expenses are specifically excluded** from the reinstated §67 deduction. The result: hobby income is fully taxable and hobby expenses produce **zero tax benefit** for TY2026.

The Nine-Factor Test — Treas. Reg. §1.183-2(b)

Treasury Regulation §1.183-2(b) lists nine factors the IRS considers when determining whether an activity is engaged in for profit. **No single factor is decisive** — all facts and circumstances are weighed together. A taxpayer does not need to show a profit expectation above 50% — only a bona fide, good-faith intent to make a profit.

Nine Factors — Treas. Reg. §1.183-2(b)

1

Manner in Which the Activity Is Conducted

Does the taxpayer conduct the activity in a businesslike manner? Maintaining complete and accurate records, having a separate business bank account, and following industry practices all favor business classification.

2

Expertise of the Taxpayer or Advisors

Has the taxpayer studied the business practices of the industry? Consulting experts, attending trade shows, or taking courses relevant to the activity suggests profit intent.

3

Time and Effort Devoted

Spending substantial personal time on the activity, especially if the taxpayer quit another job to pursue it, indicates profit motive. Part-time participation is not automatically a hobby — but limited involvement weighs against business classification.

4

Expectation That Assets Will Appreciate

Even if current operations run at a loss, expected appreciation in the value of assets used in the activity (land, livestock, art) can support a profit motive. The overall economic picture matters.

5

Success in Similar or Dissimilar Activities

Has the taxpayer converted similar activities from loss to profit in the past? Prior success in any business — even a different type — suggests the taxpayer understands what it takes to run a profitable enterprise.

6

History of Income or Losses

Years of unbroken losses — especially large ones — weigh against profit motive. Losses in startup years are understandable. Losses due to unforeseen circumstances (drought, illness) are explainable. Consistent losses with no improvement plan suggest hobby status.

7

Amount of Occasional Profits

Has the activity ever generated a profit? Small occasional profits relative to large consistent losses may not be enough. A large profit in one year can support profit motive even with several loss years surrounding it.

8

Financial Status of the Taxpayer

If the taxpayer has substantial income from other sources, the IRS may view losses from the activity as a way to shelter that income — particularly when losses consistently exceed activity income by a large margin. Wealthy taxpayers receive extra scrutiny on this factor.

9

Elements of Personal Pleasure or Recreation

Activities that are inherently pleasurable — racing horses, breeding dogs, art, photography, travel writing — receive heightened scrutiny. Personal enjoyment does not automatically disqualify an activity, but it raises the burden of demonstrating profit intent.

The Profit Presumption — IRC §183(d)

IRC §183(d) creates a **rebuttable presumption** that an activity is for profit if it shows a profit in at least **three of the five consecutive tax years** ending with the current year (two of seven years for horse breeding, training, showing, or racing).

Most Activities

3 of 5

Profit in 3 of the last 5 consecutive years creates the presumption

Horse Activities

2 of 7

Breeding, training, showing, or racing horses — profit in 2 of last 7 years

Still Rebuttable

IRS Can Challenge

Meeting the test creates a presumption — the IRS can still rebut it with contrary evidence

Election to Postpone Determination — Form 5213

A taxpayer who starts a new activity may file **Form 5213** (Election to Postpone Determination) to delay an IRS audit determination of whether the activity is for profit until after the fifth year of the activity (seventh year for horse activities). This election must be filed within three years of the due date of the return for the first tax year of the activity. It gives the taxpayer time to establish a profit history — but also extends the statute of limitations for those years.

Hobby Income — How It Is Reported for TY2026

If an activity is classified as a hobby, income must still be reported — but the reporting location changed after TCJA. Hobby income is reported on **Schedule 1, Line 8z** (Other Income) and flows to Form 1040, Line 8. It is **not** reported on Schedule C.

Item	Business (Schedule C)	Hobby (IRC §183)
Income reported on	Schedule C, Line 1	Schedule 1, Line 8z
Expenses deductible?	Yes — Schedule C	No — TY2026
Net loss offsets other income?	Yes	No
Self-employment tax?	Yes — on net profit	No
§179 / Bonus depreciation?	Yes	No

Common Hobby Loss Audit Triggers

These Patterns Draw IRS Attention

- Consistent losses for five or more consecutive years with no change in approach or improvement plan
- Activity is inherently recreational — horses, art, photography, travel, wine, classic cars
- High W-2 income or investment income — losses from the activity generate large tax savings relative to the activity's scale
- No separate business bank account, no invoices, no marketing efforts, and no business plan
- Activity is primarily operated from a vacation home, farm, or recreational property also used personally
- Expenses far exceed income with no realistic path to profitability — e.g., spending $40,000 on equipment to generate $2,000 in craft fair sales

Worked Examples — TY2026

Example 1 — Hobby Classification

Patricia is an attorney earning $280,000 per year. She paints watercolors on weekends and sells occasional pieces at local art fairs. TY2026: **$1,800 in art sales**. **$14,200 in art supply expenses** and studio rental. She has reported losses from painting for 7 consecutive years with no improvement plan.

Art sales income — reported on	Schedule 1, Line 8z — **$1,800**
Art supply expenses — deductible?	$0 — hobby, not deductible TY2026
Net tax impact — Patricia pays income tax on	$1,800

Patricia cannot deduct the $14,200 in expenses. Her $12,400 economic loss produces zero tax benefit. Under pre-TCJA rules she could have deducted expenses up to $1,800 (income limit) as a 2% misc. deduction.

Example 2 — Business Classification

Marcus is a full-time photographer who left corporate employment to run a photography business. He maintains a separate business account, has a portfolio website, advertises on social media, and keeps meticulous records. TY2026: **$38,000 in revenue**. **$51,000 in expenses**. Net loss of $13,000 — his third year, with revenue growing each year.

Photography income — Schedule C, Line 1	$38,000
Business expenses — Schedule C	($51,000)
Net loss — offsets other income (at-risk rules met)	($13,000)
$13,000 loss deductible — reduces AGI	Full deduction

Marcus demonstrates profit motive: businesslike conduct, expertise, time devoted, growing revenue, and prior employment change. The startup loss is deductible. Patricia's situation is the opposite on nearly every factor.

Business vs. Hobby — Quick Reference

Item	Rule
Governing code section	IRC §183 — Activities Not Engaged in for Profit
Profit intent test	9-factor facts and circumstances — Treas. Reg. §1.183-2(b)
Profit presumption — most activities	Profit in 3 of last 5 consecutive years — IRC §183(d)
Profit presumption — horse activities	Profit in 2 of last 7 consecutive years
Postpone determination	Form 5213 — must file within 3 years of first year's return due date
Hobby income reported on	Schedule 1, Line 8z — not Schedule C
Hobby expenses — TY2026	Not deductible — zero tax benefit
SE tax on hobby income	Not subject to SE tax — ordinary income only

2.8.3 Business use of home (regular vs. simplified method

2.8.3 — Business Use of Home

[Image: Working-from-home.webp]

Lesson 2.8.3 — Business Use of Home · TY2026

Taxpayers who use part of their home exclusively and regularly for business may deduct home office expenses under IRC §280A. Two methods are available — the **Regular Method** (actual expenses prorated by square footage) and the **Simplified Method** ($5 per square foot, up to 300 sq ft). The method chosen can significantly affect the deduction and the taxpayer's basis in the home.

IRC §280A Authority

$5 / sq ft Simplified Rate

300 sq ft Simplified Max

$1,500 Simplified Max Deduction

Form 8829 Regular Method

Eligibility Requirements — IRC §280A

To deduct home office expenses, the taxpayer must meet **all** of the following requirements. Both methods share the same eligibility rules — the method choice only affects how the deduction is calculated.

All Requirements Must Be Met

- **Regular and exclusive use** — the area must be used regularly and exclusively for business. Personal use of any kind disqualifies the space, even occasional use.
- **Principal place of business** — the home office must be the taxpayer's principal place of business, or a place where clients/customers/patients are regularly met, or a separate structure used in connection with the business.
- **Self-employed taxpayers** — the deduction is available to sole proprietors (Schedule C), farmers (Schedule F), and partners who use the home for the partnership's convenience. **Employees** may no longer deduct home office expenses — this deduction was suspended by TCJA for W-2 employees through 2025 and made permanent by OBBBA.
- **Gross income limitation** — home office deductions may not exceed the gross income from the business conducted in the home. Disallowed amounts carry forward to future years (regular method only).

Employees — Home Office Deduction Not Available for TY2026

W-2 employees cannot deduct home office expenses under the TCJA suspension, now made permanent by OBBBA. Even if working from home full-time at the employer's direction, an employee has no home office deduction available on Schedule A. The 2% miscellaneous deduction reinstated by IRC §67 does not restore the employee home office deduction.

The Two Methods — Side by Side

Regular Method — Form 8829

- Deduction based on the **percentage** of home used for business (office sq ft ÷ total home sq ft)
- Deductible expenses include: mortgage interest, real estate taxes, insurance, utilities, repairs, and depreciation — prorated by the business-use percentage
- Depreciation on the business portion of the home reduces basis — must recapture on sale (unrecaptured §1250 gain, max 25%)
- Disallowed amounts due to income limit carry forward to future years
- Reported on **Form 8829** — flows to Schedule C, Line 30
- Can switch to simplified in a later year — but if switching back to regular, must depreciate based on adjusted basis at time of switch

Simplified Method — Rev. Proc. 2013-13

- **$5 per square foot** of the area used exclusively for business
- Maximum allowable area: **300 square feet** — maximum deduction **$1,500**
- No depreciation deduction — no basis reduction — no depreciation recapture on home sale
- No carryforward of disallowed amounts — the income limit applies but excess is simply lost
- Reported directly on **Schedule C, Line 30** — no Form 8829 needed
- Mortgage interest and real estate taxes still fully deductible on Schedule A as personal itemized deductions — not split

Head-to-Head Comparison

Feature	Regular Method	Simplified Method
Deduction basis	Actual expenses × business-use %	$5 × sq ft (max 300 sq ft)
Maximum deduction	Unlimited (subject to income limit)	$1,500
Depreciation included?	Yes — reduces basis	No — no basis impact
Depreciation recapture on sale?	Yes — unrecaptured §1250 gain	No
Carryforward of excess?	Yes — indefinite carryforward	No — excess is lost
Mortgage interest / RE taxes	Split — business % on Sch C; personal % on Sch A	100% on Schedule A — not split
Form required	Form 8829 required	No Form 8829 — Sch C Line 30 only
Renters eligible?	Yes	Yes

Regular Method — Calculation Steps

Form 8829 — Four Steps

1

Determine the Business-Use Percentage

Office square footage ÷ Total home square footage = Business-use %. Must use exclusively and regularly for business.

2

Deduct Direct Expenses in Full

Expenses that benefit only the office (painting the office, dedicated phone line) are 100% deductible — no proration needed.

3

Prorate Indirect Expenses by Business-Use %

Mortgage interest, real estate taxes, utilities, insurance, general repairs — multiplied by business-use %. Mortgage interest and RE taxes not claimed on Sch C are deductible on Schedule A.

4

Apply Depreciation — Basis × Business % × MACRS Rate

Depreciate the business portion of the home using the straight-line method over 39 years (nonresidential rate applies). Land is not depreciable — allocate based on assessed values.

Worked Examples — TY2026

Example 1 — Regular Method

Maria is a sole proprietor. Her home is **2,000 sq ft**. Her dedicated office is **200 sq ft** (10% business use). Annual home expenses: mortgage interest $14,000; real estate taxes $4,000; utilities $3,600; insurance $1,200; home depreciation (building portion) $8,000.

Business-use percentage	200 ÷ 2,000 = **10%**
Mortgage interest (10%)	$1,400
Real estate taxes (10%)	$400
Utilities (10%)	$360
Insurance (10%)	$120
Depreciation (10% × $8,000)	$800
Total home office deduction (Schedule C via Form 8829)	$3,080

The remaining 90% of mortgage interest ($12,600) and RE taxes ($3,600) remain deductible on Schedule A. The $800 depreciation reduces Maria's basis in the home.

Example 2 — Simplified Method (same taxpayer)

Same Maria — 200 sq ft office. Under the simplified method:

Office sq ft (under 300 limit)	200 sq ft
Rate	$5.00
Total home office deduction (Schedule C, Line 30)	$1,000

Regular method gives $3,080 vs simplified $1,000 for Maria. **Regular method wins here** — but simplified eliminates depreciation recapture risk on home sale and requires no Form 8829.

Special Rules to Know

Day Care Facility Exception

A day care facility that is licensed and uses a portion of the home does **not** require exclusive use — the same space can be used for personal purposes outside of day care hours. The deduction is calculated using a time-based fraction (hours used for day care ÷ total hours in the year) applied to the area-use percentage.

Inventory and Product Storage Exception

Space used to store inventory or product samples for a business where the home is the only fixed location of the business does **not** require exclusive use. The storage area must be a separately identifiable space suitable for storage.

Home Sale — §121 Exclusion and Depreciation Recapture

When a home office is located **within the home** (not a separate structure), the §121 exclusion ($250,000 single / $500,000 MFJ) still applies to the entire home including the office portion. However, **depreciation claimed under the regular method** must be recaptured as unrecaptured §1250 gain (taxed at a maximum 25% rate) — it is not excluded by §121.

This is one of the key planning considerations when choosing between methods. Taxpayers who anticipate selling their home may prefer the simplified method to avoid all depreciation recapture exposure.

Quick Reference — TY2026

Item	Rule
Exclusive use test	Required for all methods — any personal use disqualifies the space
Simplified rate	$5 per sq ft — maximum 300 sq ft — maximum deduction $1,500

Item	Rule
Carryforward	Regular method — yes (indefinite). Simplified method — no
Depreciation recapture on sale	Regular method — yes, unrecaptured §1250 (max 25%). Simplified — no
Employees	Not available — TCJA suspension made permanent by OBBBA
Day care exception	No exclusive use required — time-fraction method applies
Form required	Regular: Form 8829 → Schedule C Line 30. Simplified: Schedule C Line 30 directly
IRC authority	IRC §280A; Rev. Proc. 2013-13 (simplified method)

2.8.4 Recordkeeping requirements

Recordkeeping — Schedule C · Sole Proprietorship · TY2026

A sole proprietor must maintain records sufficient to prepare an accurate Schedule C and support every income and deduction item if questioned on audit. IRC §6001 imposes the recordkeeping obligation. Records must be kept as long as they may be relevant — generally until the statute of limitations expires for the return they support. **The burden of proof is always on the taxpayer.**

IRC §6001 Legal Requirement

3 Years Minimum Retention

6 Years 25%+ Understatement

Unlimited Fraud / No Return

Strict §274 Listed Property

Why Records Matter — Schedule C Context

Schedule C is one of the most frequently audited forms in the individual tax return. Sole proprietors report **gross receipts, cost of goods sold, and every business deduction** on a single form — and the IRS can challenge any line. Without adequate records, deductions are disallowed and income may be reconstructed using bank deposits or other indirect methods.

The Cohan Rule — Limited Protection for Schedule C

Under the *Cohan rule*, courts may allow an estimated deduction when a taxpayer clearly incurred a business expense but records are incomplete. However, this provides **limited protection** — courts often allow only a fraction of the claimed amount, and the Cohan rule **does not apply at all** to expenses subject to IRC §274 strict substantiation (vehicles, meals, travel, entertainment, listed property).

For §274 expenses, the rule is absolute: **no records = no deduction**, regardless of whether the expense obviously occurred.

Income Records — Gross Receipts

Every dollar received in the business must be documented. The IRS can reconstruct unreported income using bank deposit analysis, so all deposits — business and personal — must be traceable.

What to Keep — Business Income

- Invoices issued to customers or clients — numbered sequentially and dated
- Bank statements for all business accounts — showing deposits, withdrawals, and account balances
- Cash register tapes, point-of-sale reports, or daily sales summaries if selling to the public
- Forms 1099-NEC and 1099-K received — reconcile against actual gross receipts (may differ due to timing)
- Contracts, purchase orders, and service agreements showing the terms of each transaction
- Records of refunds, returns, and allowances — to support reductions from gross receipts

Expense Records — By Schedule C Category

Advertising (Line 8)

- Invoices from ad agencies, print shops, social media platforms, and online ad networks
- Bank or credit card statements confirming payment with business purpose noted
- Samples of the advertising material help establish the business connection if questioned

Car and Truck Expenses (Line 9) — §274 Strict Substantiation

- **Contemporaneous mileage log required** — Treas. Reg. §1.274-5T. Must record: date, destination, business purpose, and odometer reading (or miles) at or near the time of each trip. Reconstructed logs are rejected.
- Total annual mileage — business, commuting (not deductible), and personal — must all be tracked to establish the business-use percentage
- For the actual expense method — receipts for fuel, oil, tires, repairs, insurance, registration, and depreciation records (purchase invoice and Form 4562)
- Vehicle information required on Schedule C, Part IV — date placed in service, total miles, business miles, and whether vehicle is available for personal use

Meals (Line 24b — 50% deductible) — §274 Strict Substantiation

- Keep the actual restaurant receipt — itemized, showing all charges including tip

- Write on the receipt at the time: date, names of all attendees, their business relationship, and the specific business purpose discussed
- Only 50% of the documented amount is deductible — Schedule C line 24b shows the full amount; the 50% reduction is applied automatically

Travel (Line 24a) — §274 Strict Substantiation

- Airfare, train, and bus tickets — boarding passes, e-ticket confirmations showing business destination
- Hotel receipts showing dates of stay, location, and folio charges — not just the credit card slip
- Business purpose of each trip documented — conference programs, meeting agendas, client correspondence confirming the appointment
- For mixed personal/business trips — daily itinerary showing business vs. personal days to support the allocation of deductible expenses

Business Use of Home (Line 30 — Form 8829 or Simplified)

- Floor plan or measurements showing the square footage of the exclusive-use office area vs. total home — photograph the dedicated workspace
- Mortgage statements, lease agreement, or rent receipts showing the home address and amounts paid
- Utility bills — electricity, gas, internet — for the full year to support the indirect expense calculation
- Receipts for direct expenses — office repairs, dedicated phone lines, painting the office

Wages Paid to Employees (Line 26)

- Payroll records — pay stubs, payroll journals, and copies of all Forms W-2 issued to employees
- Bank records showing payroll deposits and employer FICA tax deposits to confirm all taxes were remitted
- For contractors — Forms 1099-NEC issued, plus the contractor's W-9 on file showing their TIN

Other Common Schedule C Expenses

- **Rent or lease (Line 20a/20b)** — signed lease agreement, monthly rent receipts or cancelled checks, and the address of the rented property or equipment
- **Insurance (Line 15)** — policy declarations page showing the business named as insured, and premium payment receipts
- **Professional development (Other expenses)** — receipts for courses, books, subscriptions, and licenses directly related to the current trade or business
- **Legal and professional fees (Line 17)** — invoices from attorneys, CPAs, and consultants with description of the business-related services performed

- **Repairs and maintenance (Line 21)** — invoices or receipts showing the business asset repaired, the nature of the repair, and the vendor
- **Supplies (Line 22)** — receipts for office and operating supplies consumed in the business during the year — separate from inventory

Cost of Goods Sold — Schedule C Part III

Businesses that sell products must maintain inventory records to support the Cost of Goods Sold (COGS) calculation. COGS = Beginning Inventory + Purchases − Ending Inventory.

Records Required for COGS

- Beginning and ending inventory counts — physical count sheets dated at the beginning and end of the tax year
- Purchase invoices for all goods purchased during the year — from vendors, wholesale suppliers, or manufacturers
- Valuation method used — cost, lower of cost or market, or other IRS-approved method. Must be consistent year to year; a change requires IRS consent
- Records of goods withdrawn for personal use — must be removed from COGS and treated as a draw, not a deductible expense

How Long to Keep Business Records

Situation	Keep For	Authority
Return filed, no significant issues	3 years	IRC §6501(a)
Income omitted by more than 25%	6 years	IRC §6501(e)
No return filed or fraudulent return	Unlimited	IRC §6501(c)
Business asset records (equipment, vehicles, improvements)	Until sold + 3 yrs	Basis tracking for gain/loss on disposal
Employment tax records	4 years	IRC §6501; Treas. Reg. §31.6001-1
NOL, §179 carryforward, or credit carryforward records	Until used + 3 yrs	Carryforward substantiation

Digital Records — IRS Acceptance

Rev. Proc. 98-25 and IRS guidance confirm that **electronic records are acceptable** — scanned receipts, PDF invoices, accounting software exports, and digital bank statements all qualify. The key requirement is that records must be **accurate, complete, legible, and retrievable** upon IRS request.

Scanned Receipts

Photos or scans — must be complete and legible. Scan thermal receipts promptly before they fade.

Accounting Software

QuickBooks, Wave, FreshBooks — export and retain reports. Back up annually.

Mileage Apps

GPS tracking apps acceptable if they capture date, destination, and business purpose per trip.

Cloud Backup

Store records in at least two locations — cloud plus local drive. Organize by tax year and expense category.

Consequences of Inadequate Records

Consequence	Detail
Deductions disallowed	Unsubstantiated expenses disallowed in full — tax assessed as if deduction was never claimed
Bank deposit reconstruction	IRS may reconstruct unreported income by treating all unexplained bank deposits as gross receipts
Accuracy-related penalty	20% of underpayment for negligence or substantial understatement — IRC §6662
Fraud penalty	75% of underpayment if due to fraud — IRC §6663. Extended unlimited statute of limitations applies
Preparer penalties	IRC §6694 penalties for preparers who claim deductions without adequate documentation — unreasonable positions

Schedule C Recordkeeping — Quick Reference

Schedule C Item	Minimum Documentation	§274 Strict Rule?
Gross receipts	Invoices, bank statements, 1099s received	No
Cost of goods sold	Inventory counts, purchase invoices, valuation method	No
Vehicle expenses	Contemporaneous mileage log + actual expense receipts if applicable	YES — §274(d)
Travel	Receipts, boarding passes, hotel folios, business purpose documentation	YES — §274(d)
Meals (50%)	Itemized receipt + names, business relationships, and specific purpose noted	YES — §274(d)
Home office	Square footage measurements, mortgage/rent, utilities, Form 8829 or simplified election	No
Depreciation (§179 / bonus)	Purchase invoice, Form 4562, placed-in-service date, business-use documentation	No (but vehicle needs log)
Wages / contractor payments	Payroll records, W-2s issued, 1099-NECs issued, W-9s on file	No

2.8.5 Entertainment expenses (50% of business meals deductible)

[Image: Business Meals and Entertainment Expenses TY2026]

Entertainment Expenses & Business Meals · TY2026

The Tax Cuts and Jobs Act (TCJA) permanently disallowed deductions for **entertainment, amusement, and recreation expenses**. Business meals remain **50% deductible** when ordinary and necessary business conditions are met. Lavish or extravagant meals reduce the deductible base. Understanding what is a meal vs. entertainment — and what documentation is required — is critical for TY2026.

50% Business Meals

0% Entertainment

IRC §274 Authority

Not Lavish Meal Requirement

Strict Substantiation Required

Entertainment Expenses — Permanently Disallowed

Under IRC §274(a), as amended by TCJA and made permanent by OBBBA, **no deduction is allowed** for any item generally considered entertainment, amusement, or recreation — even if there is a clear business purpose for the activity. The prior "directly related" and "associated with" tests no longer apply.

Pre-TCJA — Through 2017

50% Deductible

If directly related to or associated with business

TY2018 Forward — Permanent

0% Deductible

No deduction regardless of business purpose

What Counts as Entertainment — Zero Deduction

- Sports tickets — regular season, playoffs, suite/box seats — regardless of business discussion
- Golf, tennis, hunting, fishing trips, ski trips — even if used to entertain clients
- Concerts, theater, nightclub outings, event tickets of any kind
- Yacht, vacation home, or club membership costs — even if business guests are entertained there
- Club dues — athletic clubs, social clubs, golf clubs — any membership primarily for entertainment or recreation

- Skybox or luxury suite rentals — even if client meetings are held there

Business Meals — 50% Deductible Rule

Business meals are **50% deductible** under IRC §274(n) when all qualifying conditions are met. The 50% limit applies to the *otherwise allowable* deductible amount — meaning if the meal itself does not qualify, no deduction is allowed at all, not even 50%.

All Five Conditions Required — IRC §274

- **Ordinary and necessary** — the expense must be an ordinary and necessary business expense under IRC §162
- **Not lavish or extravagant** — the meal cannot be lavish or extravagant under the circumstances (no absolute dollar threshold — facts and circumstances apply)
- **Taxpayer or employee present** — the taxpayer or an employee of the taxpayer must be present at the meal
- **Business associate present** — the meal must be with a current or prospective client, customer, employee, partner, agent, or similar business associate
- **Business purpose** — there must be a bona fide expectation of deriving income or a specific business benefit other than goodwill

Meals at Entertainment Events — The Separation Rule

When a meal occurs at the same time as an entertainment event — for example, dinner before a ball game or food at a luxury suite — the meal cost may still be **50% deductible**, but only if the food and beverage costs are **separately stated** from the entertainment costs on the invoice or receipt.

Separately Billed Meal

Food and beverage separately stated on invoice — 50% of meal cost is deductible. Entertainment portion is zero.

Combined Single Bill

Food bundled with entertainment on one invoice — entire amount is non-deductible. No allocation allowed without separate billing.

Practical Example — Suite at a Sporting Event

A company rents a luxury suite at a baseball playoff game for $8,000 and has food and beverages catered for $1,500. The catering invoice is separate. Result: the $8,000 suite rental is **0% deductible** (entertainment). The $1,500 catering is **50% deductible** = $750 — provided all five meal conditions are met and the taxpayer or employee was present.

If the venue charges one combined price of $9,500 with no breakdown — **the entire amount is non-deductible**.

The 50% Limit — What It Applies To

Expense Type	Deductible %	Notes
Business meal with client / associate	50%	All five conditions must be met
Meals while traveling for business	50%	Travel must be away from tax home overnight
Meals provided to employees on premises (convenience of employer)	50%	TCJA reduced from 100% to 50%; fully disallowed after 2025 under OBBBA unless qualifying exception applies
Office holiday parties / employee social events	100%	IRC §274(e)(4) exception — available to all employees, not primarily for top management
Tickets to sporting events / concerts	0%	Entertainment — permanently disallowed
Golf, fishing, hunting, recreational activities	0%	Entertainment — permanently disallowed regardless of business purpose
Club dues (social, athletic, golf)	0%	Disallowed — even if used exclusively for business entertainment
Charitable sports events (all proceeds to charity)	100%	IRC §274(l) exception — tickets to qualifying charitable sporting events

Lavish or Extravagant — The Standard

The IRC does not provide a specific dollar threshold for what is "lavish or extravagant." The standard is based on **facts and circumstances** — taking into account the nature of the business, the business relationship with the guest, and what is customary in the industry.

Worked Example — The Chef's Tasting Menu

A consultant takes a prospective client to a fine dining restaurant. The bill: food $420, wine $380, service charge $80 = **$880 total**. The meal is separately billed (no entertainment). All five conditions are met.

Total meal cost	$880
Less: portion deemed lavish (IRS may challenge wine at $380 for a routine client dinner)	Facts & circumstances
Assume full $880 is reasonable for this industry/circumstance	$880 qualifies
50% limitation	× 50%
Deductible meal expense	$440

If the IRS determines $200 of the wine was lavish, the deductible base drops to $680 × 50% = $340. Document the business purpose and relationship on the receipt.

Required Documentation — IRC §274(d)

Business meals are subject to the **strict substantiation requirements** of IRC §274(d). The Cohan rule — allowing estimated deductions — does **not** apply. Without adequate records the entire deduction is disallowed.

Four Things You Must Document — Every Meal

1

Amount

The exact cost of the meal — keep the receipt showing itemized charges. Tips are included in the deductible base.

2

Time and Place

Date of the meal and name/location of the restaurant. Write it on the receipt at the time — not reconstructed later.

3

Business Purpose

The specific business reason for the meal — "discussed Q4 contract renewal" is sufficient. "Business lunch" is not.

4

Business Relationship

Name and business relationship of each person at the meal — "Jane Smith, VP of Operations, ABC Corp" — note it on the receipt or in an expense log.

Quick Reference — TY2026

Item	TY2026 Rule
Business meals	50% deductible — all five conditions met
Entertainment	0% — permanently disallowed (IRC §274(a))
Employee holiday parties	100% — IRC §274(e)(4) exception
Charitable sporting event tickets	100% — IRC §274(l) exception
Meal at entertainment event	50% of meal if separately stated — 0% if combined on one bill
Documentation required	Amount, time & place, business purpose, business relationship — Cohan rule does not apply
Lavish or extravagant	Facts and circumstances — excess above reasonable amount is disallowed before applying 50%
IRC authority	IRC §162 (ordinary & necessary); IRC §274 (limitations);

Item	TY2026 Rule
	Treas. Reg. §1.274-2

2.8.6 Section 179 expense limits

Section 179 Expense Limits · TY2026

IRC §179 allows businesses to **immediately expense** the cost of qualifying property placed in service during the tax year — rather than depreciating it over multiple years. For TY2026, the maximum §179 deduction is **$2,560,000**, with a phase-out beginning at **$4,090,000** in total §179 property placed in service.

$2,560,000 Max Deduction

$4,090,000 Phase-Out Begins

$32,000 SUV Cap

$6,650,000 Fully Phased Out

IRC §179 Authority

TY2026 Section 179 Limits

Prior Lesson Amounts

$1,220,000

Phase-out began at $3,050,000

Correct TY2026

$2,560,000

Phase-out begins at $4,090,000

TY2026 Key §179 Figures

Item	TY2026 Amount	Prior Lesson Amount
Maximum §179 deduction	$2,560,000	$1,220,000
Phase-out threshold	$4,090,000	$3,050,000
SUV cap under §179	$32,000	$30,500
§179 fully phased out	$6,650,000	$4,270,000

What Qualifies for §179

Qualifies — §179 Eligible

- Tangible personal property used in a trade or business, such as machinery, equipment, and tools.
- Computers and peripheral equipment used in the business.

- Vehicles used more than 50% for business, subject to vehicle-specific limits.
- Qualified improvement property, such as eligible interior improvements to nonresidential buildings.
- Off-the-shelf computer software that is not amortizable under §197.
- Used property, if it is new to the taxpayer and not acquired from a related party.

Does NOT Qualify

- Land, residential rental buildings, commercial buildings, and most structural components.
- Property acquired from a related party.
- Property acquired in a like-kind exchange or involuntary conversion, to the extent of carryover basis.
- Property used predominantly outside the United States.
- Listed property used 50% or less for business.

The Phase-Out — Dollar-for-Dollar Reduction

The §179 deduction is reduced **dollar-for-dollar** for every dollar of qualifying §179 property placed in service above the phase-out threshold. For TY2026, the deduction begins to phase out above **$4,090,000.** Once total §179 property placed in service reaches **$6,650,000** ($4,090,000 + $2,560,000), the §179 deduction is completely eliminated.

Total §179 Property Placed in Service	§179 Available	Note
$4,090,000 or less	$2,560,000	Full deduction limit available
$4,290,000	$2,360,000	$2,560,000 − $200,000 excess
$5,000,000	$1,650,000	$2,560,000 − $910,000 excess
$6,650,000 or more	$0	§179 fully eliminated

Taxable Income Limitation

The §179 deduction is further limited to the taxpayer's taxable income from the active conduct of a trade or business. The §179 deduction cannot create or increase a net operating loss. Any amount disallowed by the taxable income limitation carries forward indefinitely.

Taxable Income Limitation — How It Works

- First apply the §179 dollar limit and phase-out reduction.
- Then compare the remaining §179 amount to active business taxable income.
- The allowed deduction is limited to taxable income from active trades or businesses.
- Any disallowed amount carries forward indefinitely as a §179 carryforward.

Section 179 vs. 100% Bonus Depreciation — TY2026

For TY2026, both §179 and 100% bonus depreciation may allow large first-year deductions. However, §179 is elective and subject to dollar limits, phase-out, and taxable income limits. Bonus depreciation is generally automatic for qualified property unless the taxpayer elects out.

Feature	§179	100% Bonus Depreciation
First-year deduction	Up to $2,560,000 before phase-out and income limits	100% of eligible basis for qualified property
Taxable income limit	Yes — cannot exceed active business taxable income	No — may create or increase an NOL
Carryforward	Yes — indefinite carryforward	No carryforward of unused bonus depreciation
Election	Taxpayer elects on Form 4562	Generally automatic unless taxpayer elects out
SUV cap	$32,000 §179 cap for certain SUVs	No §179 SUV cap, but vehicle rules still matter

AFTR Planning Point

- Use §179 when the taxpayer wants to choose specific assets and has enough active business taxable income.
- Use bonus depreciation for eligible remaining basis or when the taxable income limitation restricts §179.
- Always check state conformity because states may treat §179 and bonus depreciation differently.

Worked Examples — TY2026

Example 1 — Small Business, Under Phase-Out

Carter's HVAC purchases **$180,000** of new equipment in TY2026. Total §179 property placed in service is $180,000, which is below the $4,090,000 phase-out threshold. Business taxable income before §179 is $210,000.

Equipment cost	$180,000
§179 dollar limit	$2,560,000 — not a constraint
Taxable income limit	$210,000 — not a constraint
§179 deduction	$180,000

Example 2 — Large Purchase, Phase-Out Applies

Riverside Manufacturing places **$4,500,000** of qualifying §179 property in service during TY2026. The phase-out threshold is $4,090,000. Excess property is $410,000.

Total §179 property placed in service	$4,500,000
Less: phase-out threshold	($4,090,000)
Excess	$410,000

§179 maximum before phase-out	$2,560,000
Less: phase-out reduction	($410,000)
Maximum §179 deduction after phase-out	$2,150,000

Example 3 — SUV Cap

A contractor purchases a **$72,000 SUV** with a GVWR over 6,000 pounds and uses it 100% for business. The TY2026 §179 SUV cap is **$32,000**.

SUV cost	$72,000
Maximum §179 SUV amount	$32,000
Remaining basis	$40,000
Remaining basis may qualify for bonus depreciation	$40,000

Section 179 — TY2026 Quick Reference

Item	TY2026 Amount / Rule
Maximum §179 deduction	$2,560,000
Phase-out threshold	$4,090,000 — dollar-for-dollar reduction above this amount
Phase-out complete	$6,650,000 — §179 = $0
SUV cap	$32,000 for §179
Taxable income limit	Cannot exceed active business taxable income; excess carries forward indefinitely
Form	Form 4562 — Part I
Authority	IRC §179; Rev. Proc. 2025-32; Form 4562

2.8.7 Depreciation

Lesson 2.8.7 — Depreciation · TY2026

Three major depreciation changes apply for TY2026. **Notice 2026-11** confirms that **100% bonus depreciation is reinstated** for qualified property placed in service after December 31, 2025. **Rev. Proc. 2026-15** sets updated luxury automobile depreciation limits. Listed property rules are updated to reflect the current definition of computers and technology.

100% Bonus Depreciation

Notice
2026-11 Authority

Rev. Proc.
2026-15 Luxury Auto Limits

IRC §168(k) Bonus Dep. Code

IRC §280F Luxury Auto / Listed

2.8.7.1 — Bonus Depreciation — 100% Reinstated

Notice 2026-11 · IRC §168(k)

The TCJA introduced 100% bonus depreciation but phased it down beginning in 2023 (80%), 2024 (60%), and 2025 (40%). OBBBA and Notice 2026-11 **fully reinstate 100% bonus depreciation** for qualified property placed in service after December 31, 2025. Taxpayers may deduct the entire cost of eligible property in the year it is placed in service.

TY2025 — Phase-Down

40%

IRC §168(k) as phased down by TCJA schedule

TY2026 — Reinstated

100%

Notice 2026-11 · IRC §168(k)

What Qualifies for 100% Bonus Depreciation — TY2026

- **Qualified property —** new or used tangible personal property with a MACRS recovery period of 20 years or less
- **Qualified improvement property (QIP) —** improvements to the interior of a nonresidential building (15-year property)
- Computer software not amortizable under §197
- Certain film, television, and live theatrical productions
- Property must be **placed in service** after December 31, 2025
- Used property qualifies if not previously used by the taxpayer and not acquired from a related party

Does NOT Qualify for Bonus Depreciation

- Real property with a MACRS recovery period over 20 years (residential rental — 27.5 yrs; nonresidential — 39 yrs)
- Property used predominantly outside the United States
- Property acquired in a like-kind exchange or involuntary conversion
- Property for which the taxpayer elects out of bonus depreciation under IRC §168(k)(7)
- Listed property used 50% or less for business (must use ADS straight-line instead)

Bonus Depreciation Phase-Down History

Tax Year	Bonus Rate	Authority
2018–2022	100%	TCJA original

Tax Year	Bonus Rate	Authority
2023	80%	TCJA phase-down
2024	60%	TCJA phase-down
2025	40%	TCJA phase-down
2026 (TY2026)	100%	REINSTATED — Notice 2026-11

Worked Example — 100% Bonus Depreciation

Atlas Plumbing LLC purchases a new service van for **$58,000** and places it in service on March 15, 2026. The van is used 100% for business. No §179 election is made.

Cost of property	$58,000
Bonus depreciation rate (TY2026)	100%
Year 1 depreciation deduction	$58,000

Under TY2025 rules (40% bonus), the Year 1 deduction would have been only $23,200. The reinstatement provides $34,800 in additional first-year deductions.

2.8.7.2 — Luxury Automobile Depreciation Limits

Rev. Proc. 2026-15 · IRC §280F

IRC §280F limits annual depreciation deductions on passenger automobiles used for business. **Rev. Proc. 2026-15** sets the TY2026 dollar caps. These limits apply regardless of the depreciation method — MACRS, §179, or bonus depreciation. The caps apply per vehicle per year.

TY2026 Luxury Auto Depreciation Caps — Rev. Proc. 2026-15

Year	Passenger Auto (No Bonus)	Passenger Auto (With Bonus)	Trucks & Vans (No Bonus)	Trucks & Vans (With Bonus)
Year 1	$12,400	$20,400	$12,900	$20,900
Year 2	$19,800	$19,800	$19,900	$19,900
Year 3	$11,900	$11,900	$11,900	$11,900
Year 4+	$7,160	$7,160	$7,160	$7,160

How the §280F Cap Interacts with 100% Bonus — TY2026

Even with 100% bonus depreciation reinstated, a passenger automobile placed in service in TY2026 is still capped at **$20,400** in Year 1 (with bonus). If the vehicle costs more than $20,400, the excess deduction is deferred and taken in future years subject to the Year 4+ cap of $7,160 per year until fully recovered.

The §280F cap does **not** apply to vehicles with a GVWR over 6,000 lbs — heavy SUVs, vans, and pickup trucks over this threshold are not subject to luxury auto limits (though they may be subject to the §179 SUV cap of $30,500 for TY2026).

Worked Example — Luxury Auto Cap with Bonus Depreciation

Dr. Chen purchases a **$68,000** luxury sedan on June 1, 2026 for 80% business use. Adjusted basis = $68,000 × 80% = $54,400. With 100% bonus depreciation, the computed deduction would be $54,400 — but §280F limits Year 1 to:

Computed bonus depreciation (80% × $68,000)	$54,400
§280F Year 1 cap with bonus (passenger auto)	$20,400
TY2026 actual deduction	$20,400

The remaining $34,000 in unrecovered basis is deducted in future years at the Year 4+ rate of $7,160/year (80% business use applied each year).

2.8.7.3 — Listed Property Updates

IRC §280F(d)(4) · Treas. Reg. §1.280F-6

Listed property is subject to special substantiation requirements and reduced depreciation rules when business use falls to 50% or below. The current definition of listed property has been updated to reflect the modern business environment — notably, computers and peripheral equipment were **removed from listed property** effective for property placed in service after December 31, 2017, and that remains the rule for TY2026.

Listed Property — Strict Rules Apply

- **Passenger automobiles** (GVWR 6,000 lbs or less)
- **Other transportation vehicles** — boats, planes, motorcycles
- **Property generally used for entertainment** — cameras, video recording equipment used for both business and personal purposes
- Any property of a type generally used for entertainment, recreation, or amusement

No Longer Listed Property — TY2026

- **Computers and peripheral equipment** — removed from listed property effective 2018; normal MACRS / bonus / §179 rules apply
- Cell phones — removed from listed property effective 2010
- Regular business machinery and equipment
- Qualified improvement property (QIP)

Listed Property — The 50% Business Use Test

The most important rule for listed property is the **50% qualified business use test**. The depreciation method available depends on whether business use exceeds or falls at/below 50%.

Business Use	Depreciation Method	Bonus & §179 Eligible?
Over 50% business use	MACRS (accelerated) — normal recovery period	Yes — subject to §280F caps for autos
50% or less business use	ADS straight-line only — longer recovery period	No — bonus and §179 not available
Drops to 50% or below after year 1	Switch to ADS; recapture excess depreciation previously claimed	Recapture included in income — Form 4797

Substantiation — Treas. Reg. §1.274-5T

For all listed property, the taxpayer must maintain **adequate records** or sufficient evidence to corroborate the taxpayer's own statement — showing the amount of business use, the time and place of use, the business purpose, and the business relationship. For vehicles this means a **contemporaneous mileage log**. Without adequate records, the IRS may recharacterize all use as personal and disallow the entire depreciation deduction.

Depreciation — TY2026 Quick Reference

Item	TY2026 Rule
Bonus depreciation rate	100% — reinstated for property placed in service after Dec. 31, 2025 (Notice 2026-11)
Luxury auto — Year 1 (no bonus)	$12,400 passenger auto / $12,900 trucks & vans
Luxury auto — Year 1 (with bonus)	$20,400 passenger auto / $20,900 trucks & vans
Luxury auto — Year 4+	$7,160 per year until fully recovered
Heavy SUV §179 cap (GVWR > 6,000 lbs)	$30,500 for TY2026 — not subject to §280F luxury auto caps
Computers — listed property?	No — removed from listed property effective 2018
Cell phones — listed property?	No — removed from listed property effective 2010
Listed property 50% test failure	ADS straight-line only — no bonus or §179; recapture if drops below 50% after year 1
Records required	Contemporaneous log — amount, time, place, purpose, business relationship — Treas. Reg. §1.274-5T

2.9 Overview of capital gains and losses

[Image: Overview-of-capital-gains-and-losses.webp]

TY2026 Long-Term Capital Gains Tax Rates — Rev. Proc. 2025-32(.03)

Rate	Single — Taxable Income	MFJ — Taxable Income	HoH — Taxable Income
0%	Up to $48,350	Up to $96,700	Up to $64,750
15%	$48,351 – $533,400	$96,701 – $600,050	$64,751 – $566,700
20%	Over $533,400	Over $600,050	Over $566,700

Special rates not affected by the 0%/15%/20% brackets:

Special Capital Gain Rates

Rates Not Controlled by the 0% / 15% / 20% Brackets

Collectibles

Art, coins, stamps, antiques, gems, and similar collectibles may be taxed at a special long-term rate.

Maximum Long-Term Rate: 28%

Unrecaptured §1250 Gain

Depreciation recapture from real property may be taxed separately from standard LTCG rates.

Maximum Rate: 25%

Short-Term Gains

Assets held one year or less do not qualify for preferential capital gain treatment.

Taxed at Ordinary Rates: 10%–37%

Important Planning Point

These special categories override the normal 0% / 15% / 20% long-term capital gain brackets. Always identify the type of asset before applying preferential capital gain rates.

Holding Period

- **Short-term:** Held **1 year or less** — ordinary income rates apply
- **Long-term:** Held **more than 1 year** — preferential 0%/15%/20% rates apply

The holding period begins the **day after** the asset is acquired and ends **on** the day it is sold or exchanged. A holding period of exactly 12 months is short-term; one day more is long-term.

Calculating Gain or Loss

Gain or Loss = Amount Realized – Adjusted Basis

- **Amount Realized** = selling price minus selling expenses (commissions, fees)
- **Adjusted Basis** = original cost + capital improvements − depreciation taken − return of capital received

Form 8949 and Schedule D

Each sale or exchange is reported on Form 8949, grouped into short-term (Part I) and long-term (Part II) transactions. The applicable checkbox (A, B, C for short-term; D, E, F for long-term) indicates whether the IRS received basis information from the broker on Form 1099-B.

Totals from Form 8949 flow to **Schedule D**, which nets short-term and long-term gains and losses, applies the $3,000 ordinary income offset if there is a net capital loss, and computes the net capital gain entered on Form 1040 Line 7.

Capital Loss Rules — TY2026

- Short-term losses first offset short-term gains; long-term losses first offset long-term gains.
- Excess losses then cross over to offset the other character.
- Net capital losses may offset up to **$3,000** of ordinary income ($1,500 for MFS).
- Remaining losses carry forward indefinitely, retaining their short-term or long-term character.

Avoiding wash sales:

[Image: wash-sales.webp]

Form 1099-B and Form 1099-DIV

- **Form 1099-B** (Proceeds from Broker and Barter Exchange Transactions) reports each individual securities sale. Key boxes: Box 1d (proceeds), Box 1e (cost or other basis), Box 1g (wash sale loss disallowed), Box 2 (short-term/long-term indicator), Box 4 (backup withholding — credit, not income).
- **Form 1099-DIV Box 2a** reports capital gain distributions from mutual funds — these are long-term by nature and flow to Schedule D or directly to Form 1040 Line 7 if Schedule D is not otherwise required.

2.10 Standard Deduction

Lesson 2.10 — Standard Deduction · TY2026 (Filed 2027)

The standard deduction is a flat dollar amount that reduces taxable income for taxpayers who do not itemize on Schedule A. Amounts are adjusted annually for inflation under **Rev. Proc. 2025-32**. Additional amounts apply for taxpayers who are **age 65 or older** or **legally blind**. OBBBA §70103 also created a new **$6,000 senior bonus deduction** for taxpayers age 65+ with qualifying income levels.

$16,100 Single / MFS

$32,200 MFJ / QSS

$24,150 Head of Household

+$2,050 Age 65+/Blind Single/HOH

+$1,650 Age 65+/Blind MFJ/MFS

Standard Deduction by Filing Status — TY2026

Filing Status	TY2026	TY2025
Single / Married Filing Separately	$16,100	$15,750
Married Filing Jointly / Qualifying Surviving Spouse	$32,200	$31,500
Head of Household	$24,150	$23,625

Additional Standard Deduction — Age 65 or Older / Blind

An additional amount is added per qualifying condition — age 65 or older, or legally blind. The amounts differ by filing status and **stack** — a taxpayer who is both age 65 and blind receives the add-on twice.

Filing Status	Per Condition (TY2026)	Per Condition (TY2025)
Single / Head of Household	$2,050	$2,000
MFJ / MFS / QSS (per qualifying spouse)	$1,650	$1,600

Examples — Total Standard Deduction with Add-Ons

Situation	Total
Single, age 66 — $16,100 + $2,050	$18,150
Single, age 68 AND legally blind — $16,100 + $2,050 + $2,050	$20,200
Head of Household, age 67 — $24,150 + $2,050	$26,200
MFJ, both spouses age 65+ — $32,200 + $1,650 + $1,650	$35,500
MFJ, one spouse 65+, one spouse blind — $32,200 + $1,650 + $1,650	$35,500

Age is determined as of December 31, 2026. A taxpayer born January 1, 1962 is considered age 65 for TY2026.

New — OBBBA §70103 Senior Bonus Deduction (TY2025–2028)

New Above-the-Line Deduction for Seniors — OBBBA §70103

- Taxpayers age 65 or older may claim an additional **$6,000 above-the-line deduction** — separate from and in addition to the standard deduction age add-on
- Phases out at **$60 per $1,000** of MAGI above $75,000 (Single / HOH) or $150,000 (MFJ) — fully phased out at $175,000 / $250,000

- Available for **tax years 2025 through 2028 only** — it is a temporary provision, not permanent
- Available even to taxpayers who itemize — it is not limited to standard deduction filers

Standard Deduction for Dependents — IRC §63(c)(5)

A taxpayer who can be claimed as a dependent on another person's return receives the **greater of** $1,350 or $450 plus the dependent's earned income — but cannot exceed the regular standard deduction for their filing status.

- Dependent with **$200 interest only** (no earned income): floor applies → deduction = **$1,350**
- Dependent with **$4,000 wages**: $450 + $4,000 = $4,450 — exceeds floor → deduction = **$4,450**
- Dependent with **$20,000 wages**: $450 + $20,000 = $20,450 — but cannot exceed the $16,100 regular single deduction → deduction = **$16,100**

2.11.1 Medical and dental expense

[Image: Medical and Dental Expenses TY2026]

Lesson 2.11.1 — Medical & Dental Expenses · TY2026

Medical and dental expenses are deductible on Schedule A to the extent they exceed **7.5% of AGI** (IRC §213). For TY2026, **Rev. Proc. 2025-32** updates the eligible long-term care (LTC) premium limits by age. Qualifying LTC insurance premiums are treated as medical expenses subject to the same 7.5% AGI floor. Form 1099-LTC reports benefits received from LTC contracts and accelerated death benefits.

7.5% AGI Floor

IRC §213 Authority

Rev. Proc.
2025-32 LTC Premium Limits

Schedule A Reported On

Form 1099-LTC Benefits Received

The 7.5% AGI Floor — How It Works

Under IRC §213, a taxpayer may deduct unreimbursed medical and dental expenses paid during the tax year to the extent the total exceeds **7.5% of Adjusted Gross Income**. Only the amount *above* the floor is deductible on Schedule A, Line 4.

Worked Example — Medical Expense Deduction

Patricia, Single, AGI **$65,000.** Unreimbursed medical expenses paid in TY2026: **$7,200.**

Total unreimbursed medical expenses	$7,200
7.5% AGI floor: $65,000 × 7.5%	($4,875)
Deductible on Schedule A, Line 4	$2,325

Patricia must also be itemizing — if her total itemized deductions do not exceed the TY2026 standard deduction for Single filers, the medical deduction provides no benefit.

What Qualifies as a Medical Expense

Qualified medical expenses are amounts paid for the **diagnosis, cure, mitigation, treatment, or prevention of disease**, and for treatments affecting any structure or function of the body. Expenses must be for the taxpayer, spouse, or a dependent.

Qualifies — Deductible	Does Not Qualify
Doctor, dentist, hospital, and specialist fees	Cosmetic surgery, unless correcting deformity from disease or accident
Prescription medications and insulin	Over-the-counter drugs, unless prescribed
Health insurance premiums not paid pre-tax through an employer	Premiums paid with pre-tax dollars
Long-term care insurance premiums within age-based limits	Gym memberships and general health programs
Medical transportation, 20.5¢ per mile for TY2026	Funeral, burial, or cremation expenses

Insurance Reimbursement Offset

Only **unreimbursed** expenses qualify. Any amount reimbursed by insurance, an FSA, HSA, or HRA must be subtracted before applying the 7.5% floor. If a reimbursement is received in a later year for an expense previously deducted, the reimbursement is included in income in the year received under the tax benefit rule.

Eligible Long-Term Care Premiums — Rev. Proc. 2025-32

Premiums paid for a **qualified long-term care insurance contract** are treated as medical expenses under IRC §213(d)(1)(D). However, only premiums up to the applicable dollar limit — determined by the insured's age at the end of the tax year — may be included.

TY2026 Eligible LTC Premium Limits — Rev. Proc. 2025-32(.27)

Age Before Close of TY2026	Maximum Eligible Premium
40 or younger	$500
41 through 50	$930
51 through 60	$1,860
61 through 70	$4,960
71 or older	$6,200

Qualified LTC Contract Requirements — IRC §7702B

To use the eligible premium limits, the contract must be a **qualified LTC insurance contract**.

- Covers only qualified long-term care services.
- Cannot be surrendered for cash value or used as collateral.
- Refunds and policyholder dividends generally must reduce future premiums or increase future benefits.
- Must meet consumer protection requirements under state law.

Worked Example — MFJ Couple with LTC Premiums

Harold, age **67**, and Betty, age **64**, file MFJ. AGI: **$90,000**. Harold pays **$5,200** in qualified LTC premiums. Betty pays **$2,100**. They also have **$4,800** in other unreimbursed medical expenses.

Harold's actual LTC premium paid	$5,200
Harold's eligible limit, age 67	$4,960 cap
Betty's actual LTC premium paid	$2,100
Betty's eligible limit, age 64	$4,960 limit — full $2,100 allowed
Other unreimbursed medical expenses	$4,800
Total medical expenses: $4,960 + $2,100 + $4,800	$11,860
7.5% AGI floor: $90,000 × 7.5%	($6,750)
Deductible on Schedule A, Line 4	$5,110

Harold's excess premium ($5,200 – $4,960 = $240) is not eligible. The limit is per insured person and is not transferable to Betty's limit.

Form 1099-LTC — Long Term Care & Accelerated Death Benefits

Form 1099-LTC is issued by insurance companies to report benefits paid under qualified long-term care insurance contracts and accelerated death benefits paid under life insurance policies. Receiving a Form 1099-LTC does **not** automatically mean the benefits are taxable.

Box	What It Reports	Tax Treatment
Box 1	Gross LTC benefits paid	May be partially or fully excludable
Box 2	Accelerated death benefits paid	Generally excludable if terminally or chronically ill
Box 3	Per diem or reimbursement indicator	R = reimbursement; P = per diem
Box 4	Qualified LTC services indicator	If checked, contract is a qualified LTC contract

Box	What It Reports	Tax Treatment
Box 5	Chronically ill indicator	Key for exclusion eligibility
Box 6	Terminally ill indicator	Generally 100% excludable

LTC Benefit Exclusion — Reimbursement vs. Per Diem

LTC benefits received from a qualified contract are generally excludable from gross income. The exclusion rules differ depending on whether the policy pays on a **reimbursement basis** or a **per diem basis**.

Reimbursement Basis — Box 3 = R

Benefits that reimburse actual qualified LTC expenses paid are generally **fully excludable** from gross income as long as they do not exceed the actual cost of LTC services. Report on Form 8853, Section C when required.

Per Diem Basis — Box 3 = P — TY2026 Daily Limit

Per diem benefits are excludable up to the greater of:

- The IRS per diem limit for TY2026: **$430 per day**; or
- The actual cost of qualified LTC services for the day.

Per diem benefits exceeding the greater of these two amounts are included in gross income. Report on Form 8853, Section C when required.

Accelerated Death Benefits — Form 1099-LTC Box 2

Accelerated death benefits are amounts paid under a life insurance contract to a policyholder who is **terminally or chronically ill** before the insured's death. These are reportable on Form 1099-LTC, Box 2.

Recipient Type	Tax Treatment
Terminally ill insured	Generally 100% excludable from gross income
Chronically ill insured	Excludable up to the applicable LTC per diem limits
Viatical settlement	May be excludable if insured is terminally or chronically ill

Business-Owned Policies — No Exclusion

The exclusion for accelerated death benefits does **not apply** if the policyholder has a **business ownership interest** in the insured, such as an employer-owned life insurance policy where the employer is the policyholder.

Quick Reference — Medical Expenses & LTC for TY2026

Item	TY2026 Rule
AGI floor	7.5% of AGI

Item	TY2026 Rule
Medical mileage rate	20.5¢ per mile
LTC eligible premium — age 40 or younger	$500
LTC eligible premium — age 41–50	$930
LTC eligible premium — age 51–60	$1,860
LTC eligible premium — age 61–70	$4,960
LTC eligible premium — age 71+	$6,200
LTC per diem exclusion limit	$430 per day
Accelerated death benefits — terminally ill	Generally 100% excludable
Authority	IRC §213; IRC §7702B; IRC §101(g); Rev. Proc. 2025-32(.27); Form 8853

2.11.2 State and local tax deduction

Lesson 2.11.2 — State & Local Tax (SALT) Deduction · TY2026

This topic is covered in full detail in **Lesson 1.9.5 — SALT Deduction (OBBBA §70120)**. The summary below highlights the key numbers for quick reference in the context of Schedule A itemized deductions.

$40,400 New Cap

$20,200 MFS Cap

$10,000 Phaseout Floor

§70120 OBBBA Authority

Key Highlights for Schedule A — TY2026

Cap Increased

$10,000 $40,400

TCJA flat cap replaced by OBBBA §70120 for TY2026

MFS Filers

$20,200 cap

Married Filing Separately — half the joint cap

Phaseout Floor

$10,000 minimum

Cap phases down with rising AGI — never below $10,000

Year of Payment

Cash basis rule

SALT deducted in the year paid — not the year assessed

What Counts Toward the SALT Cap

Eligible — Counts Toward Cap	Not Eligible
State and local income taxes paid	Foreign taxes (use Form 1116)
State/local general sales taxes (in lieu of income tax)	Federal income taxes
Real property taxes on personal residence	Transfer taxes on real estate sales
Personal property taxes based on vehicle value	Business taxes (go to Schedule C / E / F)

Phaseout — Three Zones

AGI Zone	Available SALT Cap	Note
Below phaseout threshold	$40,400 full cap	No reduction
Within phaseout range	Between $10,000 and $40,400	Reduced per §70120 formula
Above phaseout ceiling	$10,000 floor — minimum	Cannot go below $10,000

Full Coverage in Lesson 1.9.5

For complete coverage including worked examples, filing-status breakdown, PTET workaround analysis, and the year-of-payment rule — see **Lesson 1.9.5 — State and Local Tax (SALT) Deduction, OBBBA §70120**.

2.11.3 Home mortgage interest

Lesson 2.11.3 — Home Mortgage Interest · TY2026

Full detail is covered in **Lesson 1.9.2 — Mortgage Interest Deduction (OBBBA §70108)**. This lesson highlights the key rules for Schedule A in the context of Domain 2 itemized deductions — including the new **mortgage insurance premium** treatment and the continuing **home equity indebtedness disallowance**.

$750,000 Acquisition Debt Limit

$375,000 MFS Limit

$0 Home Equity Interest

MIP New — Now Qualified

§70108 OBBBA Authority

Key Highlights for Schedule A — TY2026

Acquisition Debt

$750,000 limit

Interest on loans to buy, build, or substantially improve a qualified residence — permanent under OBBBA

Home Equity Interest

Not deductible

Interest on home equity debt not used to buy, build, or improve the residence remains disallowed

Mortgage Insurance Premium

Now qualified interest

OBBBA §70108 — MIP on acquisition indebtedness treated as qualified residence interest

Qualified Residences

Up to 2 homes

Principal residence plus one second home — $750,000 limit applies across both combined

What Is New for TY2026 — OBBBA §70108

Mortgage Insurance Premiums — Now Treated as Qualified Residence Interest

Prior to OBBBA §70108, the deductibility of mortgage insurance premiums (MIP/PMI) had expired and been repeatedly extended by Congress on a temporary basis. **OBBBA §70108 makes this treatment permanent** — MIP paid on acquisition indebtedness secured by a qualified residence is now treated as **qualified residence interest** under IRC §163(h).

This applies to premiums for FHA, VA, USDA, and private mortgage insurance (PMI) on loans used to acquire the residence. The deduction is subject to the same $750,000 acquisition debt limit and the general Schedule A rules.

Mortgage Interest — Allowed vs. Disallowed

Deductible on Schedule A	Not Deductible
Interest on acquisition debt up to $750,000	Interest on home equity debt used for non-acquisition purposes
Mortgage insurance premiums (MIP/PMI) on acquisition debt — OBBBA §70108	Interest on the portion of debt exceeding $750,000 ($375,000 MFS)
Points paid to obtain a loan on principal	Interest on a third or additional

Deductible on Schedule A	Not Deductible
residence (may be deductible in year paid)	residence
Interest on pre-2018 grandfathered debt up to $1,000,000	Late payment charges that are not interest

Home Equity Exception — When It IS Deductible

Interest on a home equity loan or HELOC **is deductible** if the proceeds were used to **buy, build, or substantially improve** the qualified residence securing the loan — because in that case the debt qualifies as acquisition indebtedness, not home equity indebtedness. The label on the loan does not control; the **use of the proceeds** controls.

Form 1098 — Mortgage Interest Statement

Box	What It Reports	Schedule A Treatment
Box 1	Mortgage interest received	Deductible — subject to $750,000 limit
Box 2	Outstanding mortgage principal	Used to determine if $750,000 limit applies
Box 5	Mortgage insurance premiums (MIP/PMI)	Deductible as qualified residence interest — OBBBA §70108
Box 6	Points paid on purchase of principal residence	Generally deductible in year paid for purchase loans
Box 7	Address of property securing the mortgage	Used to confirm qualified residence status

Full Coverage in Lesson 1.9.2

For complete coverage including the grandfathered $1,000,000 pre-2018 debt rules, refinancing analysis, mixed-use loan tracing, and worked examples — see **Lesson 1.9.2 — Mortgage Interest Deduction, OBBBA §70108**.

2.11.4 Charitable contribution

Lesson 2.11.4 — Charitable Contributions · TY2026

Full detail is covered in **Lesson 1.11 — Charitable Contributions (OBBBA §70424 & §70425)**. This lesson highlights the three key areas for Schedule A — the **60% AGI limit**, the **$250 written acknowledgment rule**, and the two OBBBA changes that affect both itemizers and non-itemizers for TY2026.

60% AGI Limit — Cash

$250 Acknowledgment Floor

0.5% Itemizer AGI Floor

$1,000 Non-Itemizer Deduction

$2,000 MFJ Non-Itemizer

2.11.4.1 — AGI Limits on Charitable Contributions

The deductibility of charitable contributions on Schedule A is subject to AGI-based percentage limits that vary by the **type of property contributed** and the **type of organization** receiving the gift. Amounts exceeding the limit carry forward for up to **five years**.

Type of Contribution	Organization Type	AGI Limit
Cash	50% organizations (public charities, churches, schools, hospitals)	60%
Capital gain property (FMV)	50% organizations	30%
Cash	30% organizations (private foundations, veterans orgs)	30%
Capital gain property (FMV)	30% organizations	20%
Ordinary income property	Any qualifying organization	50% / cost basis only

60% Limit — Cash to Public Charities

The 60% AGI limit for **cash contributions to 50% organizations** (public charities, churches, educational institutions, hospitals) was made permanent by the TCJA and continues for TY2026. This is the most commonly used limit for individual taxpayers.

Example: Taxpayer with AGI $100,000 donates $65,000 cash to a public charity. The deductible amount this year is limited to **$60,000** (60% of AGI). The remaining $5,000 carries forward to TY2027.

5-Year Carryforward

Contributions exceeding the applicable AGI limit carry forward for up to **five tax years** and are subject to the same percentage limit in each carryforward year. Carryforward amounts are used after current-year contributions of the same type. Unused carryforwards after five years are permanently lost.

2.11.4.2 — Contemporaneous Written Acknowledgment — $250 or More

Under IRC §170(f)(8), no deduction is allowed for any contribution of **$250 or more** (cash or property) unless the taxpayer obtains a **contemporaneous written acknowledgment (CWA)** from the donee organization. The CWA must be obtained by the **earlier of** the date the return is filed or the due date (including extensions).

Amount of Contribution

CWA must state the amount of cash — or describe property donated (no valuation required from org)

Goods or Services

Must state whether any goods or services were provided in exchange — and a good-faith estimate of their value

Timing — Contemporaneous

Must be in hand by the earlier of the return filing date or due date (with extensions)

Who Provides It

The donee organization — not the taxpayer. A bank statement alone is not sufficient for a single $250+ donation

No CWA = No Deduction — No Exceptions

The Supreme Court confirmed in *Kunkel v. Commissioner* and the Tax Court has consistently held that the CWA requirement is **strict and unforgiving**. A CWA obtained after the return is filed — even one day late — does not cure the deficiency. The deduction is disallowed in full, not just reduced.

A donor who received **something of value in exchange** (gala dinner, goods, raffle entry) may only deduct the excess of the contribution over the fair market value of the benefit received — the quid pro quo rules of IRC §170(f)(8)(B).

What Is New for TY2026 — OBBBA §70424 & §70425

OBBBA §70424 — Non-Itemizers

$1,000

Single / HOH / MFS

$2,000

Married Filing Jointly

Above-the-line deduction on Schedule 1 — available to taxpayers who take the standard deduction. Cash contributions only. Qualifying organizations must be public charities under IRC §170(b)(1)(A).

OBBBA §70425 — Itemizer 0.5% Floor

0.5% of AGI

Must exceed this before any deduction allowed

Itemizers may only deduct the amount of charitable contributions **exceeding 0.5% of their contribution base (AGI)**. This floor is separate from and applied before the 60% / 30% / 20% AGI percentage limits.

How the Two OBBBA Rules Interact — TY2026

Taxpayer	Rule That Applies	Deduction Mechanism
Takes standard deduction	OBBBA §70424	Above-the-line up to $1,000 / $2,000 MFJ on Schedule 1 — 0.5% floor does NOT apply
Itemizes on Schedule A	OBBBA §70425	Only contributions exceeding 0.5% of AGI are deductible — then subject to 60%/30%/20% limits

Example — §70425 floor: Itemizer with AGI $80,000 donates $600 cash to a public charity. Floor = $80,000 × 0.5% = $400. Deductible on Schedule A = $600 – $400 = **$200**.

Charitable Contribution Rules — TY2026 at a Glance

Rule	TY2026 Detail
Cash to public charities	60% of AGI limit — excess carries forward 5 years
Capital gain property to public charities	30% of AGI limit — excess carries forward 5 years
Written acknowledgment required	$250 or more — cash or property — must be contemporaneous
Non-itemizer deduction (OBBBA §70424)	$1,000 Single / $2,000 MFJ — above-the-line on Schedule 1 — cash only
Itemizer floor (OBBBA §70425)	Only contributions exceeding 0.5% of AGI deductible — applied before the percentage limits
Charitable mileage rate	14¢ per mile (statutory — IRC §170(i) — unchanged)
Cash contributions under $250	Bank record or written receipt from organization — CWA not required but documentation still needed

Full Coverage in Lesson 1.11

For complete coverage including non-cash property valuation rules, vehicle donation requirements, conservation easements, donor-advised funds, and worked examples for both OBBBA provisions — see **Lesson 1.11 — Charitable Contributions, OBBBA §70424 & §70425**.

2.11.5 Federally declared and state declared disaster area casualty loss deduction (including loss deduction for non-itemizers

[Image: Casualty Loss Deduction TY2026]

Lesson 2.11.5 — Casualty Loss Deduction · TY2026

Full detail is covered in **Lesson 1.9.3 — Casualty Loss Deduction (OBBBA §70109)**. This lesson highlights the key rules for both **itemizers (Schedule A)** and the **non-itemizer casualty loss deduction** — including the expanded coverage to state-declared disaster areas for TY2026.

Federal + State Qualifying Declarations

$100 Per-Event Floor

10% AGI Floor

Non-Itemizers Also Eligible

§70109 OBBBA Authority

What Changed for TY2026 — OBBBA §70109

TY2018–2025 · TCJA

Federal Declaration
Only

State disasters not eligible for personal property losses

TY2026 · OBBBA §70109

Federal OR State
Declaration

Either declaration qualifies — both eligible for TY2026

Key Rules — Both Itemizers and Non-Itemizers

Step 1 — Per-Event Floor

Subtract $100

Reduce each separate casualty event by $100 before any other calculation

Step 2 — AGI Floor

Subtract 10% AGI

Only the amount exceeding 10% of AGI (after the $100 reduction) is deductible

Insurance Offset

Reduce by reimbursement

Must reduce the loss by insurance or other reimbursement received or reasonably expected

Loss Measurement

Lesser of two

Lesser of: (a) decrease in FMV, or (b) adjusted basis of the property

Non-Itemizer Casualty Loss Deduction — TY2026

Taxpayers Who Take the Standard Deduction Can Also Claim Casualty Losses

For TY2026, a taxpayer who takes the **standard deduction** is not barred from claiming a qualifying casualty loss. The loss from a federally or state-declared disaster area is deductible as an **above-the-line adjustment** — it does not require itemizing on Schedule A.

The same $100 per-event floor and 10% AGI floor apply. The loss is reported on **Form 4684** (Casualties and Thefts) and flows to **Schedule 1, Line 8c** as an other income adjustment for non-itemizers, reducing AGI directly.

Item	Itemizer	Non-Itemizer
Can claim casualty loss?	Yes	Yes
Where reported	Schedule A, Line 15 (via Form 4684)	Schedule 1, Line 8c (via Form 4684)
$100 per-event floor	Applies	Applies
10% AGI floor	Applies	Applies
Disaster declaration required	Federal or State	Federal or State
Effect on AGI	Below-the-line Reduces taxable income only	Above-the-line Reduces AGI directly

These Losses Still Do Not Qualify

- Losses from **progressive deterioration** — termite damage, rust, rot, dry rot, disease
- Losses on personal property **outside any declared disaster area** — still disallowed under TCJA suspension
- Losses **fully covered by insurance** — or where taxpayer failed to file a timely claim
- Losses from **willful acts** or negligence of the taxpayer
- **Business property** follows separate rules — Form 4684 Section B, deductible regardless of declaration

The Calculation — Four Steps

1

Determine Loss

Lesser of FMV decrease or adjusted basis — minus insurance reimbursement

2

Apply $100 Floor

Subtract $100 from the net loss for each separate casualty event

3

Apply 10% AGI Floor

Subtract 10% of AGI from total of all casualty losses (after Step 2)

4

Report on Form 4684

Itemizer: flows to Sch. A Line 15 — Non-itemizer: flows to Sch. 1 Line 8c

Full Coverage in Lesson 1.9.3

For complete coverage including the full worked example, the federal vs. state declaration comparison table, the prior-year election, and business property rules — see **Lesson 1.9.3 — Casualty Loss Deduction, OBBBA §70109**.

2.11.6 Moving expense deduction not allowed and reimbursement is taxable (except for active military and members of the intelligence community (OBBBA §70113

2.11.6 — Moving Expense Deduction (OBBBA §70113)

[Image: exception-moving.webp]

Lesson 2.11.6 — Moving Expense Deduction · TY2026

The moving expense deduction under IRC §217 is **suspended for most taxpayers** through at least 2025 by TCJA and made effectively permanent by OBBBA. The deduction — and the exclusion from income for employer reimbursements — remains available **only for active-duty members of the Armed Forces** and, new for TY2026, **certain members of the intelligence community** under **OBBBA §70113**. For all other taxpayers, moving expense reimbursements from an employer are **taxable wages.**

Suspended Most Taxpayers

Military Active Duty — Qualifies

Intel Community New for TY2026

Taxable Reimbursements — Others

20.5¢ Moving Mileage Rate

Who May — and May Not — Deduct Moving Expenses

Deduction NOT Available — TY2026

- Private-sector employees relocating for a new job
- Self-employed individuals moving for business
- Retirees moving after leaving the workforce
- Students relocating for school

- Civilians transferred by a non-government employer
- Any taxpayer not in an eligible category below

Deduction Available — TY2026

- **Active-duty Armed Forces member** moving pursuant to a military order and incident to a permanent change of station (PCS)
- **Certain members of the intelligence community** — new for TY2026 under OBBBA §70113 — moving pursuant to a qualifying order
- Spouse or dependents of eligible member following a PCS or qualifying order

What Is New for TY2026 — OBBBA §70113

Intelligence Community Members — Now Eligible

OBBBA §70113 extends the moving expense deduction and the employer reimbursement exclusion to **certain members of the intelligence community** who are required to move pursuant to a qualifying government order, effective for TY2026.

The intelligence community is defined by reference to the National Security Act of 1947 and includes employees and officers of agencies such as the CIA, NSA, DIA, and related intelligence elements of the federal government. The move must be:

- Pursuant to a **government order** directing the move
- Incident to a **change of official duty station**
- Not voluntary — the move must be required by the employing agency

Qualifying Moving Expenses — Eligible Members Only

For taxpayers who qualify (active military or eligible intelligence community members), deductible moving expenses under IRC §217 are limited to **reasonable costs** of:

Deductible Moving Costs	Not Deductible
Moving household goods and personal effects	Pre-move house-hunting trips
Travel (including lodging) from old home to new home	Meals during the move
Mileage at **20.5¢ per mile** for TY2026 (Notice 2026-10) — see Lesson 1.2	Temporary living expenses at new location
Storage costs — up to 30 days after household goods leave old home	Real estate costs (selling old home, buying new home)
Connecting / disconnecting utilities required by the move	Security deposits or lease-breaking fees

Moving Mileage Rate — Cross-Reference to Lesson 1.2

The standard mileage rate for qualified moving expenses is **20.5 cents per mile** for TY2026, per IRS Notice 2026-10. The rate applies only to eligible taxpayers (active military and qualifying intelligence community members). Full mileage rate context is covered in **Lesson 1.2 — Standard Mileage Rates (Notice 2026-10)**.

Employer Reimbursements — Taxable or Excludable

The tax treatment of employer-paid moving expense reimbursements depends entirely on whether the employee is an **eligible member** (active military or qualifying intelligence community) or a **civilian employee**.

Civilian Employee

Reimbursement is TAXABLE

- Included in Box 1 wages on Form W-2
- Subject to federal income tax withholding
- Subject to FICA (Social Security and Medicare)
- No offsetting deduction available
- No exclusion under IRC §132(g)

Active Military / Intel Community

Reimbursement is EXCLUDABLE

- Excluded from wages under IRC §132(g)
- Shown in Box 12, Code P on Form W-2
- Not subject to income tax withholding
- Not subject to FICA
- Move must be pursuant to qualifying order

Form 3903 — Moving Expenses

Eligible taxpayers (active military and qualifying intelligence community members) report deductible moving expenses on **Form 3903**. The deductible amount flows to **Schedule 1, Line 14** as an above-the-line adjustment — the deduction is available whether the taxpayer itemizes or takes the standard deduction.

Item	Detail
Form used	Form 3903 — Moving Expenses
Flows to	Schedule 1, Line 14 — above-the-line deduction
Who files it	Active-duty military and qualifying intelligence community members only
Mileage rate	20.5¢ per mile — TY2026 (Notice 2026-10) — see Lesson 1.2
W-2 Box 12 Code P	Employer-paid moving expense reimbursements excluded from income — must reduce deductible expenses by this amount on Form 3903
Itemizing required?	No — above-the-line; available with standard deduction

Worked Example — Active Military PCS Move

Active Duty PCS — TY2026

Sergeant Torres receives PCS orders. He drives **1,400 miles** to the new duty station. Moving company charges: **$3,200**. His employer (the government) reimbursed **$2,000**, shown in Box 12, Code P on his W-2.

Mileage: 1,400 miles x $0.205	$287
Moving company cost	$3,200
Total qualifying expenses	$3,487
Less: government reimbursement (W-2 Box 12, Code P)	($2,000)
Deductible on Form 3903 — Schedule 1, Line 14	$1,487

The $2,000 reimbursement is excluded from income (Box 12, Code P) and is not taxable. Meals during the move are not deductible even if not reimbursed.

Moving Expense Rules — TY2026 Quick Reference

Item	Most Taxpayers	Military / Intel Community
Moving expense deduction	Not allowed	Allowed
Employer reimbursement	Taxable wages	Excludable — IRC §132(g)
W-2 reporting	Box 1 — taxable wages	Box 12, Code P — excluded
Itemizing required	N/A	No — above-the-line
Form filed	None	Form 3903 — Sch. 1, Line 14
Mileage rate	N/A	20.5¢/mile (Notice 2026-10)
OBBBA new for TY2026	No change	Intel community added §70113

Related Lesson — Mileage Rate

The 20.5¢ standard mileage rate for qualified moving expenses, its derivation, and the depreciation component are covered in **Lesson 1.2 — Standard Mileage Rates (Notice 2026-10)**.

2.11.7 Recordkeeping and documentation of deductions

[Image: Recordkeeping and Documentation of Deductions]

Lesson 2.11.7 — Recordkeeping & Documentation · TY2026

A deduction is only as strong as the records that support it. IRC §6001 requires every taxpayer to keep records sufficient to establish the amount of gross income, deductions, credits, and other items. Inadequate documentation is one of the most common reasons deductions are disallowed on audit — even when the expense was legitimate and actually paid.

3 Years Standard Retention

6 Years 25%+ Understatement

Unlimited Fraud / No Return

IRC §6001 Authority

§274 / §6694 Substantiation Rules

The Legal Framework — IRC §6001

IRC §6001 requires taxpayers to maintain books and records sufficient to establish their tax liability. Treas. Reg. §1.6001-1 specifies that records must be kept as long as they may be relevant to the administration of any internal revenue law — which in practice means at least until the statute of limitations expires for the returns those records support.

The burden of proof rests with the taxpayer. When a deduction is questioned on audit, it is the taxpayer's responsibility to substantiate the deduction — not the IRS's responsibility to disprove it. Under the *Cohan rule*, courts may allow an estimated deduction when records are incomplete — but this doctrine does not apply to expenses with strict substantiation requirements under IRC §274 (listed property, travel, meals, and vehicle expenses).

Cohan Rule Does NOT Apply to §274 Expenses

For **listed property** (vehicles, computers, other listed items), **travel**, **meals**, and **entertainment** — IRC §274(d) imposes strict substantiation requirements. No deduction is allowed if records are missing, regardless of whether the expense clearly occurred. Estimates and reconstructed logs are not acceptable substitutes for contemporaneous records.

How Long to Keep Records

The minimum retention period is tied to the **statute of limitations** for assessment under IRC §6501. Keep records for the longest period that applies to your situation.

Situation	Keep Records	Authority
Return filed, no understatement issues	3 years	IRC §6501(a)
Substantial understatement of income (>25% omitted)	6 years	IRC §6501(e)
No return filed or fraudulent return	Unlimited	IRC §6501(c)
Property records (home, investments, business assets)	Until sold + 3 years	IRC §6001; basis tracking
Employment tax records	4 years	IRC §6501; Treas. Reg. §31.6001-1
NOL, credit carryforward, or basis carryover records	Until used + 3 years	IRC §6001; carryforward rules

Required Documentation by Deduction Type

Medical & Dental Expenses

- Receipts or Explanation of Benefits (EOB) from insurer showing amount billed and amount paid by patient
- Prescription records and pharmacy receipts
- Mileage log for medical travel — date, destination, purpose, miles (20.5¢/mile for TY2026)
- Documentation that expenses were **not reimbursed** by insurance, FSA, or HSA
- For LTC premiums — copy of qualified LTC contract and annual premium statement

State & Local Taxes (SALT)

- State income tax — Form W-2 withholding, state estimated payment confirmations, prior-year state return showing refund or balance due paid
- Real property tax — annual property tax bill and proof of payment (bank statement, cancelled check)
- Personal property tax — vehicle registration receipt showing tax amount based on value
- Sales tax (if elected) — IRS Optional Sales Tax Tables or receipts for large purchases

Mortgage Interest & MIP

- Form 1098 — Mortgage Interest Statement from lender (Box 1 interest, Box 5 MIP, Box 6 points)
- Loan documents showing original principal, acquisition date, and that loan is secured by qualified residence
- For loans over $750,000 — amortization schedule to compute the deductible proportion
- For points paid — HUD-1 or Closing Disclosure from purchase settlement
- For home equity loans used to improve the home — contractor invoices and payment records tracing proceeds to the improvement

Charitable Contributions

- **Cash under $250** — bank record, cancelled check, or written receipt from organization
- **Cash $250 or more** — Contemporaneous Written Acknowledgment (CWA) from donee organization, obtained by return due date
- **Non-cash under $250** — receipt from organization describing property donated
- **Non-cash $250–$500** — CWA required
- **Non-cash $501–$5,000** — CWA plus Form 8283, Section A
- **Non-cash over $5,000** — qualified written appraisal plus Form 8283, Section B; appraisal must be within 60 days before donation and no later than return due date
- Charitable mileage — date, destination, purpose, and miles (14¢/mile for TY2026)

Casualty & Theft Losses

- Copy of federal or state disaster declaration — including declaration number and covered area
- Evidence the property was located in the declared disaster area
- Proof of ownership and adjusted basis (purchase records, prior depreciation schedules)
- Documentation of FMV before and after — independent appraisal, contractor repair estimates, or IRS-approved safe harbor methods
- Insurance claim documentation — claim filed, amount received or expected
- Photographs or video of damage

Vehicle & Mileage (IRC §274 — Strict Substantiation)

- **Contemporaneous mileage log** required — Treas. Reg. §1.274-5T
- Each entry must show: **date, destination, business purpose, and number of miles**
- Total annual mileage — business, commuting, and personal — must be tracked separately
- For actual expense method — receipts for gas, oil, repairs, insurance, registration, and depreciation records
- Reconstructed logs are generally not accepted for §274 expenses — contemporaneous means recorded at or near the time of the trip

Digital & Electronic Records — IRS Acceptance

Rev. Proc. 98-25 and subsequent IRS guidance confirm that **electronic records are acceptable** provided they are accurate, complete, legible, and retrievable. The IRS accepts:

Scanned Receipts

Photos or scans of paper receipts stored digitally — must be legible and complete

Email Confirmations

Order confirmations, donation acknowledgments, and statements received by email

Mileage Apps

GPS-based mileage tracking apps — acceptable if they record date, destination, and purpose

Bank & Card Statements

Acceptable for cash contributions under $250 and general expense corroboration

Digital Records — Best Practices

- Back up electronic records to at least **two separate locations** (cloud + local drive)
- Organize by tax year and deduction category so records can be produced quickly on audit

- Retain original paper receipts for high-value items — digital backup is supplemental, not always sufficient on its own for large deductions
- Ensure scanned images are **fully legible** — faded thermal paper receipts deteriorate; scan promptly

Consequences of Inadequate Documentation

Consequence	Detail
Deduction disallowed	Unsubstantiated deductions are disallowed in full — the tax is assessed as if the deduction was never claimed
Accuracy-related penalty	20% penalty on the underpayment attributable to negligence or substantial understatement — IRC §6662
Fraud penalty	75% penalty if underpayment is due to fraud — IRC §6663
Preparer penalties	Tax preparers who claim deductions without adequate supporting documentation may face penalties under IRC §6694 — unreasonable positions or willful disregard
Extended audit window	Omission of more than 25% of gross income extends the statute of limitations to 6 years — all records for that return must be retained longer

Quick Reference — Document Checklist by Deduction

Deduction	Minimum Documentation Required	Strict §274 Rule?
Medical expenses	Receipts, EOBs, mileage log	No
SALT	Tax bills, payment confirmations, W-2	No
Mortgage interest / MIP	Form 1098, loan documents	No
Charitable — cash <$250	Bank record or written receipt	No
Charitable — $250 or more	Contemporaneous Written Acknowledgment (CWA)	Yes — IRC §170(f)(8)
Charitable — non-cash >$5,000	Qualified appraisal + Form 8283 Section B	Yes — IRC §170(f)(11)
Casualty loss	Disaster declaration, appraisal, insurance records, photos	No
Vehicle / mileage	Contemporaneous log — date, destination, purpose, miles	Yes — IRC §274(d)
Misc. 2% expenses (reinstated)	Receipts, employer statements, invoices showing business purpose	Depends on type

2.12 Tax credit eligibility

Tax Credits Overview — TY2026

Credits Reduce Tax Dollar-for-Dollar

Why Credits Matter

Tax credits directly reduce tax liability dollar-for-dollar — more valuable than a deduction of the same amount because they reduce the actual tax owed.

Child Tax Credit

For TY2026, the CTC is **$2,200** per qualifying child, with up to **$1,700 refundable**.

Earned Income Credit

The EITC may be as high as **$8,046** for taxpayers with three or more qualifying children for TY2026.

Child & Dependent Care

Claimed on **Form 2441** for qualifying care expenses that allow the taxpayer to work or look for work.

Education Credits

The AOC and LLC are claimed on **Form 8863** and commonly supported by Form 1098-T.

Form 8862 Reclaim

Taxpayers previously denied credits due to reckless or fraudulent claims must file **Form 8862** before reclaiming the credit.

Tax Credit Eligibility · TY2026 (Filed 2027)

Tax credits reduce tax liability dollar-for-dollar — more powerful than deductions. For TY2026, **Rev. Proc. 2025-32** updates the Child Tax Credit and Earned Income Credit amounts. This lesson covers eligibility requirements, credit amounts, and the key forms for all major individual tax credits.

$2,200 CTC Per Child

$1,700 CTC Refundable

$8,046 Max EITC

$2,500 Max AOTC

$3,000 / $6,000 Care Credit Base

Child Tax Credit (CTC) — Rev. Proc. 2025-32(.05)

The CTC provides **$2,200 per qualifying child** for TY2026. Up to **$1,700** is refundable as the Additional Child Tax Credit (ACTC), claimed on Schedule 8812. The credit phases out for higher-income taxpayers.

Item	TY2026 Amount / Rule
Credit amount	$2,200 per qualifying child
Refundable portion (ACTC)	Up to $1,700 per child — Schedule 8812
Qualifying child age	Under age 17 at end of TY2026
Phaseout — Single / HOH	Begins at $200,000 AGI — $50 reduction per $1,000 (or fraction) above threshold
Phaseout — MFJ	Begins at $400,000 AGI — same $50 per $1,000 reduction
SSN required	Child must have a valid SSN issued before the return due date
Form	Schedule 8812 (Credits for Qualifying Children and Other Dependents)

Credit for Other Dependents (ODC) — $500

A non-refundable credit of **$500** is available for each qualifying dependent who does not qualify for the CTC — including dependents age 17 or older, qualifying relatives, and dependents with an ITIN (instead of SSN). Also reported on Schedule 8812. Subject to the same $200,000 / $400,000 phaseout thresholds as the CTC.

Earned Income Tax Credit (EITC) — Rev. Proc. 2025-32(.06)

The EITC is a refundable credit for low-to-moderate income workers. The maximum credit amount depends on the number of qualifying children. For TY2026, the maximum credit is **$8,046** for taxpayers with three or more qualifying children.

TY2026 EITC Maximum Credits & Income Limits — Rev. Proc. 2025-32(.06)

Qualifying Children	Max Credit	Income Limit (Single / HOH)	Income Limit (MFJ)
None	$649	$19,104	$25,511
One	$4,328	$46,560	$52,918
Two	$7,152	$52,918	$59,276
Three or more	$8,046	$56,838	$63,196

EITC Key Eligibility Rules — TY2026

- Must have **earned income** (wages, self-employment income) — investment income only does not qualify
- Investment income limit: **$11,950** for TY2026 — exceeding this disqualifies the taxpayer entirely
- Must have a valid **SSN** by the return due date (including extensions)
- Filing status cannot be **Married Filing Separately**
- Cannot be claimed as a dependent on another person's return
- Age rule (no qualifying children): taxpayer must be at least **age 25** and under **age 65**

- Reported on **Schedule EIC** (attached to Form 1040)

EITC Due Diligence — IRC §6695(g)

Paid preparers must meet due diligence requirements when claiming the EITC, CTC/ACTC, AOTC, and Head of Household filing status — completing **Form 8867** (Paid Preparer's Due Diligence Checklist). The penalty for failure to meet due diligence requirements is **$640 per credit per return** for TY2026.

Child & Dependent Care Credit — Form 2441

The Child and Dependent Care Credit is a **non-refundable** credit for expenses paid to care for a qualifying person so the taxpayer (and spouse, if MFJ) can work or look for work. The credit is a percentage of qualifying expenses, ranging from **20% to 35%** depending on AGI.

Item	TY2026 Rule
Qualifying expense base	$3,000 for one qualifying person; $6,000 for two or more
Credit percentage	35% (AGI $15,000 or less) — decreases to 20% (AGI over $43,000)
Maximum credit	$1,050 (one person) / $2,100 (two or more) at the 35% rate
Qualifying person	Child under age 13; spouse or dependent unable to care for themselves
Employer-provided DCAP	Dependent Care FSA amounts excluded from income ($5,000 limit) must reduce qualifying expenses dollar-for-dollar
Provider information required	Name, address, and TIN (SSN or EIN) of care provider must be reported on Form 2441
Form	Form 2441 — flows to Schedule 3, Line 2

Education Credits — Form 8863 & Form 1098-T

American Opportunity Credit (AOTC)

- Maximum: **$2,500** per eligible student
- 40% refundable — up to **$1,000**
- First **4 years** of post-secondary education only
- At least **half-time** enrollment required
- Phaseout: $80,000–$90,000 Single; $160,000–$180,000 MFJ
- Felony drug conviction **disqualifies** the student
- Based on first $2,000 expenses (100%) + next $2,000 (25%)

Lifetime Learning Credit (LLC)

- Maximum: **$2,000** per return (not per student)
- **Non-refundable** — cannot exceed tax liability
- No limit on years of study — graduate, professional, any course

- Does not require degree program enrollment
- Phaseout: $80,000–$90,000 Single; $160,000–$180,000 MFJ
- 20% of first **$10,000** of qualifying expenses
- Cannot claim AOTC and LLC for same student same year

Form 1098-T — Tuition Statement

Eligible educational institutions issue Form 1098-T to students reporting amounts billed or paid for qualified tuition and related expenses. **Box 1** reports amounts paid; **Box 5** reports scholarships and grants received. The net qualifying expense = Box 1 minus Box 5 (scholarships reduce qualifying expenses).

A Form 1098-T is required to claim the AOTC — the IRS matches credit claims against 1098-T data. For the LLC, 1098-T is not strictly required but is strong supporting documentation.

Form 8862 — Reclaiming Credits After Disallowance

Taxpayers whose EITC, CTC/ACTC, or AOTC was previously disallowed by the IRS due to **reckless or intentional disregard of rules** must file Form 8862 to reclaim the credit in a subsequent year. The form certifies the taxpayer's eligibility and explains why the earlier disallowance does not apply.

Reason for Prior Disallowance	Ban Period	Form 8862 Required to Reclaim?
Reckless or intentional disregard	2 years	Yes — after 2-year ban
Fraud	10 years	Yes — after 10-year ban
Math error or clerical error only	No ban	Not required

Form 8862 — Do Not File If...

- The ban period has not yet expired
- The IRS has determined the taxpayer does not have a qualifying child for EITC purposes and the taxpayer is claiming EITC without a qualifying child
- The disallowance was solely due to a math or clerical error

Tax Credits — TY2026 Quick Reference

Credit	Max Amount	Refundable?	Form
Child Tax Credit (CTC)	$2,200 / child	Partially — up to $1,700 (ACTC)	Schedule 8812
Credit for Other Dependents	$500 / dependent	No	Schedule 8812
EITC (3+ children)	$8,046	Yes — fully refundable	Schedule EIC
Child & Dependent Care	$2,100 (2+ persons)	No	Form 2441
American Opportunity	$2,500 / student	Partially — up to $1,000	Form 8863

Credit	Max Amount	Refundable?	Form
(AOTC)			
Lifetime Learning (LLC)	$2,000 / return	No	Form 8863
Form 8862 Reclaim	N/A — eligibility form	N/A	Form 8862

2.13.1 — Tax Treatment of the Acquisition and Disposition of Digital Assets

[Image: Digital Asset Taxation]

Digital Asset Reporting

Digital Assets & Cryptocurrency

Digital assets—including cryptocurrency, NFTs, stablecoins, and other blockchain-based property—are treated as property for federal tax purposes under IRS Notice 2014-21. As a result, taxpayers must recognize gain or loss whenever a taxable disposition occurs.

Property, Not Currency

- Digital assets are treated as property rather than foreign currency for federal tax purposes.
- Gain or loss is generally calculated using the asset's basis and the amount realized on disposition.
- IRS Notice 2014-21 remains the foundational authority for digital asset taxation.

Taxable Transactions

- Selling cryptocurrency for cash is a taxable disposition.
- Exchanging one digital asset for another creates a taxable event.
- Using digital assets to purchase goods or services may trigger gain or loss recognition.

Form 1099-DA Reporting

Beginning TY2026, brokers are required to report digital asset transactions on Form 1099-DA, Digital Asset Proceeds From Broker Transactions.

Digital asset brokers are now subject to third-party reporting requirements.

Form 1099-DA serves a role similar to Form 1099-B for traditional securities.

IRS matching programs will have significantly more visibility into digital asset transactions.

- **The Form 1040 Digital Asset Question**
- Every taxpayer must answer the digital asset question on Page 1 of Form 1040.
- The answer must be either "Yes" or "No" regardless of whether a taxable transaction occurred.

- Failure to properly answer the question may attract additional IRS scrutiny when digital asset activity exists.

Practitioner Tip

Never assume that a client who answers "No" to the digital asset question had no activity. Ask follow-up questions about cryptocurrency exchanges, digital wallets, NFTs, staking rewards, stablecoins, and peer-to-peer transfers. Beginning with Form 1099-DA reporting, the IRS will receive substantially more transaction data than in prior years.

Notice 2014-21

Background — Property Treatment

The IRS first addressed cryptocurrency taxation in Notice 2014-21, concluding that virtual currency is treated as property—not currency—for federal tax purposes.

Why Property Treatment Matters

- Digital assets are subject to the same general tax principles that apply to stocks, real estate, and other capital assets.
- Taxpayers must determine basis, amount realized, and resulting gain or loss when a taxable disposition occurs.
- Capital gain or loss treatment frequently applies depending on the nature and use of the asset.

Common Taxable Events

- Selling cryptocurrency for cash.
- Exchanging one digital asset for another digital asset.
- Using cryptocurrency or another digital asset to purchase goods or services.

Why Small Transactions Matter

[Image: Bitcoin Coffee Purchase]

- The IRS first addressed the tax treatment of cryptocurrency in Notice 2014-21, concluding that virtual currency is treated as property—not currency—for federal tax purposes.
- This means the same tax rules that apply to stocks, real estate, and other capital assets generally apply to digital assets.
- Every time a taxpayer disposes of a digital asset—whether by selling it, exchanging it, or using it to purchase goods or services—a taxable event occurs and gain or loss must be computed.
- A taxpayer who uses Bitcoin to buy a cup of coffee has technically made a taxable disposition of property and must calculate any resulting gain or loss—even on a de minimis transaction.

The Form 1040 Digital Asset Question

Form 1040 for TY2026 asks on Page 1: *"At any time during 2026, 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)?"*

- Answer **Yes** if the taxpayer received digital assets as payment for services, rewards, awards, or grants; sold, exchanged, or gifted digital assets; or disposed of any digital assets in any way.

- Answer **Yes** if the taxpayer received new digital assets through mining, staking, airdrops, or hard forks.

- Answer **No** only if the taxpayer's sole digital asset activity was holding, transferring between their own wallets, or purchasing with cash — with no sales, exchanges, or income-generating events.

[Image: digital-asset-question.webp]

The digital asset question must be answered by every taxpayer — not just those who had transactions. Leaving it blank is an error. Answering "No" when the taxpayer had taxable transactions is a potential accuracy-related issue.

Taxable vs. Non-Taxable Digital Asset Events

Event	Taxable?	Character
Sale of digital asset for cash	Yes	Capital gain or loss (short- or long-term based on holding period)
Exchange of one digital asset for another (e.g., BTC for ETH)	Yes	Capital gain or loss at FMV of asset received
Using digital assets to purchase goods or services	Yes	Capital gain or loss; amount realized = FMV of goods/services received
Receipt of digital assets as payment for services	Yes	Ordinary income at FMV when received; basis = FMV at receipt
Mining income	Yes	Ordinary income at FMV when received; may also trigger SE tax
Staking rewards	Yes	Ordinary income at FMV when received (per current IRS guidance)
Airdrop received	Yes (if dominion and control established)	Ordinary income at FMV when received
Hard fork resulting in new coins	Yes (if received and in taxpayer's control)	Ordinary income at FMV when received

Event	Taxable?	Character
Purchasing digital assets with cash	No	Not a taxable event; establishes basis
Transferring digital assets between own wallets	No	Not a taxable event; basis carries over
Donating digital assets to charity	No gain recognition	Charitable deduction at FMV if held >1 year; deduction at lower of basis or FMV if short-term
Gifting digital assets	No (donor); no (donee at receipt)	Carryover basis to donee; gift tax rules may apply if over annual exclusion

Form 1099-DA — TY2026 Broker Reporting

[Image: Form 1099-DA Reporting Flow]

Beginning for transactions occurring on or after January 1, 2026, brokers—including centralized cryptocurrency exchanges—are required to issue Form 1099-DA, Digital Asset Proceeds From Broker Transactions, to both customers and the IRS. This reporting framework is similar to Form 1099-B reporting used for traditional securities.

- Gross proceeds from digital asset dispositions.
- Date of acquisition and date of sale.
- Cost basis information when known to the broker.
- Whether the transaction produced a short-term or long-term gain or loss.
- Any backup withholding applied to the transaction.

Form 1099-DA limitations for TY2026: Brokers report only transactions occurring on their platforms. Transactions in self-custody wallets, decentralized exchanges (DEX), peer-to-peer transfers, and assets transferred in from other platforms may have incomplete or missing basis information. Practitioners must ask clients for wallet records, exchange statements, and transaction histories from all platforms used — do not assume the 1099-DA captures all activity or reflects correct basis.

Computing Gain or Loss on Digital Assets
Gain or Loss = Amount Realized − Adjusted Basis

Digital Asset Gain or Loss Formula

Gain or Loss = Amount Realized − Adjusted Basis

Amount Realized

The fair market value (FMV) of what was received in the transaction.

Examples include:
• cash proceeds
• FMV of other digital assets received
• FMV of goods or services received

Adjusted Basis

The cost to acquire the digital asset, including transaction fees.

Basis may increase or decrease over time depending on later adjustments.

For mining, staking, or services income:
basis equals the **FMV previously reported as income** when received.

Identification Methods for Basis

When a taxpayer holds multiple units of the same digital asset purchased at different times and prices, they must identify which units are being sold. Acceptable methods include:

- **First In, First Out (FIFO):** Default if no specific identification is made
- **Specific Identification:** The taxpayer identifies the specific units sold (requires adequate records showing cost and acquisition date of each unit)
- **Highest Cost:** Some platforms offer this method; IRS guidance on acceptability for digital assets should be monitored

Reporting Digital Asset Transactions

Digital asset dispositions are reported on **Form 8949, Sales and Other Dispositions of Capital Assets**, and summarized on **Schedule D**, exactly as traditional securities sales are reported. Ordinary income from digital assets (mining, staking, services) is reported on the applicable line — Schedule C for business mining, Schedule 1 for other ordinary income.

2.13.2 Alternative Minimum Tax (AMT) – exemption/phaseout amounts

[Image: Alternative Minimum Tax]

Form 6251 — Alternative Minimum Tax · TY2026

Rev. Proc. 2025-32 · Exemption & Phaseout Amounts · IRC §55–§59

Lesson 2.13.2 — Alternative Minimum Tax · TY2026

The Alternative Minimum Tax (AMT) is a parallel tax system designed to ensure high-income taxpayers pay a minimum level of tax regardless of deductions and preferences. For TY2026, **Rev. Proc. 2025-32(.10)** updates the AMT exemption amounts and phaseout thresholds. Taxpayers who may owe AMT must complete **Form 6251** and pay the higher of their regular tax or their tentative minimum tax.

$137,000 Exemption — Single

$220,700 Exemption — MFJ

26% / 28% AMT Rates

Form 6251 Reporting Form

IRC §55 Authority

How the AMT Works

The AMT requires certain taxpayers to compute their tax liability twice — once under the regular tax rules and once under the AMT rules — and pay the higher amount. The AMT eliminates or reduces many deductions and preferences that reduce regular tax, creating an **Alternative Minimum Taxable Income (AMTI)** that is then reduced by the applicable exemption before applying the AMT rates.

AMT Calculation — Step by Step

1

Start with Taxable Income

Regular taxable income from Form 1040

2

Add Back AMT Preferences & Adjustments

Add back: SALT deduction, standard deduction, miscellaneous deductions, certain depreciation differences, ISO stock option spreads, and other tax preference items — IRC §57, §58

3

= Alternative Minimum Taxable Income (AMTI)

Taxable income plus all AMT adjustments and preferences

4

Subtract AMT Exemption

Subtract the applicable exemption (indexed for TY2026 per Rev. Proc. 2025-32) — phased out at higher AMTI levels

5

Apply AMT Rates — 26% / 28%

26% on AMTI up to $239,100 ($119,550 MFS); 28% on the excess — this is the Tentative Minimum Tax (TMT)

Compare TMT to Regular Tax — Pay the Higher

If TMT exceeds regular tax, the excess is the AMT owed — reported on Schedule 2, Line 1 and Form 6251

TY2026 AMT Exemption & Phaseout Amounts — Rev. Proc. 2025-32(.10)

TY2026 Exemption & Phaseout Thresholds — Rev. Proc. 2025-32(.10)

Filing Status	Exemption Amount	Phaseout Begins	Phaseout Complete
Single / Head of Household	$137,000	$609,350	$1,157,350
Married Filing Jointly / QSS	$220,700	$1,218,700	$2,101,500
Married Filing Separately	$110,350	$609,350	$1,050,750
Estate or Trust	$29,900	$99,700	$219,300

How the Phaseout Works

The AMT exemption phases out at a rate of **25 cents for every $1 of AMTI** above the phaseout threshold. Once AMTI reaches the phaseout complete amount, the exemption is fully eliminated and the taxpayer's entire AMTI is subject to AMT rates.

Example — MFJ: AMTI of $1,318,700. Phaseout begins at $1,218,700. Excess = $100,000. Exemption reduction = $100,000 × 25% = $25,000. Remaining exemption = $220,700 – $25,000 = **$195,700**.

AMT Rate Structure — TY2026

AMTI After Exemption	AMT Rate	Filing Status
Up to $239,100	26%	All filers except MFS
Above $239,100	28%	All filers except MFS
Up to $119,550	26%	Married Filing Separately
Above $119,550	28%	Married Filing Separately

Common AMT Preferences & Adjustments

These items reduce regular tax but are added back when computing AMTI — they are the most common triggers for AMT liability for individual taxpayers.

Item	Regular Tax Treatment	AMT Treatment
SALT deduction	Deductible up to $40,400	Added back — not allowed for AMT
Accelerated depreciation (MACRS vs. ADS)	MACRS accelerated depreciation	Adjustment = MACRS minus ADS straight-line depreciation
Incentive Stock Options	Not taxable at	Spread at exercise is an AMT

Item	Regular Tax Treatment	AMT Treatment
(ISO) spread	exercise	preference item — added to AMTI
Home equity loan interest (non-acquisition)	Not deductible under TCJA	No adjustment needed — already disallowed for regular tax
Percentage depletion in excess of cost	Percentage depletion allowed	Excess percentage depletion over adjusted basis added back
Tax-exempt private activity bond interest	Excluded from gross income	Preference item — added to AMTI (unless qualified bonds)

AMT Credit — Form 8801

Recovering AMT Paid in Prior Years

AMT paid in a prior year on **deferral items** (items that create timing differences rather than permanent differences — such as ISO spreads or depreciation adjustments) generates an **AMT credit** that can be used to offset regular tax in future years when regular tax exceeds tentative minimum tax.

The credit is computed on **Form 8801** (Credit for Prior Year Minimum Tax) and carried forward indefinitely. AMT paid on **exclusion items** (permanent differences such as tax-exempt private activity bond interest) does not generate a credit.

Form 6251 — Who Must File

Form 6251 must be attached to Form 1040 when the taxpayer has AMT liability. The IRS also instructs taxpayers to complete Form 6251 — or use the AMT worksheet in the Form 1040 instructions — when any of the following apply:

File Form 6251 If...
Taxpayer claimed accelerated depreciation on property placed in service after 1986
Taxpayer exercised Incentive Stock Options (ISOs) during the year
Taxpayer received tax-exempt interest from private activity bonds
Taxpayer had a large SALT deduction in prior years (now added back to AMTI)
Taxpayer has a prior-year minimum tax credit carryforward from Form 8801
The AMT worksheet in the instructions indicates potential AMT liability

Form 6251 — Where It Flows

AMT computed on Form 6251 flows to **Schedule 2, Line 1**, then to Form 1040, Line 17. The AMT is added to regular tax — it does not replace it. If the tentative minimum tax is less than or equal to regular tax, no AMT is owed and Form 6251 is not required to be attached (though it may still be completed to verify).

Worked Example — Single Filer with ISO Exercise

Single Filer — TY2026

Daniel, Single, AGI **$380,000**. Regular taxable income: $320,000. He exercised ISOs during TY2026 with a spread of **$95,000**. SALT deduction claimed: $28,000.

Regular taxable income	$320,000
Add back: SALT deduction	+$28,000
Add back: ISO spread (AMT preference)	+$95,000
AMTI	$443,000
Less: Single exemption ($137,000 — no phaseout; phaseout starts at $609,350)	($137,000)
AMTI after exemption	$306,000
AMT: $239,100 × 26% = $62,166; ($306,000 − $239,100) × 28% = $18,732	$80,898
If regular tax is less than $80,898 — AMT is owed on the difference	TMT: $80,898

The $95,000 ISO spread creates an AMT credit carryforward on Form 8801 — recoverable in future years when regular tax exceeds the tentative minimum tax.

AMT Quick Reference — TY2026

Item	TY2026 Amount / Rule
Single / HOH exemption	$137,000
MFJ / QSS exemption	$220,700
MFS exemption	$110,350
AMT rates	26% up to $239,100 AMTI; 28% above ($119,550 for MFS)
Phaseout rate	25 cents per $1 of AMTI above threshold
Form filed	Form 6251 — flows to Schedule 2, Line 1 — Form 1040, Line 17
AMT credit (deferral items)	Form 8801 — carried forward indefinitely
Authority	IRC §55–§59; Rev. Proc. 2025-32(.10)

2.13.3 QBI deduction (including Form 8995 and Form 8995-A)

[Image: Qualified Business Income Deduction]

Section 199A Deduction

Qualified Business Income (QBI) Deduction

The §199A Qualified Business Income deduction allows eligible taxpayers to deduct up to 20% of qualified business income from pass-through businesses, including sole proprietorships, partnerships, S corporations, and certain trusts.

Who May Qualify

- Sole proprietors reporting qualified business income.
- Partners receiving qualified business income from partnerships.
- S corporation shareholders receiving qualified business income.
- Certain trusts and estates with eligible pass-through income.

Basic Deduction Rule

- The deduction can be up to 20% of qualified business income.
- Taxpayers below the taxable income threshold generally avoid the wage and property limitations.
- For lower-income taxpayers, the deduction is generally 20% of QBI with no additional business limitation.

When Limitations Apply

For taxpayers above the taxable income threshold, the QBI deduction may be limited by W-2 wages, the unadjusted basis immediately after acquisition of qualified property, and the taxpayer's type of business.

W-2 wage limitations may reduce the deduction.

Qualified property basis may affect the allowable deduction.

Specified Service Trades or Businesses may be phased out at higher income levels.

Forms Used to Claim the Deduction

Form 8995 is generally used for the simplified QBI deduction computation.

Form 8995-A is used when the more detailed QBI deduction computation is required.

Practitioner Tip

Start every QBI analysis by identifying the type of business, the taxpayer's taxable income level, and whether the activity is a Specified Service Trade or Business. For taxpayers below the threshold, the calculation is usually straightforward. For taxpayers above the threshold, wage limits, qualified property, and SSTB rules can materially change or eliminate the deduction.

Background

What is QBI?

Qualified Business Income is the net amount of qualified items of income, gain, deduction, and loss from a qualified trade or business.

QBI Includes

- Qualified business income from a domestic trade or business.
- Qualified items of income, gain, deduction, and loss.

- Income connected with an eligible qualified trade or business.

QBI Does NOT Include

- Capital gains or losses.
- Dividends or interest income, unless properly allocable to the business.
- Reasonable compensation paid to the taxpayer from an S corporation.
- Guaranteed payments from a partnership.
- Foreign income not effectively connected with a U.S. trade or business.

The Two Tiers — Below and Above the Income Threshold

The QBI deduction operates differently depending on whether the taxpayer's taxable income (before the QBI deduction) is above or below the income threshold set by Rev. Proc. 2025-32(.26). Verify the exact TY2026 threshold amounts in Rev. Proc. 2025-32(.26) — these are indexed annually.

Qualified Business Income Deduction

Below vs. Above the Threshold

Below the Threshold

Simple Calculation

QBI deduction is the lesser of:

1. 20% of QBI from all qualified trades or businesses

2. 20% of taxable income minus net capital gains

No W-2 wage limitation applies.

SSTB status does not matter. All qualified businesses are treated the same below the threshold.

Use Form 8995 for the simplified computation.

Above the Threshold

Complex Calculation

The deduction may be limited. Within the phaseout range, limitations phase in. Above the upper threshold, limitations apply in full.

Non-SSTB businesses:
Deduction is limited to the lesser of 20% of QBI or the greater of:

• 50% of W-2 wages paid by the business

• 25% of W-2 wages + 2.5% of qualified property basis

SSTB businesses:
The deduction phases out completely above the upper threshold.

Use Form 8995-A for the detailed computation.

Practitioner Shortcut

Below the taxable income threshold, the QBI deduction is usually straightforward. Above the threshold, always determine whether the business is an SSTB and whether W-2 wages or qualified property limits apply.

Specified Service Trades or Businesses (SSTBs)

Specified Service Trades or Businesses (SSTBs)

SSTBs are businesses where the principal asset is the reputation or skill of the owners or employees. For taxpayers above the §199A taxable income threshold, QBI from SSTBs is subject to additional phase-out rules and may be partially or completely disallowed.

- Professional Services
- Health professions including physicians, dentists, veterinarians, nurses, and similar medical providers.
- Law practices and legal services.
- Accounting and tax preparation services.
- Actuarial science and related professional advisory services.
- Reputation & Skill-Based Fields
- Performing arts and entertainment professions.
- Consulting businesses where expertise is the primary service being sold.
- Athletics and professional sports activities.
- Businesses where the principal asset is the reputation or skill of one or more owners or employees.
- Financial & Investment Fields
- Financial advisory and financial services businesses.
- Brokerage services.
- Investing, trading, or dealing in securities, partnership interests, or commodities.

Practitioner Tip

Many tax preparers, CPAs, attorneys, physicians, consultants, financial advisors, and similar professionals operate SSTBs. Below the §199A taxable income threshold, SSTB status generally does not matter. Above the threshold, however, the deduction may be partially reduced or completely phased out. Always determine whether the business is an SSTB before calculating a high-income taxpayer's QBI deduction.

Engineering and architecture are NOT SSTBs. Despite being professions, engineering and architecture firms were specifically excluded from the SSTB definition and fully qualify for the QBI deduction at all income levels. This is a common exam point.

§199A Dividends from REITs

[Image: QBI Deduction for REIT Dividends]

Special QBI Rule

§199A Dividends from REITs

Dividends received from Real Estate Investment Trusts (REITs) that are designated as §199A dividends qualify for the Qualified Business Income deduction even though they are not income from an operating business.

Identifying §199A Dividends

- REIT dividends designated as §199A dividends qualify for the QBI deduction.
- These amounts are reported in Box 5 of Form 1099-DIV.
- The deduction is generally entered directly on Form 8995.

Special Advantage

- REIT §199A dividends qualify for the 20% deduction.
- They are not subject to the W-2 wage limitation.
- They are not subject to the qualified property limitation regardless of income level.

The Overall Limitation

QBI Deduction ≤ 20% × (Taxable Income − Net Capital Gains)

- Regardless of the amount otherwise calculated, the QBI deduction cannot exceed 20% of taxable income reduced by net capital gains.
- Large capital gains can reduce the amount of taxable income available for the QBI deduction limitation calculation.
- Even taxpayers below the taxable income threshold can have their QBI deduction reduced by this overall limitation.

Practitioner Tip

REIT §199A dividends are often overlooked because they originate from investment accounts rather than operating businesses. Always review Box 5 of Form 1099-DIV. Many taxpayers who do not own a business still qualify for a QBI deduction through REIT investments, and the deduction is not subject to the wage and qualified property limitations that apply to higher-income business owners.

Use Form 8995 when:	Use Form 8995-A when:
• Taxable income is below the threshold • The taxpayer is not a patron of a specified agricultural or horticultural cooperative • No SSTB income (or SSTB is below threshold — no limitation)	• Taxable income is above the threshold (or in phaseout range) • Taxable income is above the threshold (or in phaseout range) • W-2 wage or qualified property limitations may apply • The taxpayer is a patron of a specified cooperative

[Image: qbi_20.webp]

2.13.4 Kiddie Tax

[Image: Kiddie Tax Rules]

IRC §1(g)

Kiddie Tax

The Kiddie Tax prevents parents from shifting investment income to children in order to benefit from the child's lower tax rates. When a child's net unearned income exceeds the applicable threshold, the excess income is taxed using the parents' marginal tax rate.

Purpose of the Kiddie Tax

- Prevents families from shifting investment income to children solely to obtain lower tax rates.
- Applies primarily to unearned income such as interest, dividends, capital gains, and investment income.
- Excess net unearned income is taxed at the parents' marginal tax rate rather than the child's rate.

Common Types of Unearned Income

- Interest income from savings accounts, CDs, and bonds.
- Dividends from stocks, mutual funds, and REITs.
- Capital gains and other investment-related income.

Two Reporting Options

Form 8615

The child files their own tax return and uses Form 8615 to calculate the Kiddie Tax using the parents' marginal tax rate.

Form 8814

If specific requirements are met, parents may elect to include the child's income on their own return using Form 8814.

- **Why Practitioners Must Understand Kiddie Tax**
- Many children own investment accounts funded by parents or grandparents.
- UGMA and UTMA accounts frequently generate dividends, interest, and capital gains subject to Kiddie Tax rules.
- Determining whether Form 8615 or Form 8814 is appropriate is an important planning and compliance decision.

Practitioner Tip

Whenever a dependent child receives a Form 1099-DIV, Form 1099-INT, brokerage statement, or other investment income document, evaluate whether Kiddie Tax rules apply before preparing the return. Many preparers focus on the filing requirement and overlook Form 8615, resulting in an incorrect tax calculation.

Who Is Subject to Kiddie Tax?

Kiddie Tax — TY2026

Who Is Subject to Kiddie Tax?

A child may be subject to the Kiddie Tax when the child has net unearned income above the TY2026 threshold and meets the required age, support, parent, filing, and joint-return rules.

Net Unearned Income

The child has net unearned income above the TY2026 threshold.

Age Test

Applies to children under age 18, certain age 18 children, and full-time students age 19–23.

Parent Alive

At least one parent must be alive at the end of the tax year.

Return Required

The child must be required to file a tax return for the year.

No Joint Return

The child must not file a joint return for the year.

Age Test Details

The child meets the age test if the child is under age 18 at year-end, age 18 with earned income not exceeding half of support, or age 19–23 as a full-time student with earned income not exceeding half of support.

The Kiddie Tax reaches college students up to age 23. Many practitioners overlook this — a 21-year-old full-time college student with significant investment income (from an inheritance, trust, or custodial account) whose earned income does not exceed half their support is subject to Kiddie Tax. This is a frequent AFTR exam question.

Key Definitions

[Image: unearned-income.webp]

[Image: net-unearned-income.webp]

[Image: ceo-and-son.webp]

TY2026 Threshold — Rev. Proc. 2025-32(.02) and (.11)

The Kiddie Tax threshold for TY2026 is set by Rev. Proc. 2025-32 in two sections:

✓ **(.02)** — Sets the base unearned income threshold (the amount sheltered at the child's rate)
✓ **(.11)** — Sets the additional related threshold for the dependent standard deduction calculation that feeds into the Kiddie Tax computation

```
Always verify the exact TY2026 amounts from Rev. Proc. 2025-32 — these are
indexed annually. For TY2026, the threshold is the sum of two times the
dependent standard deduction floor amount.
```

Kiddie Tax Filing Options

Form 8615 vs. Form 8814

Form 8615

- Child files their own return.
- Used to compute income taxed at the parent's marginal rate.
- Required when the child has capital gains or income other than interest and dividends.
- Requires parent filing status, taxable income, tax before credits, and other Kiddie Tax children if applicable.

Form 8814

- Parent elects to include the child's income on the parent's return.
- Available only when income consists entirely of interest, dividends, and Alaska Permanent Fund dividends.
- Not available if the child has capital gains, withholding, estimated payments, other income, or files a separate return.
- May increase parents' AGI and affect deductions, AMT, and Net Investment Income Tax.

Form 8814 vs. Form 8615 — which is better?

Factor	Form 8814 (Election on Parent Return)	Form 8615 (Separate Child Return)
Administrative Burden	**Low** (1 return total)	**Moderate** (2 separate returns)
Impact on Parent AGI	**Increases** parent's AGI and MAGI	**No impact** on parent's AGI
Taxing the $1,350 to $2,700 Band	Taxed at a flat **10%** on parent's return	Often taxed at **0%** if comprised of qualified dividends/capital gains
Risk of Credit Phaseouts	**High**	**None** (from child's income)
Risk of IRMAA Cliff	**High** (Could trigger thousands in Medicare surcharges)	**None** (from child's income)

2.13.5 Section 529 Plans

[Image: Section 529 Qualified Tuition Programs]

Education Tax Benefits

Section 529 Qualified Tuition Programs

Section 529 qualified tuition programs allow families to save for education with tax-free growth and tax-free withdrawals when distributions are used for qualified education expenses.

Tax Treatment

- Account earnings grow tax-free while funds remain in the §529 plan.
- Withdrawals are tax-free when used for qualified education expenses.
- Contributions are not deductible for federal income tax purposes.

State Tax Benefit

- Many states allow a state income tax deduction or credit for §529 contributions.
- State rules vary by plan, contribution amount, residency, and filing status.
- Practitioners should verify the taxpayer's state-specific §529 deduction rules.

Form 1099-Q Reporting

Distributions from §529 qualified tuition programs are reported on Form 1099-Q. The preparer must determine whether the distribution was used for qualified education expenses.

Match 1099-Q distributions to qualified education expenses.

Keep school billing records and payment documentation.

Do not assume every 1099-Q distribution is automatically tax-free.

- **Non-Qualified Distributions**
- Non-qualified distributions are taxable only on the earnings portion.
- The taxable earnings portion is generally subject to ordinary income tax.
- A 10% additional tax may apply to the earnings portion of a non-qualified distribution.

- **SECURE 2.0 Roth IRA Rollover Option**
- Excess §529 funds may be rolled over to the beneficiary's Roth IRA if strict requirements are met.
- The rollover rules contain important timing, contribution, beneficiary, and lifetime limitation requirements.
- Practitioners should verify all rollover conditions before treating a transfer as tax-free.

Practitioner Tip

A Form 1099-Q does not automatically mean the taxpayer owes tax. The key question is whether the distribution was matched to qualified education expenses. Always compare the distribution to tuition, required fees, books, supplies, equipment, and other eligible expenses before determining whether any earnings are taxable.

Qualified Education Expenses

- Tuition, fees, books, supplies, and equipment required for enrollment at an eligible institution
- Room and board (up to the school's cost-of-attendance allowance) for students enrolled at least half-time
- Special needs services for special needs beneficiaries
- Computer, internet access, and related technology used primarily by beneficiary while enrolled
- **K-12 tuition:** Up to **$10,000 per year** per beneficiary for tuition at public, private, or religious K-12 schools
- **Student loan repayment:** Up to **$10,000 lifetime per beneficiary** (and $10,000 per sibling) may be used to repay qualified student loans
- **Apprenticeship programs:** Registered apprenticeship program costs qualify

Computing a §529 Distribution

Form 1099-Q reports the gross distribution in Box 1, earnings in Box 2, and basis in Box 3. The taxable portion is computed as:

$$Earnings\ Ratio = \frac{Earnings}{Total\ Account\ Value \text{at Distribution Date}}$$

If the distribution exceeds qualified expenses, the excess is non-qualified. The earnings portion of the non-qualified distribution is taxable as ordinary income plus 10% penalty. The basis portion of non-qualified distributions is never taxable.

Coordination with education credits: Expenses used to claim the American Opportunity Credit or Lifetime Learning Credit cannot also be used to justify a tax-free §529 distribution. The taxpayer must reduce qualified §529 expenses by any amounts used for education credit calculations.

SECURE 2.0 — Roth IRA Rollover Option

SECURE 2.0 — Roth IRA Rollover Option

[Image: 529 Plan to Roth IRA Conversion]

Beginning in 2024, SECURE 2.0 allows unused §529 plan funds to be rolled over to the designated beneficiary's Roth IRA. This provision helps families avoid penalties when education savings remain after educational goals have been met.

All Requirements Must Be Met

- The §529 account must have been open for at least **15 years**.
- Contributions and earnings from the most recent **5 years** cannot be rolled over.
- The transfer must be made **directly** from the §529 plan to the beneficiary's Roth IRA.
- Annual rollover amounts are limited by the applicable **Roth IRA contribution limit** after considering any other Roth IRA contributions made during the year.
- The beneficiary must have **earned income** at least equal to the rollover amount.
- Lifetime rollover limit: **$35,000 per beneficiary**.

2.13.6 Achieving a Better Life Experience (ABLE) account

[Image: ABLE Accounts]

IRC §529A

ABLE Accounts (Achieving a Better Life Experience)

ABLE accounts allow individuals with qualifying disabilities to save money while preserving eligibility for federal means-tested programs such as Medicaid and

Supplemental Security Income (SSI). Similar to a §529 education plan, earnings grow tax-free and qualified distributions are tax-free.

Tax Advantages

- Contributions are not deductible for federal income tax purposes.
- Earnings accumulate tax-free inside the account.
- Qualified distributions are tax-free.

Benefit Protection

- Helps preserve eligibility for Medicaid.
- Helps preserve eligibility for Supplemental Security Income (SSI).
- Allows individuals with disabilities to accumulate savings without immediately jeopardizing means-tested benefits.

Key TY2026 Rules

Annual Contribution Limit

Limited to the annual gift tax exclusion amount of **$19,000 for TY2026**.

Form 1099-QA

Reports distributions from the ABLE account.

Form 5498-QA

Reports annual contributions made to the ABLE account.

OBBBA Expansion — Major 2026 Change

Prior Law

Age 26

Disability onset before age 26

TY2026 Forward

Age 46

Disability onset before age 46

The OBBBA increased the disability onset age from 26 to 46, dramatically expanding eligibility for millions of Americans who developed qualifying disabilities later in life.

Practitioner Tip

ABLE accounts are frequently overlooked during tax interviews. When a client or dependent receives disability-related benefits, ask whether an ABLE account exists and request Forms 1099-QA and 5498-QA. These accounts often contain tax-free distributions that must be properly documented even when no taxable income results.

OBBBA Change — Expanded Age Eligibility for TY2026

One of the most significant ABLE account changes for TY2026: the OBBBA raised the age-of-disability-onset requirement from age 26 to **age 46**. Beginning TY2026, individuals whose qualifying disability began before age 46 are eligible to open an ABLE account — a major expansion that brings millions of additional Americans into eligibility, including many who acquired disabilities from accidents, illness, or military service.

Practitioner alert — new ABLE eligibility:

Review all clients with disabilities acquired before age 46. Many clients who were previously ineligible (disability onset between age 26 and 45) are now eligible to open an ABLE account beginning TY2026. This is an important AFTR exam point and a valuable planning opportunity.

Eligibility Requirements

An individual is eligible to be the designated beneficiary of an ABLE account if:

- They have a qualifying disability — defined as a medically determinable physical or mental impairment resulting in marked and severe functional limitations — that began before age **46** (expanded from 26 by OBBBA for TY2026)
- They are entitled to benefits based on blindness or disability under the Social Security program (SSI or SSDI), OR they have a disability certification signed by a licensed physician certifying the disability meets the statutory criteria
- Only one ABLE account per eligible individual is permitted

Contribution Limits — TY2026

Source	TY2026 Limit
Total contributions from all sources (annual gift tax exclusion)	**$19,000**
Additional contributions by employed ABLE beneficiary	Up to the lesser of the beneficiary's compensation OR the federal poverty line for a single person (verify current amount)

Excess contributions are subject to a 6% excise tax per year until corrected. Contributions must be in cash — no in-kind property contributions.

Qualified Disability Expenses

Distributions used for qualified disability expenses (QDEs) are tax-free. QDEs include any expense related to the eligible individual's blindness or disability and intended to improve their health, independence, or quality of life:

- Education, housing, transportation, employment training and support

- Assistive technology and personal support services
- Health, prevention, and wellness expenses
- Financial management and administrative services

- Legal fees, oversight and monitoring, funeral and burial expenses
- Basic living expenses (broad category)

Non-Qualified Distributions

The earnings portion of a non-qualified distribution (not used for QDEs) is:

- Included in the beneficiary's gross income as ordinary income
- Subject to an additional **10% penalty** on the earnings portion

SSI Interaction and $100,000 Balance Rule

- ABLE account balances up to **$100,000** are excluded from SSI resource counting — balances above $100,000 cause SSI payments to be suspended (not lost permanently)
- Medicaid eligibility is generally not affected by ABLE account balances regardless of amount
- Upon the beneficiary's death, the state may file a Medicaid payback claim against the ABLE account for Medicaid expenses paid after the account was established

2.13.7 Cancellation of student debt

[Image: student_debt.webp]

General Rule — Cancelled Debt Is Taxable

Under IRC §61(a)(12), gross income includes income from the discharge of indebtedness. When a lender cancels all or part of a loan — including student loans — the cancelled amount is generally taxable as ordinary income in the year of cancellation. The lender issues Form 1099-C reporting the cancelled amount in Box 2.

Exclusions — When Student Loan Cancellation Is NOT Taxable

Type of Forgiveness	Tax Treatment	Authority
Public Service Loan Forgiveness (PSLF)	Tax-free exclusion	IRC §108(f)(1)
Teacher loan forgiveness (up to $17,500)	Tax-free exclusion	IRC §108(f)(2)

Type of Forgiveness	Tax Treatment	Authority
National Health Service Corps / state loan repayment programs	Tax-free exclusion	IRC §108(f)(4)
Death discharge of federal student loans	Tax-free exclusion	IRC §108(f)(5)
Total and permanent disability discharge (TPD)	Tax-free exclusion	IRC §108(f)(5)
School closure discharge	Tax-free exclusion	IRC §108(f)(5)
False certification discharge	Tax-free exclusion	IRC §108(f)(5)
Borrower defense discharge	Tax-free exclusion	IRC §108(f)(5)
Insolvency — amount of debt cancelled up to the insolvency amount	Excluded up to insolvency (taxpayer was insolvent immediately before cancellation)	IRC §108(a)(1)(B)
Bankruptcy — debt discharged in a Title 11 case	Excluded from income	IRC §108(a)(1)(A)
Income-driven repayment (IDR) forgiveness	See caution below — verify TY2026 status	ARPA (2021 exclusion) / subject to change

IDR forgiveness tax treatment for TY2026 — VERIFY CURRENT LAW. The American Rescue Plan Act (ARPA) provided a temporary exclusion for student loan forgiveness through 2025. The tax treatment of IDR forgiveness for TY2026 and beyond has been subject to legislative action and court challenges. Practitioners MUST verify the current-year exclusion status from IRS guidance before advising clients with IDR forgiveness or preparing returns. Do not assume the prior-year exclusion continues without verification.

Exclusions Insolvency Exclusion — IRC §108(a)(1)(B)
When Student Loan Cancellation Is NOT Taxable

A taxpayer who was insolvent immediately before the debt cancellation may exclude the cancelled amount from income — but only up to the amount of insolvency.

Insolvency = Total liabilities – Total assets (at FMV) immediately before the cancellation

If the cancelled amount exceeds the insolvency amount, the excess is taxable. The taxpayer must attach a statement to the return showing the calculation of insolvency. Form 982 is filed to report the exclusion and any required basis reductions.

Form 1099-C — Handling on the Return

- When a client receives Form 1099-C reporting cancelled student loan debt:

- Determine which exclusion, if any, applies to this specific cancellation
- If excluded: report the Form 1099-C amount but exclude it using Form 982 (Reduction of Tax Attributes Due to Discharge of Indebtedness)
- If taxable: include the Box 2 amount in gross income on Schedule 1, Line 8c
- Never simply ignore a Form 1099-C — it is reported to the IRS and will generate a matching notice if not addressed on the return

Worked Examples

[Image: pslf.webp]

[Image: insolvency_.webp]

Common Errors / Red Flags

- Treating all student loan forgiveness as tax-free without identifying the applicable exclusion.
- Not filing Form 982 when an exclusion applies — simply omitting the 1099-C income without Form 982 raises compliance issues.
- Failing to verify current IDR forgiveness tax treatment — this area changes frequently.

2.13.8 Net operating loss (NOL)

[Image: Net Operating Loss]

Loss Carryforward Rules

Net Operating Losses (NOLs)

A Net Operating Loss (NOL) occurs when a taxpayer's allowable deductions exceed gross income for the year. NOLs are most commonly generated by business losses and can provide valuable tax benefits in future years through the NOL carryforward rules.

What Creates an NOL?

- Business losses reported on Schedule C, partnerships, or S corporations.
- Casualty losses, disaster-related losses, and other significant deductible events.
- Any situation where allowable deductions exceed total gross income for the tax year.

Current Carryforward Rules

- NOLs generally cannot be carried back to prior tax years.
- Farming losses remain a limited exception to the general no-carryback rule.
- Unused NOLs carry forward indefinitely until fully utilized.

The 80% Limitation Rule

Under current law, the NOL deduction in a carryforward year is limited to 80% of taxable income computed before the NOL deduction. As a result, an NOL cannot completely eliminate taxable income in a profitable year.

Calculate taxable income before applying the NOL deduction.

Multiply that amount by 80% to determine the maximum allowable NOL deduction.

At least 20% of taxable income remains subject to tax regardless of the NOL balance.

Key Takeaway

The unlimited carryforward period allows taxpayers to preserve NOLs indefinitely, but the 80% taxable income limitation prevents taxpayers from using a single NOL carryforward to completely eliminate taxable income in future profitable years. Tax liability may be reduced significantly, but some taxable income will remain.

What Creates a NOL?

NOL Computation Rules

What Creates a Net Operating Loss?

An individual taxpayer has a Net Operating Loss (NOL) when allowable business-related deductions exceed gross income. However, not every deduction reported on a tax return is included in the NOL computation. Special adjustments must be made before determining the final NOL amount.

Included

Deductions That Create an NOL

- Schedule C business losses from sole proprietorships and independent contractor activities.
- Schedule E rental real estate losses when the taxpayer qualifies for active participation or other applicable loss rules.
- Farm losses reported on Schedule F.
- Business casualty and theft losses that qualify under the tax rules.

Added Back

Items Not Included in an NOL

- The standard deduction does not create or increase a Net Operating Loss.
- Personal exemptions must be added back, although the current exemption amount is zero.
- Non-business capital losses exceeding capital gains are excluded from the NOL calculation.

- Non-business deductions that exceed non-business income must be added back.

NOL Computation Is Not Automatic

A taxpayer's overall loss shown on Form 1040 is not necessarily their Net Operating Loss. The tax law requires adjustments that remove certain personal and non-business deductions before the final NOL amount is determined.

The Schedule A Net Operating Loss Worksheet contained in IRS Publication 536 provides the step-by-step computation required to determine an individual's allowable NOL.

Practitioner Tip

Many taxpayers assume a negative taxable income amount automatically becomes an NOL carryforward. That assumption is often incorrect. Always complete the NOL worksheet in IRS Publication 536 before calculating a carryforward amount. The final NOL may be significantly different from the loss shown on the tax return.

Current Law NOL Rules — Post-TCJA, Made Permanent by OBBBA

Rule	Treatment for TY2026
Carryback	**Not allowed** (except farming NOLs — 2-year carryback)
Carryforward period	**Indefinite** — no expiration
Annual deduction limit	**80% of taxable income** (before the NOL deduction) in the carryforward year
Character retained?	NOL retains its character as an NOL — but does not retain short-term vs. long-term capital character
Farming NOL exception	2-year carryback allowed; farming taxpayers may elect to forgo the carryback and carry forward only

Tracking NOL Carryforwards

Practitioners must maintain a careful record of:

- The year the NOL was generated
- The original NOL amount
- The amount used in each carryforward year (80% limited deduction)
- The remaining NOL balance available to carry forward

This tracking is critical — the IRS does not maintain a running balance for the taxpayer, and a missed or incorrectly calculated NOL deduction in a prior year affects all subsequent years.

2.13.9 Premium Tax Credit (FS-2025-10FS-2025-10)

Lesson at a Glance

[Image: Premium Tax Credit]

Marketplace Health Insurance

Premium Tax Credit (PTC)

- The **Premium Tax Credit (PTC)** is a refundable credit that helps eligible individuals and families afford health insurance purchased through the Health Insurance Marketplace.
- Advance PTC payments reduce monthly premiums during the year.
- At tax time, taxpayers reconcile advance payments against the actual credit amount based on final annual income using **Form 8962**.
- The key source document is **Form 1095-A** from the Marketplace. Form 8962 cannot be completed without it.
- Per **FS-2025-10**, the OBBBA made significant changes to the PTC repayment rules effective for tax years beginning after **December 31, 2025**.

Eligibility Requirements

Premium Tax Credit

Eligibility Requirements

Taxpayer Must Meet All Requirements

- Enrolled in a qualified health plan through the **Health Insurance Marketplace**.
- Household income generally falls within the applicable **Federal Poverty Level (FPL)** range.
- For **TY2026 and beyond**, verify current income eligibility rules because OBBBA changed the repayment and eligibility framework.
- Not eligible for other **minimum essential coverage**, such as an affordable employer plan that provides minimum value, Medicaid, Medicare, or CHIP.
- Not claimed as a dependent on another person's tax return.
- Does not file **Married Filing Separately**, except for limited exceptions such as survivors of domestic abuse or spousal abandonment.
- U.S. citizen, U.S. national, or lawfully present resident.

Practitioner Tip: Do not complete Form 8962 until the taxpayer provides Form 1095-A. The Marketplace form supplies the monthly enrollment, premium, SLCSP, and advance payment amounts needed to reconcile the credit correctly.

Form 1095-A — Health Insurance Marketplace Statement
Forms 1095-B and 1095-C

Health Coverage Reporting

Forms 1095-A, 1095-B, and 1095-C

Form 1095-A — Health Insurance Marketplace Statement

- Form 1095-A is issued by the Marketplace by January 31 following the coverage year.
- The form provides the information required to complete Form 8962 and reconcile the Premium Tax Credit.

Column A

Monthly enrollment premiums.

Column B

Monthly benchmark plan premium (Second Lowest Cost Silver Plan — SLCSP).

Column C

Monthly advance Premium Tax Credit payments made on behalf of the taxpayer.

Form 8962 Reconciliation

- The SLCSP premium from Column B is used to determine the amount of Premium Tax Credit the taxpayer was actually entitled to receive.
- If the actual credit exceeds advance payments, the taxpayer receives an additional refundable credit.
- If advance payments exceed the actual credit allowed, the excess advance credit generally must be repaid.

Form 1095-B

- Issued by insurance companies, Medicaid, Medicare, and certain employers.
- Shows that the taxpayer had minimum essential coverage.
- Not used to calculate the Premium Tax Credit on Form 8962.

Form 1095-C

- Issued by applicable large employers with 50 or more full-time equivalent employees.
- Shows whether employer-sponsored health coverage was offered and the employee's cost.
- Used to determine whether the employer's coverage was affordable and provided minimum value, which affects PTC eligibility.

Reconciliation on Form 8962

[Image: Form 8962 Premium Tax Credit Reconciliation]

Form 8962 — Premium Tax Credit Reconciliation

Premium Tax Credit

Reconciliation on Form 8962

Form 8962 Comparison

- **Advance PTC Received** — Total advance Premium Tax Credit payments reported in Column C of Form 1095-A for the year.
- **Allowable PTC** — The actual Premium Tax Credit computed using final household income, family size, and Marketplace information.

Allowable PTC Exceeds Advance PTC

- The taxpayer qualified for a larger credit than was received during the year.
- The difference becomes a refundable Premium Tax Credit and increases the taxpayer's refund.

Advance PTC Exceeds Allowable PTC

- The taxpayer received more advance credit than was actually allowed.
- The excess advance credit must be repaid and is added to tax liability on Schedule 2.

OBBBA Changes for TY2026

- The OBBBA made significant changes to Premium Tax Credit repayment rules for tax years beginning after December 31, 2025.
- The prior repayment caps that limited repayment amounts based on income level were eliminated.
- For TY2026, taxpayers generally must repay the full amount of excess advance Premium Tax Credit. There are no income-based repayment caps.

Worked Examples

Premium Tax Credit

Worked Examples

Example 1 — Additional Credit at Tax Time

- The Garcias enrolled in a Marketplace plan based on estimated income of **$52,000**.
- Advance Premium Tax Credit payments of **$4,800** were made during the year.

Result

- Actual household income was **$48,000**, producing an allowable PTC of **$5,600**.

- Allowable PTC ($5,600) exceeds advance PTC ($4,800).
- Net PTC = **$800 refundable credit** on Form 8962, increasing their refund.

Example 2 — Repayment Required

- The Hendersons enrolled using estimated income of **$55,000**.
- Advance Premium Tax Credit payments totaled **$6,200**.

Result

- Actual income increased to **$78,000**, reducing allowable PTC to **$3,900**.
- Excess advance PTC = **$2,300**.
- The full **$2,300** must be repaid and is added to tax liability on Schedule 2.
- Under TY2026 OBBBA rules, there is no income-based repayment cap.

Example 3 — Missing Form 1095-A

- Carlos purchased Marketplace coverage and received advance Premium Tax Credit.
- He cannot locate his Form 1095-A and wants to file immediately.

Result

- Carlos must obtain Form 1095-A before filing.
- He can download it from HealthCare.gov or his state Marketplace portal.
- Filing without Form 8962 when advance PTC was received may delay processing and create IRS reconciliation issues.

2.13.10 Employee fringe benefits

Lesson at a Glance

[Image: Employee Fringe Benefits]

Employee Compensation

Employee Fringe Benefits

What Fringe Benefits Mean

Employee fringe benefits are compensation items provided to employees beyond regular wages. Depending on the type of benefit and applicable dollar limits, the benefit may be fully taxable, partially excluded, or fully excluded from gross income.

Fully Taxable

Included in wages unless a specific exclusion applies.

Partially Excluded

Excluded only up to the statutory or annual indexed dollar limit.

Fully Excluded

Excluded from income when all tax rules and documentation requirements are met.

TY2026 Key Fringe Benefit Limits

- **Health FSA:** Employee salary reduction contributions are capped at **$3,400**.
- **Qualified Transportation Fringe:** Monthly exclusion limit is **$340 per month**.
- **HSA Contributions: $4,400** self-only coverage and **$8,750** family coverage.
- **Archer MSA:** Deductible ranges are provided in Rev. Proc. 2025-32.

Form 8889

Used to report Health Savings Account activity on the taxpayer's return.

Form 1099-SA

Reports HSA, Archer MSA, or Medicare Advantage MSA distributions.

Form 5498-SA

Reports HSA, Archer MSA, or Medicare Advantage MSA contributions.

Cafeteria Plans — Rev. Proc. 2025-32(.15)

[Image: Cafeteria Plans]

Rev. Proc. 2025-32(.15)

Cafeteria Plans

IRC §125 Employee Benefit Choice

- A cafeteria plan under **IRC §125** allows employees to choose between taxable cash compensation and certain tax-free benefits.
- When the employee chooses qualified benefits, the selected benefit may be excluded from gross income.
- The exclusion can reduce both **income tax** and **FICA taxes** on the benefits selected.

Item	TY2026 Amount (Rev. Proc. 2025-32(.15))
Maximum employee salary reduction for health FSA	$3,400
Maximum carryover of unused health FSA amounts (if plan allows)	$680
Dependent care FSA maximum (OBBBA increase)	$7,500 ($3,750 MFS)

Qualified Transportation Fringe Benefit — Rev. Proc. 2025-32(.16)

[Image: Qualified Transportation Fringe Benefit]

Rev. Proc. 2025-32(.16)

Qualified Transportation Fringe Benefit

IRC §132(f) Transportation Benefits

- Under **IRC §132(f)**, certain employer-provided transportation benefits may be excluded from an employee's taxable wages.
- The exclusion is limited to monthly amounts established by the IRS and adjusted annually for inflation.

TY2026 Monthly Exclusion Limit

$340

Per Month

Covered Transportation Benefits

- Mass transit passes and commuter rail benefits.
- Bus and public transportation programs.
- Qualified employer-provided parking benefits.

Benefits Above the Limit

- Amounts provided above the monthly exclusion limit become taxable compensation.
- Excess benefits must be included in **Box 1 wages on Form W-2**.
- Employees receiving transportation benefits above the annual limits should verify that the taxable excess has been properly included in their wages.

Benefit Type	TY2026 Monthly Exclusion
Transit passes and vanpool benefits	$340 per month
Qualified parking	$340 per month

Health Savings Accounts (HSAs) — Rev. Proc. 2025-19

Health Savings Accounts

HSA Eligibility, Tax Benefits, and Reporting

Triple Tax Advantage

- Health Savings Accounts (HSAs) are tax-advantaged accounts paired with High Deductible Health Plans (HDHPs).
- Contributions are deductible above the line.
- Earnings grow tax-free inside the account.
- Qualified medical expense distributions are tax-free.

HSA Eligibility Requirements

- Must be enrolled in a qualifying High Deductible Health Plan (HDHP).

- Cannot have other first-dollar health coverage, subject to limited statutory exceptions.
- Cannot be enrolled in Medicare. Once Medicare coverage begins, new HSA contributions must stop even if the taxpayer continues working.
- Cannot be claimed as a dependent on another person's tax return.

OBBBA Expansion for TY2026

Beginning in TY2026, certain Bronze and Catastrophic Marketplace plans are treated as HDHP-compatible plans, expanding HSA eligibility to taxpayers who were previously unable to contribute.

Contributions

- Deductible above the line on Schedule 1 through Form 8889.
- Employer contributions are excluded from income and reported in Box 12, Code W of Form W-2.

Earnings

No annual tax is imposed on interest, dividends, or investment gains while funds remain in the account.

Qualified Distributions

Tax-free when used for qualified medical expenses listed in IRS Publication 502.

Non-Qualified Distributions

- Included in gross income.
- Subject to an additional 20% tax.
- The 20% additional tax is waived after age 65, death, or disability.

Important HSA Forms

Form 8889

Filed with Form 1040 to report HSA contributions, deductions, distributions, and any additional tax on non-qualified distributions.

Form 1099-SA

Issued by the HSA custodian and reports distributions from an HSA, Archer MSA, or Medicare Advantage MSA.

Form 5498-SA

Reports annual HSA contributions and is generally issued by May 31 of the following year.

Benefit Type	**TY2026 Monthly Exclusion**
Transit passes and vanpool benefits	$340 per month

Benefit Type	TY2026 Monthly Exclusion
Qualified parking	$340 per month

Medical Savings Accounts (Archer MSAs) — Rev. Proc. 2025-32(.28) and IRC §220(b)

Medical Savings Accounts

Archer MSA Rules and Reporting

What Is an Archer MSA?

- Archer Medical Savings Accounts (MSAs) are the predecessor to today's Health Savings Accounts (HSAs).
- Archer MSAs are available only to self-employed individuals and employees of small employers with 50 or fewer employees.
- New Archer MSAs have largely been replaced by HSAs, but existing Archer MSA accounts continue to receive favorable tax treatment.

Archer MSA Contribution Limits

IRC §220(b) determines Archer MSA contribution limits as a percentage of the annual HDHP deductible.

Self-Only Coverage

65%

of the annual HDHP deductible

Family Coverage

75%

of the annual HDHP deductible

Archer MSA Tax Forms

Form 8853

Used to compute and claim the Archer MSA deduction. The deduction flows to Schedule 1 of Form 1040.

Form 1099-SA

Reports distributions from an Archer MSA, HSA, or Medicare Advantage MSA.

Form 5498-SA

Reports annual contributions made to an Archer MSA, HSA, or Medicare Advantage MSA.

Exam Tip: HSAs and Archer MSAs use many of the same reporting forms, but Archer MSA deductions are computed on **Form 8853** while HSA deductions are computed on **Form 8889**. Students commonly confuse these forms on exams.

Threshold	Self-Only	Family
Minimum annual deductible	$2,900	$5,800
Maximum annual deductible	$4,400	$8,750
Maximum out-of-pocket	$5,850	$10,750

Worked Examples

Fringe Benefits & Health Accounts

Worked Examples

Example 1 — HSA Maximum Contribution

- Sandra, age 58, has self-only HDHP coverage.
- Deductible = **$2,000**; Out-of-Pocket Maximum = **$7,000**.
- The plan qualifies as an HDHP for HSA purposes.

Result

- Base HSA contribution limit = **$4,400**.
- Age 55+ catch-up contribution = **$1,000**.
- Maximum deductible contribution = **$5,400** reported on Form 8889 and deducted on Schedule 1.

Example 2 — Transportation Fringe

An employer provides **$420 per month** in transit passes during TY2026.

Result

- First **$340 per month** is excluded under IRC §132(f).
- Excess benefit = **$80 per month** or **$960 annually**.
- The excess must be included in W-2 Box 1 wages as taxable compensation.

Example 3 — Non-Qualified HSA Distribution

- Robert, age 45, withdraws **$3,000** from his HSA.
- The funds are used to pay for a vacation rather than qualified medical expenses.

Result

- $3,000 is included in ordinary income.
- 20% additional tax = **$600**.
- At a 22% tax bracket, income tax = **$660**.
- Total tax cost = **$1,260**. Robert keeps only **$1,740** after taxes.

Example 4 — Health FSA

- An employee elects the full **$3,400** Health FSA contribution for TY2026.
- Only **$2,800** is used during the year.

Result

- Unused balance = **$600**.
- Up to **$680** may be carried over to TY2027.
- The entire **$600** unused balance may be carried forward.
- The $3,400 contribution was excluded from Box 1 wages, reducing both income tax and FICA tax.

2.14 Withholding and estimated tax payments

[Image: Withholding and Estimated Tax Payments TY2026]

Lesson 2.14 — Withholding & Estimated Tax Payments · TY2026

Taxpayers must pay tax throughout the year — either through **withholding** from wages (Form W-4) or through **estimated tax payments** (Form 1040-ES). Failure to pay enough during the year results in an underpayment penalty. This lesson covers the safe harbor rules, quarterly due dates, the redesigned Form W-4, and first-time penalty abatement.

100% Safe Harbor ≤$150K AGI

110% Safe Harbor >$150K AGI

4 Dates Quarterly Due Dates

Form W-4 Redesigned 2020+

IRC §6654 Underpayment Penalty

The Pay-As-You-Go System

The U.S. tax system requires taxpayers to pay tax throughout the year as income is earned — not in one lump sum at filing. Employees do this through **withholding** from each paycheck. Self-employed taxpayers, investors, and others without sufficient withholding must make **estimated tax payments** quarterly. Failure to pay enough during the year results in an underpayment penalty under IRC §6654 — even if the taxpayer pays in full by the April filing deadline.

Wage Withholding

Employer withholds federal income tax and FICA from each paycheck based on the employee's **Form W-4**. Withholding is credited on Form 1040, Line 25a.

Estimated Tax Payments

Self-employed individuals, investors, and those with insufficient withholding pay quarterly using **Form 1040-ES**. Credited on Form 1040, Line 26.

Underpayment Penalty

IRC §6654 penalty applies if too little is paid during the year. Applies even if full balance is paid by April 15. Computed on **Form 2210**.

Safe Harbor Rules — Avoiding the Underpayment Penalty

A taxpayer can avoid the underpayment penalty entirely by meeting one of three safe harbors. The most commonly used is the **prior-year tax safe harbor —** but the percentage depends on the taxpayer's prior-year AGI.

Prior-Year AGI $150,000 or Less

100%

of prior year's tax liability

MFS: $75,000 threshold

Prior-Year AGI Over $150,000

110%

of prior year's tax liability

MFS: $75,000 threshold

Three Ways to Avoid the Underpayment Penalty

- **90% of current year tax —** pay at least 90% of the actual tax liability for the current year through withholding and/or estimated payments
- **100% of prior year tax** (if prior AGI ≤$150,000) **—** pay an amount equal to last year's total tax liability. Guaranteed safe harbor regardless of this year's income.
- **110% of prior year tax** (if prior AGI >$150,000) — higher-income taxpayers must pay 110% of last year's tax liability to qualify for the safe harbor

Worked Example — Safe Harbor for High-Income SE Taxpayer (Q215)

A self-employed taxpayer expects to owe **$12,000** in taxes for TY2027. Their prior-year (TY2026) AGI was **$180,000**. Their TY2026 tax liability was $12,000.

Because TY2026 AGI exceeded $150,000, the taxpayer must use the **110% safe harbor**:

Prior year tax liability (TY2026)	$12,000
Safe harbor rate (prior AGI >$150,000)	× 110%
Minimum payments required to avoid penalty	$13,200

Paying only $12,000 (100%) is not sufficient because prior-year AGI exceeded $150,000. The taxpayer must pay $13,200 to be safe — even though expected tax is only $12,000.

Quarterly Estimated Tax Due Dates — TY2027 Payments

Estimated tax payments are due four times a year. The periods are **not equal quarters** — the first payment covers January–March (3 months), the second covers April–May (2 months), the third covers June–August (3 months), and the fourth covers September–December (4 months).

TY2027 Estimated Tax Payment Schedule (Form 1040-ES)

Payment	Income Period Covered	Due Date
1st Quarter	January 1 – March 31	April 15
2nd Quarter	April 1 – May 31	June 15
3rd Quarter	June 1 – August 31	September 15
4th Quarter	September 1 – December 31	January 15 (of following year)

Key Rules for Estimated Payments

- If the due date falls on a weekend or federal holiday, the payment is due the **next business day**
- The 4th quarter payment (January 15) can be skipped if the taxpayer files their return by January 31 and pays any balance due with the return
- Estimated payments can be made online via **IRS Direct Pay**, EFTPS, or by mailing Form 1040-ES with a check
- A prior year tax refund can be applied as an estimated payment toward the current year — elected on the prior year's return

Form W-4 — The Redesigned Withholding Certificate

The IRS redesigned Form W-4 effective January 1, 2020. W-4s submitted to employers after December 31, 2019 use the **new five-step format** — which claims dollar amounts for credits and deductions rather than withholding allowances. The old allowance system (personal exemptions × $4,300) no longer applies to new W-4s.

Pre-2020 W-4 — Old System

- Withholding allowances — personal exemptions × $4,300
- No direct way to account for credits or additional deductions
- Exemptions were suspended by TCJA but W-4 still used allowance language

2020+ W-4 — New Design

- Five steps — dollar amounts for credits and deductions
- Step 3 enters Child Tax Credit and other dependent credit amounts directly
- Step 4 allows adjustments for other income, deductions, and extra withholding

- Employees who do not submit a new W-4 keep their prior W-4 on file — employers continue using it

Form W-4 — Five Steps Explained

Step	What the Employee Provides	Required?
1	Personal information — name, address, SSN, filing status	Required
2	Multiple jobs or spouse works — check box, use IRS estimator, or use worksheet	If applicable
3	**Claim Dependents** — enter dollar amounts for Child Tax Credit and Credit for Other Dependents. TY2026: $2,200 per qualifying child under 17; $500 per other dependent	If applicable
4	Other adjustments — other income not from jobs (4a); deductions other than standard (4b); extra withholding per pay period (4c)	Optional
5	Signature and date — certifies under penalties of perjury	Required

Worked Example — W-4 Step 3 Calculation (Q216)

A new employee submits a 2026 Form W-4 and claims **3 qualifying children under age 17** and **1 other dependent**. What is the total amount to enter on W-4 Step 3?

3 qualifying children × $2,200 (CTC — TY2026)	$6,600
1 other dependent × $500 (Credit for Other Dependents)	$500
Total entered on W-4 Step 3	$7,100

The TY2026 Child Tax Credit amount is $2,200 per qualifying child (up from $2,000). The old allowance method ($3,300 × 3 = $9,900) is no longer used — that would be incorrect.

First-Time Penalty Abatement

The IRS offers **First-Time Penalty Abatement (FTA)** as an administrative waiver for taxpayers with a clean compliance history who receive a penalty for the first time. FTA is not found in the Internal Revenue Code — it is an IRS administrative policy under the Internal Revenue Manual (IRM 20.1.1.3).

First-Time Abatement Applies to ALL THREE of These Penalties

- **Failure-to-file penalty** (IRC §6651(a)(1)) — 5% per month of unpaid tax, up to 25% — applies when return is filed late
- **Failure-to-pay penalty** (IRC §6651(a)(2)) — 0.5% per month of unpaid tax, up to 25% — applies when tax is not paid by the due date
- **Failure-to-deposit penalty** (IRC §6656) — 2% to 15% of the undeposited amount — applies when employers fail to make timely payroll tax deposits

Qualifying for First-Time Abatement — All Three Must Be Met

- **Clean compliance history** — no penalties (other than estimated tax) in the three prior tax years for the same return type
- **All required returns filed** — the taxpayer must have filed all currently required returns (or a valid extension)
- **Tax paid or arranged** — the tax must be paid in full or the taxpayer must be in a current installment agreement

First-Time Abatement Does NOT Apply To

- Estimated tax underpayment penalty (IRC §6654) — this is a separate computational penalty, not eligible for FTA
- Accuracy-related penalties (IRC §6662) — negligence, substantial understatement — use reasonable cause instead
- Fraud penalties (IRC §6663) — not eligible for any administrative abatement
- FTA is requested by calling the IRS, sending a written request, or through the Online Payment Agreement. It is granted automatically if the taxpayer qualifies — no special form required.

Underpayment Penalty — Form 2210

If a taxpayer does not meet a safe harbor, the underpayment penalty under IRC §6654 is computed on **Form 2210**. The penalty is calculated separately for each quarterly period — not as a single annual amount. An underpayment in one quarter generates a penalty even if later quarters are overpaid.

Item	Rule
Penalty rate	Federal short-term rate + 3% — adjusted quarterly
Computation	Quarterly — each period evaluated separately on Form 2210
Form	Form 2210 — IRS may compute on behalf of taxpayer; attach if annualized income installment method used
Waiver available	IRS may waive if underpayment due to casualty, disaster, or unusual circumstances — or if taxpayer retired/became disabled during the year
De minimis exception	No penalty if total tax after withholding is less than $1,000 — or if total withholding covers the full balance

Lesson 2.14 — Quick Reference

Topic	Key Rule
Safe harbor — AGI ≤$150,000	100% of prior year tax
Safe harbor — AGI >$150,000	110% of prior year tax
Safe harbor — current year	90% of current year's actual tax liability
Quarterly due dates	April 15 · June 15 · September 15 · January 15 (following

Topic	Key Rule
(TY2027)	year)
W-4 post-2019 design	5 steps — dollar amounts for credits/deductions, no allowances
W-4 Step 3 — 3 children + 1 dependent	3 × $2,200 + 1 × $500 = **$7,100**
First-time abatement covers	Failure-to-file **+** failure-to-pay **+** failure-to-deposit — all three
FTA does NOT cover	Estimated tax underpayment penalty (§6654) · Accuracy penalties · Fraud penalties
Underpayment penalty form	Form 2210 — IRC §6654 — computed quarterly

2.15 Balance due and refund options

Lesson at a Glance

[Image: Payment and Refund Options]

TY2026 Return Filing

Payment and Refund Options

Balance Due or Refund Due

When a TY2026 return shows a balance due, taxpayers have multiple payment options available through IRS.gov/payments. When a return shows a refund, taxpayers may choose direct deposit, paper check, split refund, or apply the refund to the following year's estimated taxes.

If the Return Shows a Balance Due

- Pay electronically through IRS.gov/payments.
- Use direct debit when e-filing to schedule payment from a bank account.
- Use EFTPS for scheduled or recurring federal tax payments.
- Pay by credit or debit card, keeping in mind that processor fees may apply.
- Request an installment agreement when the taxpayer cannot pay the full balance immediately.

If the Return Shows a Refund

- Receive the refund by direct deposit to one bank account.
- Split the refund among up to three accounts using Form 8888.
- Receive the refund by paper check.
- Apply all or part of the refund to TY2027 estimated tax payments.

Form 8888 — Allocation of Refund

- Form 8888 is used to split a federal refund among up to three different accounts.
- It can also be used when the taxpayer wants structured refund allocation instead of one full deposit.

Practitioner Tip: Direct debit and direct deposit are usually the fastest, lowest-cost options. If a taxpayer cannot pay the balance due in full, filing the return on time and arranging payment is still better than failing to file. Explain that penalties and interest can continue to accrue when a balance due is not paid on time.

Balance Due — Payment Options (IRS.gov/payments)

[Image: IRS Payment Options and EFTPS]

Balance Due Returns

Payment Deadlines and Payment Options

Payment Due Date

- All balance due payments for TY2026 returns must be received by the IRS no later than **April 15, 2027** for most individual taxpayers.
- Payments may be made through IRS.gov/payments using direct debit, EFTPS, debit card, credit card, or other approved payment methods.

Common Exam Trap

- Filing an extension extends the time to file the return.
- Filing an extension does **NOT** extend the time to pay the tax.
- Any unpaid tax remaining after the due date is subject to penalties and interest even if a valid extension was filed.

Common IRS Payment Methods

Direct Debit

Fast, secure, and generally the lowest-cost payment option when e-filing.

EFTPS

Electronic Federal Tax Payment System used for scheduling federal tax payments.

Credit or Debit Card

Convenient payment option, although third-party processing fees may apply.

Consequences of Late Payment

- Failure-to-pay penalties may apply when tax is not paid by the due date.
- Interest accrues on unpaid tax from the original due date until paid in full.
- Taxpayers unable to pay in full should consider an installment agreement rather than ignoring the balance due.

Payment Method	How to Use	Fee
IRS Direct Pay	IRS.gov/payments — direct bank debit; no account setup required; same-day processing up to 8 PM ET	Free
EFTPS (Electronic Federal Tax Payment System)	EFTPS.gov — requires prior enrollment; best for businesses and recurring payments; can schedule payments up to 365 days in advance	Free
Credit or Debit Card	IRS.gov/payments — through IRS-authorized third-party processors	Processing fee (varies by processor; typically 1.82%–1.98% for credit; flat fee for debit)
Check or Money Order	Made payable to "United States Treasury"; mail with Form 1040-V payment voucher or return; write SSN, TY2026, and "1040" on the check	Free (postage)
Cash	IRS retail partners (participating stores); generate a payment code at IRS.gov/payments	$3.99 fee
IRS Online Account	View balance, payment history, and make direct payments at IRS.gov/account	Free

Failure-to-Pay Penalty and Interest

[Image: Failure to Pay Penalty and Interest]

Balance Due Returns

Failure-to-Pay Penalty and Interest

When Tax Is Not Paid by April 15, 2027

- Penalties and interest begin accruing after the original return due date.
- Filing an extension does not eliminate failure-to-pay penalties or interest on unpaid tax.

Failure-to-Pay Penalty

- **0.5%** of the unpaid tax for each month or part of a month the balance remains unpaid.
- Maximum penalty is **25% of the unpaid tax**.

Interest Charges

- Interest rate equals the federal short-term rate plus **3 percentage points**.
- Interest compounds daily and continues until the balance is paid in full.

When Failure-to-File and Failure-to-Pay Both Apply

- Failure-to-file penalty is generally **5% per month**.
- Failure-to-pay penalty is generally **0.5% per month**.
- When both penalties apply during the same month, the failure-to-file penalty is reduced to **4.5%**, resulting in a combined penalty of **5% per month**.

Installment Agreements (Payment Plans)

[Image: IRS Installment Agreements]

Balance Due Returns

Installment Agreements (Payment Plans)

What Is an Installment Agreement?

- Taxpayers who cannot pay the full balance due may request an installment agreement with the IRS.
- The agreement allows the taxpayer to make monthly payments over time rather than paying the entire balance immediately.

Reduced Failure-to-Pay Penalty

- While an approved installment agreement is in effect, the failure-to-pay penalty rate is reduced from **0.5%** per month to **0.25%** per month.
- Interest and penalties continue to accrue until the tax liability is paid in full.

Online Payment Agreement (OPA)

- Individuals who owe **$50,000 or less** in combined tax, penalties, and interest generally qualify for an online payment agreement.
- Applications are submitted online through IRS Online Payment Agreement (OPA).
- Most qualifying applications receive immediate approval without calling the IRS.

Guaranteed Installment Agreement

- Tax owed is **$10,000 or less** (excluding penalties and interest).
- All required tax returns have been filed.
- No installment agreement has been used during the previous five years.
- The taxpayer agrees to pay the balance in full within three years.

Refund Options

[Image: Refund Options]

TY2026 Refund Returns

Refund Options

Three Primary Refund Choices

When a TY2026 return shows a refund, taxpayers generally choose direct deposit, paper check, or application of the refund to next year's estimated taxes.

Direct Deposit

- Fastest and safest refund method available.
- Electronically filed returns with direct deposit are often refunded within approximately 21 days.
- Routing and account numbers are entered directly on Form 1040.
- Refunds may be deposited into a checking account, savings account, or IRA.

Form 8888 — Allocation of Refund

- Form 8888 allows taxpayers to split a refund among up to three financial accounts.
- Deposit part into checking and part into savings.
- Direct a portion to an IRA contribution. If completed by the April filing deadline, the deposit may qualify as a prior-year IRA contribution.
- Purchase up to $5,000 of U.S. Series I Savings Bonds using the Form 8888 paper bond election.

Paper Check

- Refund check is mailed to the address shown on the tax return.
- Processing time is generally 4–6 weeks or longer.
- Greater risk of loss, theft, or delivery delays compared to direct deposit.

Apply Refund to TY2027 Estimated Tax

- Taxpayers may elect to apply all or part of a refund toward TY2027 estimated taxes.
- The election is made directly on Form 1040.
- The amount applied becomes a credit toward the taxpayer's first-quarter TY2027 estimated tax obligation.

Injured Spouse and Innocent Spouse

[Image: Injured Spouse and Innocent Spouse]

Special Relief Provisions

Injured Spouse vs. Innocent Spouse

Same word. Very different tax problems.

Injured Spouse

Form 8379

- The issue is a **refund offset**.
- A joint refund was taken to pay the other spouse's debt.
- Common debts include child support, federal student loans, and prior tax liabilities.
- Form 8379 allows the non-liable spouse to recover their portion of the refund.

Innocent Spouse

Form 8857

- The issue is a **joint tax liability**.
- One spouse believes they should not be responsible for additional tax caused by the other spouse.
- Often involves omitted income, improper deductions, or fraudulent activity by the other spouse.
- Form 8857 requests relief from the tax, penalties, and interest attributable to the other spouse.

Exam Memory Trick

Injured Spouse = Refund Problem
"The IRS took my refund because of my spouse's debt."

Innocent Spouse = Tax Liability Problem
"The IRS says I owe tax because of something my spouse did."

Worked Examples

Payment & Refund Scenarios

Worked Examples

1

Fastest Zero-Cost Payment

Rodriguez Family

- Balance due: **$3,200**.
- **Result:** IRS Direct Pay through IRS.gov/payments is free, immediate, and requires no account setup. The taxpayer enters bank information, selects "Balance Due – 1040," chooses TY2026, and receives immediate payment confirmation.

2

Extension Filed, Payment Still Due

Carlos

- Form 4868 filed on April 15, 2027.

- Estimated balance due: **$4,500**.
- **Result:** The filing deadline is extended, but the tax was still due April 15. Failure-to-pay penalties and interest begin accruing April 16. By October 15, the failure-to-pay penalty alone equals **$135**, plus interest.

3

Split Refund with IRA Contribution

Sandra

- Refund available: **$4,200**.
- **Result:** Using Form 8888, Sandra can direct the entire $4,200 refund to her Traditional IRA as a TY2026 contribution. To reach the $7,000 contribution limit, she must contribute an additional $2,800 from other funds before the contribution deadline.

4

Injured Spouse Allocation

David and Maria

- Joint refund: **$2,800**.
- The refund was offset for David's past-due child support.
- **Result:** Maria files Form 8379. Because she contributed approximately $1,900 through withholding, she may recover her allocable share of the refund while the offset against David remains in effect.

5

Apply Refund to Estimated Tax

George

- Refund available: **$1,800**.
- **Result:** George elects on Form 1040 to apply the entire $1,800 refund to TY2027 estimated tax. The IRS treats the amount as a first-quarter estimated payment. Form 8888 is not required.

2.16 Tax return due dates and filing for extensions

[Image: Tax Filing Deadline]

Original Due Date

TY2026 individual income tax returns are due **April 15, 2027**.

Extension Deadline

Filing Form 4868 by April 15 gives an automatic 6-month extension to **October 15, 2027**.

Payment Still Due

The extension gives more time to file — **not more time to pay** any tax due.

Failure-to-File Penalty

If the return is not filed by the due date, including a valid extension, the failure-to-file penalty is **5% per month**, up to a maximum of **25%.**

Special Extended Due Dates

Special extended filing rules may apply to taxpayers living outside the United States and to members of the military serving in a combat zone.

TY2026 Basic Standard Deduction Amounts — Rev. Proc. 2025-32(.14)

Event	Date
TY2026 original return due date (most individual taxpayers)	**April 15, 2027**
Form 4868 must be filed to obtain automatic extension	**April 15, 2027**
All tax due must be paid (extension or not)	**April 15, 2027**
Extended return due date (after Form 4868)	**October 15, 2027**
Taxpayers outside the U.S. — automatic 2-month extension (no form required)	**June 16, 2027**
Combat zone — extended due date (180 days after last day in combat zone)	[Image: person-military-rifle.svg] **Varies by individual**
TY2026 IRA contribution deadline	**April 15, 2027** (not extended)
[Image: stopwatch.svg]	**April 15, 2030** (3 years from original due date)

Last day to file TY2026 return for a refund (statute of limitations)

Weekend/holiday adjustment: When April 15 falls on a Saturday, Sunday, or legal holiday in the District of Columbia, the due date is automatically pushed to the next business day. Always verify the exact due date for the specific filing year — do not assume April 15 is always a weekday.

Form 4868 — Application for Automatic Extension

Filing Form 4868 by April 15, 2027 grants an automatic 6-month extension of time to file the TY2026 return — extending the filing deadline to October 15, 2027. No explanation or IRS approval is required.

- **Electronically:** Through tax software, the IRS Free File system, or a paid preparer's e-file system — most common and provides instant confirmation
- **By mail:** Paper Form 4868 mailed to the correct IRS address for the taxpayer's state — must be postmarked by April 15, 2027
- **Automatically through Direct Pay:** When a taxpayer makes an extension payment through IRS Direct Pay and selects "Extension" as the payment type, the extension is automatically filed — no separate Form 4868 required

What Form 4868 Requires:

Filing Form 4868 by April 15, 2027 grants an automatic 6-month extension of time to file the TY2026 return — extending the filing deadline to October 15, 2027. No explanation or IRS approval is required.

- Taxpayer name, address, and Social Security Number(s)
- Estimate of total TY2026 tax liability
- Total payments made (withholding + estimated payments)Amount of estimated balance due (and payment of that amount to avoid penalties and interest)

Extension of time to file ≠ extension of time to pay. This is the most important concept in this lesson. Filing Form 4868 by April 15 prevents the failure-to-file penalty from accruing — but it does NOT prevent the failure-to-pay penalty or interest from accruing on any unpaid balance. Clients who cannot pay should still file Form 4868 AND pay as much as possible by April 15.

Failure-to-File Penalty — Rev. Proc. 2025-32(.52)

A taxpayer who does not file their return by the due date (including any valid extension) is subject to the failure-to-file penalty:

- **Rate:** 5% of the unpaid tax for each month or part of a month the return is late
- **Maximum:** 25% of the unpaid tax (reached after 5 months)
- **Minimum penalty:** For returns filed more than 60 days late, the minimum penalty is the lesser of $510 (for TY2026, per Rev. Proc. 2025-32(.52)) or 100% of the unpaid tax
- **Reduction:** The 5% failure-to-file rate is reduced to 4.5% in any month where the failure-to-pay penalty (0.5%) also applies, keeping the combined monthly rate at 5%

Age determination:

Even if you cannot pay — always file on time. The failure-to-file penalty (5%/month) is ten times larger than the failure-to-pay penalty (0.5%/month). A client who files on time but does not pay accrues only 0.5% per month. A client who does not file AND does not pay accrues 5% per month. Always file or extend — never simply do nothing.

Special Filing Situations

Taxpayers Outside the United States

U.S. citizens and resident aliens whose tax home and domicile are outside the U.S. on April 15 automatically receive a 2-month extension to **June 16, 2027** — no form required. They must attach a statement to their return explaining the basis for the extension. Interest on any unpaid balance still accrues from April 15. An additional extension to October 15 can be requested using Form 4868.

Military Personnel in a Combat Zone

Members of the Armed Forces serving in a designated combat zone receive an automatic extension equal to the period of combat zone service plus 180 days. This extension applies to both filing and payment — no penalty or interest accrues during the extension period. This is one of the few situations where the payment deadline is also automatically extended.

Fiscally Challenged / Financially Disabled Taxpayers

The statute of limitations on claiming a refund may be tolled (paused) for a period during which a taxpayer was financially disabled — meaning unable to manage their financial affairs due to a medically determinable physical or mental impairment. Documentation from a physician is required.

Statutes of Limitations

Situation	Assessment Period
Standard (return filed, no substantial omission)	3 years from the later of the return due date or the date the return was filed
Substantial understatement of income (omission of more than 25% of gross income)	6 years from the return filing date
Fraudulent return or willful attempt to evade tax	No limitation — IRS may assess at any time
Return never filed	No limitation — period never starts
Claiming a refund (taxpayer's deadline)	3 years from original due date OR 2 years from date of payment, whichever is later

A return that is never filed means the statute of limitations never begins to run. The IRS can assess tax — and the taxpayer can never claim a refund — on income from a year for which no return was filed. This is why filing a return, even a late return with no balance due, is always better than never filing.

Amended Returns — Form 1040-X

Taxpayers who need to correct a previously filed TY2026 return file Form 1040-X, Amended U.S. Individual Income Tax Return. Key points:

- Form 1040-X may be filed electronically for TY2026 (e-file is available for most amended returns)
- The deadline for filing an amended return to claim a refund is 3 years from the original due date or 2 years from the date of payment, whichever is later
- An amended return that shows an additional balance due should be filed and paid as soon as possible to minimize additional interest accrual
- The IRS typically takes 16 weeks or longer to process paper amended returns; e-filed amended returns process faster

3.1 Tax-related identity theft

Lesson at a Glance

[Image: Tax-Related Identity Theft]

IRS Publication 5199

Tax-Related Identity Theft

Tax-related identity theft occurs when someone uses a taxpayer's stolen **Social Security Number (SSN)** to file a fraudulent tax return and claim a refund. When the legitimate taxpayer later attempts to file, the return is often rejected because the IRS records show a return has already been submitted using that SSN.

Common Warning Sign

An electronically filed return is rejected because a return has already been filed using the taxpayer's SSN.

Resolution Time

Resolving identity theft cases can take months and, in complex situations, even years.

IRS Guidance

IRS Publication 5199 provides guidance for tax professionals on recognizing, reporting, and assisting identity theft victims.

Identity Protection PIN (IP PIN)

- The IP PIN program is one of the IRS's most effective tools for preventing tax-related identity theft.
- Returns filed without the correct IP PIN will generally be rejected by IRS processing systems.
- The program helps ensure that only the legitimate taxpayer can successfully file a return using their SSN.

Practitioner's Role

- Recognize warning signs that may indicate tax-related identity theft.
- Assist taxpayers in reporting fraudulent activity to the IRS.
- Help clients communicate with the IRS during the identity theft resolution process.
- Encourage eligible taxpayers to enroll in the IP PIN program as a preventive measure.

Practitioner Tip: If a client's e-filed return is rejected because a return has already been filed using their SSN, do not assume it is a software issue. Treat the rejection as a potential identity theft case and begin investigating immediately.

How Tax-Related Identity Theft Works

[Image: How Tax-Related Identity Theft Works]

Identity Theft Process

How Tax-Related Identity Theft Works

Why Criminals Act Early

Identity thieves typically file fraudulent tax returns **before the legitimate taxpayer files**. The goal is to obtain a refund and disappear before the victim discovers the fraud.

Step 1 — SSN Is Stolen

A criminal obtains the taxpayer's Social Security Number through:

Data breaches
Phishing scams
Stolen mail
Dark web purchases

Step 2 — Fraudulent Return Filed

The thief files a false tax return using the stolen SSN and typically claims a large refund.

The return is usually filed very early in filing season to beat the legitimate taxpayer.

Step 3 — Refund Issued

The IRS processes the fraudulent return and issues the refund before the fraud is detected.

Step 4 — Legitimate Return Rejected

When the real taxpayer attempts to file, the IRS rejects the return because a return has already been filed using that SSN.

Step 5 — Resolution Process Begins

- The taxpayer must prove their identity to the IRS.
- A paper return is generally required.
- The taxpayer waits while the IRS investigates and corrects the account.
- The process may take many months and, in complex cases, more than a year.

Warning Signs

[Image: Identity Protection PIN Program]

Identity Theft Protection

Warning Signs, Victim Response & IP PIN Program

Warning Signs a Client May Be a Victim

E-filed return rejected because a return was already filed using the taxpayer's SSN.

IRS notice received about a return the taxpayer never filed.

Notice shows wages from an employer the taxpayer never worked for.

Tax bill received for a year the taxpayer already paid.

Fraudulent Form 1099-G received for unemployment benefits never received.

IRS transcript shows unknown employers or a return filed before the taxpayer filed.

IP PIN letter received even though the taxpayer never enrolled.

[Image: Special Situations Involving SSNs]

Deceased Taxpayer SSN Fraud

Fraudsters may use the SSNs of recently deceased individuals before the death is reflected in IRS systems.

- Estate or surviving spouse receives a notice about a return filed under the deceased taxpayer's SSN.
- W-2 or 1099 appears in the deceased taxpayer's name after death.

Action: The surviving spouse or executor should file Form 14039 on behalf of the deceased taxpayer and work with the IRS to reverse the fraudulent return.

Fraudulent Unemployment Benefits

Unemployment fraud occurs when criminals file claims using stolen SSNs. Victims may receive Form 1099-G for benefits never received.

- Do not include fraudulent 1099-G income on the return.
- Report the fraud to the state unemployment agency and request a corrected 1099-G.
- File Form 14039 if a corrected 1099-G is not received before the filing deadline.

Steps for Identity Theft Victims

File Form 14039 to initiate the IRS identity theft process.

File a paper return with Form 14039 attached.

Report to the FTC at IdentityTheft.gov for a recovery plan.

Notify credit bureaus and place a fraud alert.

Contact SSA if the SSN is compromised beyond tax issues.

Obtain an IP PIN after resolution to prevent future fraud.

Identity Protection PIN (IP PIN) Program

The IP PIN is a **6-digit number assigned annually by the IRS**. Without the correct IP PIN, the return will generally be rejected, preventing fraudulent filings under the taxpayer's SSN.

Who Can Get One?

Any taxpayer who verifies identity online, confirmed identity theft victims, and voluntary enrollees.

Annual Renewal

A new 6-digit IP PIN is issued every January. The prior year's PIN cannot be reused.

Family Members

Each taxpayer, spouse, and qualifying dependent may have a separate IP PIN.

Lost PIN

Retrieve through the Individual Online Account or contact the IRS. Filing without the correct PIN is not an option.

Practitioner's Role and Responsibilities

Recognize duplicate SSN rejection as a possible identity theft warning.

Obtain Form 2848 immediately to communicate with IRS IDTVA.

Pull Wage and Income Transcripts to identify unknown W-2s or 1099s.

File the legitimate return on paper with Form 14039 attached.

Document IRS contacts, notices, transcripts, and all actions taken.

Special Situations

[Image: Special Identity Theft Situations]

Special Identity Theft Cases

Deceased Taxpayers, Unemployment Fraud & Practitioner Responsibilities

Identity Theft Involving Deceased Taxpayers

Fraudsters frequently use the Social Security Numbers of recently deceased individuals because those taxpayers generally no longer file returns and their deaths may not yet be reflected in all IRS databases.

- An estate or surviving spouse receives an IRS notice about a return filed under the deceased taxpayer's SSN.
- A W-2 or Form 1099 appears in the deceased taxpayer's name after death.

Required Action: The surviving spouse or executor should file **Form 14039, Identity Theft Affidavit**, on behalf of the deceased taxpayer and work with the IRS to reverse the fraudulent return.

Fraudulent Unemployment Benefits (Form 1099-G)

Widespread during and after the COVID-19 pandemic, unemployment fraud occurs when criminals file unemployment claims using stolen Social Security Numbers. Victims later receive a Form 1099-G reporting benefits they never received.

- **Do NOT report the fraudulent 1099-G income** on the taxpayer's return.
- Report the fraud to the state unemployment agency and request a corrected Form 1099-G.
- If a corrected Form 1099-G is not received before filing, file Form 14039 with the IRS.

Practitioner's Role and Responsibilities

- **Recognize warning signs early.** A duplicate SSN rejection is often the first indication of identity theft and should never be dismissed as a simple software issue.
- **Obtain Form 2848 immediately.** A Power of Attorney allows the practitioner to communicate directly with the IRS Identity Theft Victim Assistance (IDTVA) unit.

- **Pull a Wage and Income Transcript.** Unknown W-2s and 1099s often reveal the fraudulent employer or income source used by the identity thief.
- **File the legitimate return on paper.** After an identity theft rejection, do not continue attempting to e-file. Submit the return with Form 14039 attached.
- **Document everything.** Maintain records of IRS notices, phone calls, transcripts, correspondence, and actions taken throughout the case.

Worked Examples

Tax-Related Identity Theft

Worked Examples, Practitioner Tips & Common Errors

Worked Example 1 — Rejected E-File

A practitioner attempts to e-file a client's TY2026 return in February 2027. The return is rejected with error code **IND-031-04** because the primary taxpayer's SSN has already been used on a filed return.

- The practitioner pulls a Wage and Income Transcript and finds a W-2 from an employer the client never worked for.
- Form 14039 is filed with the client's paper return.
- Form 2848 is submitted so the practitioner can work with the IRS IDTVA unit.
- The client is advised to enroll in the IP PIN program and place fraud alerts with the credit bureaus.

Worked Example 2 — Fraudulent 1099-G

Sandra's client receives Form 1099-G showing **$12,400** in unemployment benefits. The client was employed all year and never applied for unemployment.

- Do not include the fraudulent $12,400 on the return.
- Report the fraud to the state unemployment agency and request a corrected Form 1099-G.
- File Form 14039 with the IRS.
- If no corrected 1099-G is received before filing, show $0 unemployment compensation and attach a written statement explaining the fraud and corrective steps taken.

Practitioner Tips

Recommend IP PIN enrollment to every client as part of annual tax preparation.

Encourage clients to file early once all tax documents are received.

Never include fraudulent Form 1099-G unemployment amounts on the return.

TPP letters such as 4883C or 5071C are protective holds requiring identity verification.

Common Errors & Red Flags

Including fraudulent unemployment income the client never received.

Attempting to re-e-file after an SSN rejection instead of filing on paper with Form 14039.

Failing to pull a Wage and Income Transcript to identify fraudulent income.

Failing to advise IP PIN enrollment after the identity theft case is resolved.

3.2 Safeguarding taxpayer data

[Image: Safeguarding Taxpayer Data]

IRS Publication 4557

Safeguarding Taxpayer Data

Tax practitioners are custodians of highly sensitive taxpayer information, including Social Security Numbers, bank account data, financial records, and personal identifying information. These records are valuable targets for cybercriminals and identity thieves, making data protection a critical professional responsibility.

IRS Publication 4557

Publication 4557, **Safeguarding Taxpayer Data**, provides a comprehensive framework for protecting client information and reducing the risk of identity theft, ransomware, phishing attacks, and data breaches.

Federal Requirement

The **Gramm-Leach-Bliley Act (GLBA)** and the **FTC Safeguards Rule** require tax professionals to implement a written Information Security Plan (WISP) designed to protect taxpayer information.

Consequences of Failing to Protect Taxpayer Data

Potential practitioner liability for data breaches.

IRS sanctions and enforcement actions.

State regulatory investigations and penalties.

Identity theft and financial harm to clients.

Core Security Responsibilities

Maintain a written Information Security Plan (WISP).

Protect taxpayer records from unauthorized access.

Implement cybersecurity controls and monitoring.

Train staff to recognize phishing and security threats.

Secure electronic and physical taxpayer records.

Develop an incident response plan before a breach occurs.

IRS Security Summit

The IRS Security Summit is a partnership among the IRS, state tax agencies, and the tax industry. The Summit publishes annual guidance on emerging cyber threats, identity theft trends, data protection strategies, and best practices that practitioners should incorporate into their security programs.

Practitioner Tip: Cybersecurity is no longer optional. Every tax practice, regardless of size, is legally required to maintain a Written Information Security Plan (WISP) and implement safeguards to protect taxpayer information from unauthorized access, theft, or disclosure.

The Six Required Elements of an ISP (Publication 4557)

#	Element	What It Must Address
1	Designate a coordinator	Name the person responsible for the WISP — even in a one-person firm, that person is you
2	Identify and assess risks	Document where client data is stored, who has access, and what threats exist
3	Design safeguards	Specific controls — passwords, encryption, multi-factor authentication, physical security
4	Oversee service providers	Any vendor who handles client data (cloud storage, tax software, AI tools) must contractually agree to protect it
5	Adjust the plan	Review and update annually and whenever circumstances change (new software, new employees, breach)
6	Create an incident response plan	Specific steps when a breach is discovered — who to call, what to do, how to notify affected clients

TY2026 Updates — AI Tools and Cloud Services

IRS Publication 4557 Update

Artificial Intelligence Must Be Addressed in the WISP

IRS Publication 4557 was updated to specifically require that a firm's **Written Information Security Plan (WISP)** address the use of artificial intelligence tools and cloud-based services. If a tax practice uses AI applications such as ChatGPT, Microsoft Copilot, Claude, Gemini, or similar tools that process client information, the firm's WISP must document how those tools are used and how taxpayer data is protected.

Approved AI Tools
Identify which AI platforms are authorized for use within the firm.

Permitted Data
Specify what client information may be entered into AI systems.

Prohibited Data
Define what taxpayer information must never be entered into AI tools.

Output Verification
Document how AI-generated work is reviewed and validated before use.

Cloud Service Controls
Address third-party cloud providers that process or store taxpayer information.

Incident Response
Explain how the firm will respond if an AI-related data breach occurs.

Important: Using AI without documenting it in the firm's WISP may place the practice out of compliance with IRS Publication 4557 and FTC Safeguards Rule expectations. AI should be treated as a business technology system subject to the same security, oversight, and documentation requirements as tax software, client portals, and cloud storage platforms.

Cross-Reference: See the **AI Tools for Tax Preparers** course for the complete AI Data Protection Protocol, approved-use standards, anonymization procedures, vendor review requirements, and documentation templates.

What to Do When a Data Breach Occurs

There is no requirement to submit a new W-4 every year unless the employee's situation changes. A new W-4 should be submitted when:

- **Secure the breach** — change passwords, disconnect compromised systems, contact your IT provider.
- **Report to the IRS immediately** — email *stakeholders@irs.gov* with subject line "Data Theft — Tax Return Preparer." The IRS Stakeholder Liaison will guide next steps.
- **Report to state tax agencies** — most states require notification of the state tax authority when a preparer's client data is breached.
- **Notify affected clients —** advise clients that their data may have been compromised; recommend they consider an IP PIN and fraud alert.
- **Report to the FTC** — file a report at ReportFraud.ftc.gov.
- **Document everything —** keep a written log of what happened, when, what data was affected, and what steps were taken.

IRS Data Theft Resources:

The IRS Security Summit provides a free Publication 4557, a data theft checklist, and a sample ISP template at IRS.gov/securitysummit. Every practitioner should download these resources and use the sample ISP as a starting point.

3.3 Overview and expiration of Individual Taxpayer Identification Numbers (ITINs)

[Image: Who Needs an ITIN]

ITIN Eligibility & Renewal

Who Needs an ITIN?

An Individual Taxpayer Identification Number (ITIN) is required for individuals who must have a U.S. taxpayer identification number for tax purposes but are not eligible to receive a Social Security Number (SSN).

Basic Eligibility Rule

- The individual is required to file a U.S. tax return or be listed on a tax return.
- The individual is not eligible to obtain a Social Security Number (SSN).

Common ITIN Holders

- Nonresident aliens required to file a U.S. tax return.
- Resident aliens who are not eligible for an SSN.
- Foreign nationals claimed as dependents on a U.S. tax return.
- Spouses of U.S. citizens or resident aliens who are not eligible for an SSN.
- Foreign nationals receiving taxable scholarship or fellowship income.

ITIN Expiration Rules

- An ITIN automatically expires if it is not used on a federal tax return for three consecutive tax years.
- For TY2026 returns filed in 2027, an ITIN unused for TY2023, TY2024, and TY2025 would be expired.
- Certain pre-2013 ITINs also expire under IRS rolling expiration schedules based on middle digits.

Consequences of an Expired ITIN

- Child Tax Credit, Other Dependent Credit, and education credits may be disallowed.
- No retroactive credits are allowed for years in which the ITIN was expired.
- Tax return processing may be significantly delayed until the ITIN is renewed.

Form W-7 — ITIN Application and Renewal

Individuals apply for or renew an ITIN using Form W-7, Application for IRS Individual Taxpayer Identification Number.

By Mail
Mail Form W-7, supporting documents, and the tax return to IRS ITIN Operations in Austin, Texas.

IRS Taxpayer Assistance Center
Original documents are authenticated and returned immediately.

Certifying Acceptance Agent (CAA)
Verifies identity documents without mailing originals to the IRS. Often the safest option.

Required Documentation

- Proof of foreign status.
- Proof of identity.
- A passport is the only document that satisfies both requirements by itself.

Practitioner Tip

- Mail applications generally take 7–11 weeks to process under normal conditions.
- Encourage clients to renew expiring ITINs well before filing season.
- Always verify current expiration schedules and acceptable documents in the latest Form W-7 instructions.

Certifying Acceptance Agents (CAAs)

ITIN Processing Assistance

Certifying Acceptance Agents (CAAs)

Certifying Acceptance Agents (CAAs) are individuals and businesses authorized by the IRS to assist foreign individuals and other taxpayers who are not eligible for a Social Security Number in obtaining and renewing Individual Taxpayer Identification Numbers (ITINs).

What CAAs Do

- Review and certify original identity documents on behalf of the IRS.
- Submit Form W-7 applications and supporting documentation to the IRS for applicants.
- Assist taxpayers with both initial ITIN applications and ITIN renewals.

Why Clients Prefer CAAs

- Eliminates the need to mail original passports and other identification documents to the IRS.
- Reduces the risk of lost or delayed identity documents during processing.

- Provides a more convenient application experience for taxpayers with international documentation.

- **Becoming a CAA**
- Tax professionals who wish to become Certifying Acceptance Agents must complete IRS-required training.
- The practitioner must enter into a formal agreement with the IRS authorizing them to perform CAA services.

Practitioner Tip

Tax professionals serving immigrant communities, international students, foreign investors, or other taxpayers who regularly require ITINs should strongly consider becoming a Certifying Acceptance Agent or establishing a referral relationship with a local CAA. Doing so can simplify the application process, reduce document-handling risks, and improve client service.

ITIN and Credit Eligibility

Credit	ITIN Holder Eligible?	Notes
Child Tax Credit (CTC)	No — child must have SSN	Child listed with ITIN on return does not qualify for CTC; may qualify for Credit for Other Dependents ($500)
Credit for Other Dependents (ODC)	Yes — ITIN acceptable for dependent	$500 nonrefundable credit; ITIN must be valid (not expired)
Earned Income Tax Credit (EITC)	No	Taxpayer, spouse, and qualifying children must all have SSNs valid for employment
Child and Dependent Care Credit	Yes — ITIN acceptable for taxpayer	Qualifying person must have SSN or ITIN
American Opportunity Credit (AOC)	Yes — ITIN acceptable for student	Student must be listed on the return with a valid TIN
Premium Tax Credit (PTC)	No — SSN required	ITIN holders are not eligible for Marketplace coverage or PTC

Worked Examples & Practitioner Guidance

ITIN Filing Scenarios

Worked Example 1

Expired ITIN, Lost Credit

Maria, a lawful permanent resident, uses an ITIN. Her ITIN was last used on her TY2022 return. She did not file returns for TY2023, TY2024, or TY2025. She files TY2026 and claims the Child Tax Credit for her U.S. citizen child.

- Maria's ITIN expired after three consecutive years of non-use.
- The Child Tax Credit will be disallowed until the ITIN is renewed.
- Maria must renew her ITIN by filing Form W-7.
- Practitioners should verify ITIN validity before every filing season to avoid permanently lost credits.

Worked Example 2

CAA Assists Foreign Spouse

James, a U.S. citizen, married Ana, a foreign national, in 2026. They wish to file a joint return, but Ana is not eligible for an SSN and needs an ITIN.

- The practitioner refers Ana to a Certifying Acceptance Agent (CAA).
- The CAA reviews and certifies Ana's passport and supporting documentation.
- The W-7 application is submitted without Ana mailing her original passport to the IRS.
- The IRS processes the ITIN application and the couple may proceed with their MFJ filing once the ITIN is assigned.

Practitioner Tips

Screen every ITIN client for expiration before filing. Check whether the ITIN was used during each of the previous three tax years.

Encourage renewal before filing season. The typical 7–11 week processing time can create filing delays if renewal is postponed.

Becoming a Certifying Acceptance Agent can be a valuable practice differentiator for firms serving immigrant or international communities.

ITIN eligibility does not automatically qualify a taxpayer for every tax credit. Verify each credit's identification requirements separately.

Common Errors & Red Flags

Filing with an expired ITIN and claiming credits that will be denied.

Claiming Earned Income Tax Credit for a taxpayer, spouse, or child who does not have a valid SSN.

Mailing original passports and identity documents when a CAA or IRS TAC could eliminate that risk.

Failing to explain that an ITIN is for tax administration purposes only and does not authorize employment or establish immigration status.

3.4 Preparer penalties (inflation adjustments to penalty amounts)

Lesson at a Glance

[Image: Tax Preparer Penalties]

Preparer Penalties

Understanding IRS Penalties for Tax Return Preparers

Tax return preparers are subject to a wide range of IRS-imposed penalties for violations of professional obligations — from failing to sign a return to willfully understating a taxpayer's liability. Many preparer penalties are adjusted annually for inflation.

Most Significant Preparer Penalty

The most significant preparer penalty is the **IRC §6694 penalty for understatement of taxpayer liability.** This penalty applies when a preparer takes an unreasonable position on a return or willfully understates the taxpayer's correct tax liability.

§6694

Understatement of taxpayer liability due to unreasonable positions or willful conduct.

§6695

Administrative preparer penalties such as failure to sign, failure to furnish copies, or due diligence failures.

Circular 230

OPR disciplinary actions including censure, suspension, disbarment, and monetary penalties.

Exam Tip: For AFTR purposes, remember that §6694 penalties focus on unreasonable tax positions, while §6695 penalties generally address procedural and due diligence failures. Both can apply to the same return.

Understatement of Taxpayer Liability

Preparer Penalties

IRC §§6694 and 6695

§6694 — Understatement of Taxpayer Liability

The most significant preparer penalty. IRC §6694 applies when a preparer prepares a return containing an understatement of tax liability due to an unreasonable position or willful conduct.

Unreasonable Position

- Position does not meet the required authority standard.
- Position was not adequately disclosed using Form 8275 or Form 8275-R.
- **TY2026 Penalty:** Greater of $1,000 or 15% of income derived from preparing the return.

Willful or Reckless Conduct

- Willful attempt to understate the taxpayer's liability.
- Reckless or intentional disregard of IRS rules and regulations.
- **TY2026 Penalty:** Greater of $5,000 or 75% of income derived from the return.
- Adequate disclosure does not eliminate a willful conduct penalty.

§6695 — Administrative Preparer Penalties

These penalties generally apply on a per-return or per-failure basis for administrative violations committed by paid preparers.

Failure to sign a return as paid preparer.

Failure to furnish a copy of the return to the taxpayer.

Failure to provide or use the preparer's identifying number (PTIN).

Failure to retain required records and documentation.

Failure to satisfy due diligence requirements under §6695(g).

Violation	Code Section	TY2026 Penalty (Rev. Proc. 2025-32(.54))
Failure to furnish copy to taxpayer	§6695(a)	$65 per failure; max $33,000 per year
Failure to sign the return	§6695(b)	$65 per failure; max $33,000 per year
Failure to furnish identifying number (PTIN)	§6695(c)	$65 per failure; max $33,000 per year
Failure to retain copy or list of returns	§6695(d)	$65 per failure; max $33,000 per year
• Failure to file correct information returns	§6695(e)	$65 per failure; max $33,000 per year
Negotiating a taxpayer's refund check	§6695(f)	$670 per check
Failure to meet due diligence requirements (EITC, CTC, ODC, AOC, HoH)	§6695(g)	$665 per failure

[Image: peanlty.webp]

§6694 penalties are per return — not per preparer per year.

If a preparer prepares multiple returns with unreasonable positions, each return generates a separate penalty. A pattern of such returns can also trigger PTIN suspension or injunction proceedings under §7407.

Additional Preparer Penalties

Due Diligence, Abusive Tax Shelters & Injunctions

§6695(g) — Due Diligence Penalty

The due diligence penalty is **$665 per failure** for TY2026 and applies when a preparer fails to satisfy due diligence requirements for certain credits and filing statuses.

EITC

CTC / ACTC

ODC

AOC

Head of Household

Required Due Diligence Steps

- Complete Form 8867 for each return claiming EITC, CTC/ACTC, ODC, AOC, or Head of Household status.
- Complete all required IRS credit computation worksheets.
- Ask adequate eligibility questions and document client responses.
- Not know or have reason to know that information provided is incorrect.
- Retain all due diligence records for 3 years.

§6700 — Promoting Abusive Tax Shelters

Applies to any person who organizes, promotes, or assists with abusive tax shelters while making statements they know or should know are false or fraudulent.

TY2026 Penalty: Greater of $1,000 per activity or 100% of the gross income derived from the activity.

§6701 — Aiding and Abetting Understatement

Applies when a person assists in preparing a document that causes an understatement of another person's tax liability and knows, or has reason to know, the understatement will occur.

TY2026 Penalty: $1,000 per document or $10,000 per document involving a corporation.

§7407 — Injunction Against Preparers

The IRS may seek a court injunction prohibiting a preparer from preparing returns if the preparer engages in conduct subject to penalties under §§6694, 6695, 6700, or 6701.

A permanent injunction can effectively end a preparer's practice. This is commonly viewed as the IRS's most severe enforcement tool for repeat or egregious violators.

Defenses to Preparer Penalties

- **Reasonable Cause & Good Faith:** The preparer reasonably believed the position was supported by law after appropriate research or analysis.
- **Advice of Counsel:** Reliance on advice from a qualified attorney or tax professional with relevant expertise.
- **Reliance on Client Information:** Allowed when the information appears reasonable and not obviously incorrect.
- **Adequate Disclosure:** Disclosure on Form 8275 or Form 8275-R may reduce §6694(a) exposure but does not protect frivolous or reckless positions.

Worked Examples

[Image: Unreasonable Position Penalty]

Worked Example 2 — §6694(a) Unreasonable Position

A preparer deducts **$28,000** of personal expenses as Schedule C business expenses. No research supports the position and no disclosure is made on Form 8275.

Penalty Calculation:

- Greater of $1,000 or 50% of preparation income.
- $400 preparation fee → $1,000 penalty.
- $10,000 preparation fee → $5,000 penalty (50%).

If the conduct is reckless or intentional, §6694(b) applies and the penalty increases to the greater of **$5,000 or 75% of the fee.**

[Image: EITC Due Diligence]

Worked Example 1 — §6695(g) Due Diligence Penalty

A preparer prepares **40 EITC returns** during filing season but fails to complete Form 8867 or document client interviews.

An IRS audit discovers the failure.

Penalty:

$665 × 40 = $26,600

This penalty applies even if the credits themselves were calculated correctly.

Due diligence is a mandatory compliance requirement — not an optional documentation step.

Practitioner Tips

- Complete Form 8867 on every return claiming EITC, CTC, ODC, AOC, or Head of Household status.
- Document legal research supporting aggressive tax positions and retain it with the client file.
- When appropriate, disclose uncertain positions using Form 8275.
- Never negotiate, cash, or endorse a client's refund check. §6695(f

3.5 Tax preparation due diligence

Lesson at a Glance

[Image: Tax Preparer Due Diligence]

IRC §6695(g)

Tax Preparer Due Diligence

What Is Due Diligence?

- Tax preparation due diligence is the legal obligation of paid preparers to make reasonable inquiries and verify eligibility before claiming certain tax benefits on a return.
- Due diligence requirements are enforced under **IRC §6695(g)** and apply to specific credits and filing statuses that are frequently abused or claimed incorrectly.

TY2026 Due Diligence Penalty

$665

Per Failure

The due diligence penalty is **$665 for each failure** for TY2026 under Rev. Proc. 2025-32(.54). Multiple failures on the same return can result in multiple penalties.

Credits and Filing Statuses Covered by Due Diligence

EITC

Earned Income Tax Credit

CTC / ACTC

Child Tax Credits

ODC

Credit for Other Dependents

AOTC

American Opportunity Tax Credit

HoH

Head of Household Status

Form 8867 Requirement

- Form 8867, Paid Preparer's Due Diligence Checklist, must be completed whenever a return claims one or more covered credits or Head of Household filing status.
- The completed form and supporting documentation must be retained as part of the preparer's due diligence records.

Practitioner Tip: Due diligence means more than asking a question and recording the answer. Preparers must make reasonable inquiries whenever information appears incomplete, inconsistent, or incorrect. A completed Form 8867 is important, but it does not replace the underlying responsibility to verify eligibility.

Background — Why Due Diligence Matters

[Image: Due Diligence Requirements]

Form 8867 Compliance

Why Due Diligence Matters

Congress Put the Responsibility on Preparers

- The Earned Income Tax Credit (EITC), Child Tax Credit (CTC), Additional Child Tax Credit (ACTC), Credit for Other Dependents (ODC), American Opportunity Tax Credit (AOTC), and Head of Household (HoH) filing status are among the most valuable benefits available to taxpayers.
- These benefits are also among the most frequently abused and improperly claimed items on individual income tax returns.
- Congress created the due diligence rules to place responsibility on paid preparers to ask appropriate questions, evaluate the answers, and document eligibility before claiming these tax benefits.

Form 8867 Is the IRS Audit Tool

- The IRS relies heavily on **Form 8867, Paid Preparer's Due Diligence Checklist**, when examining preparer compliance.
- During a due diligence examination, the IRS reviews Form 8867 and supporting documentation to determine whether the preparer satisfied the required due diligence standards.

Due Diligence Creates Protection

- Due diligence does not guarantee that a credit or filing status is ultimately correct.
- Instead, it creates a defensible record demonstrating that the preparer acted reasonably based on the information available at the time the return was prepared.
- A preparer who satisfies all due diligence requirements is protected even if the taxpayer later turns out to be ineligible, provided the preparer did not know—or have reason to know—that the information was false.

Key Concept

The due diligence rules do not require preparers to be detectives. They require preparers to ask reasonable questions, follow up when information appears inconsistent or incomplete, document the responses received, and retain the required records. Meeting those obligations is often the difference between a successful defense and a costly IRC §6695(g) penalty assessment.

The Five Due Diligence Triggers

Credit / Status	**Form**	**Due Diligence Required?**
Earned Income Tax Credit (EITC)	Schedule EIC	Yes
Child Tax Credit (CTC) / Additional Child Tax Credit (ACTC)	Schedule 8812	Yes
Credit for Other Dependents (ODC)	Schedule 8812	Yes
American Opportunity Tax Credit (AOTC)	Form 8863	Yes
Head of Household filing status	Form 1040 Box	Yes
Lifetime Learning Credit (LLC)	Form 8863	No — not a due diligence trigger
Child and Dependent Care Credit	Form 2441	No — not a due diligence trigger

The Four Components of Due Diligence

[Image: The Four Components of Due Diligence]

IRC §6695(g)

The Four Components of Due Diligence

Component 1

Complete Form 8867

- The preparer must complete **Form 8867, Paid Preparer's Due Diligence Checklist**, for every return claiming EITC, CTC/ACTC, ODC, AOTC, or Head of Household filing status.
- Form 8867 must be submitted with the return — electronically for e-filed returns or attached to paper returns.

Component 2

Complete Relevant Sections

- Form 8867 has separate sections for each triggered item.
- The preparer completes only the sections relevant to the credits or filing status claimed on that specific return.

Component 3

Complete IRS Worksheets

- The preparer must complete the credit eligibility worksheets provided by the IRS for each applicable credit.
- Worksheets built into tax software must not be bypassed or overridden without documentation.

Component 4

Apply Professional Judgment

- The preparer must ask adequate questions to determine whether the credit or filing status is proper.
- The IRS evaluates the preparer under the **reasonable, well-trained tax professional** standard.

Required Questions Vary by Credit

- EITC, CTC, ACTC, and ODC questions often focus on relationship, residency, support, age, and whether another taxpayer can claim the child.
- AOTC questions focus on student status, eligible education expenses, Form 1098-T, degree program enrollment, and prior years claimed.
- Head of Household questions focus on marital status, qualifying person, household costs, and whether the taxpayer maintained the home.

The Five Due Diligence Triggers

Credit / Status	Key Interview Questions
EITC	Does the client have earned income? What is the source? Are the

Credit / Status	Key Interview Questions
	qualifying children the client's biological/adopted/step children? Did they live with the client more than 6 months? Are the children being claimed on another return? Does the client have investment income above the limit?
CTC / ACTC / ODC	Is the child under 17 at year-end? Does the child have a valid SSN? Did the child live with the client more than half the year? Is anyone else claiming this child? Is the dependent a qualifying relative or qualifying child?
AOTC	Is the student in their first 4 years of higher education? Were they enrolled at least half-time? Do they have a felony drug conviction? Has the student claimed AOTC in more than 3 prior years? Does the student's Form 1098-T match the expenses claimed?
HoH	Is the taxpayer unmarried (or considered unmarried under abandoned spouse rules)? Did the taxpayer pay more than half the cost of maintaining the home? Did a qualifying person live in the home more than half the year? Is the qualifying person the taxpayer's qualifying child or a parent?

Documentation and Retention

[Image: Documentation and Retention Requirements]

Due Diligence Requirements

Documentation and Retention

Three-Year Retention Requirement

3 Years

Minimum Retention Period

- The preparer must retain due diligence records for **three years**.
- The retention period begins from the later of the return due date (excluding extensions) or the date the return was actually filed.
- Proper record retention is critical because due diligence examinations often occur years after the return was prepared.

Records That Should Be Retained

Copy of Form 8867
Retain the completed due diligence checklist exactly as submitted with the return.

Eligibility Worksheets
Retain the completed IRS worksheets used to determine credit eligibility.

Interview Notes
Maintain notes documenting questions asked and answers received during the client interview.

Documents Reviewed
Record which documents were reviewed, such as school records, lease agreements, or birth certificates.

Important Clarification

The IRS does not generally require preparers to collect and keep copies of supporting documents. However, if documents were reviewed to verify eligibility, the preparer should document what was reviewed and how it supported the credit or filing status claimed.

Consequences of Failing Due Diligence

IRC §6695(g)

Consequences of Failing Due Diligence

Monetary Penalties Add Up Quickly

$665

Penalty Per Failure
TY2026

$1,330

EITC + AOTC
Two Failures

$1,995

EITC + CTC + HoH
Three Failures

Real-World Impact

$33,250

50 Non-Compliant Returns × $665

A preparer with systemic due diligence failures can accumulate tens of thousands of dollars in penalties during a single filing season.

Additional IRS Enforcement Actions

IRS Office Audit
The IRS may conduct a site visit and review returns, procedures, and due diligence records maintained by the preparer.

PTIN Suspension or Revocation
Serious or repeated violations may result in the loss of the preparer's ability to prepare federal tax returns for compensation.

§7407 Injunction Proceedings
The Department of Justice may seek a court order prohibiting the preparer from preparing federal tax returns.

Criminal Referral
Preparers who intentionally facilitate fraudulent credits may be referred for criminal investigation and prosecution.

Why the IRS Takes Due Diligence Seriously

- The IRS considers preparers the first line of defense against improper refundable credits and filing status abuse.
- Proper due diligence protects taxpayers, protects the tax system, and protects the preparer from penalties and enforcement actions.

Worked Examples

IRC §6695(g)

Due Diligence Worked Examples

1

EITC Red Flag Not Pursued

Due Diligence Failure

- A client claims three qualifying children and reports $18,000 of babysitting income received entirely in cash. She has no receipts, bank records, or Forms 1099.
- The income amount happens to maximize the Earned Income Tax Credit, yet the preparer accepts the information without further inquiry.
- **Due Diligence Analysis:** A reasonable, well-trained tax professional would recognize multiple red flags. Additional questions and supporting evidence should have been requested. Merely checking "Yes" on Form 8867 does not satisfy due diligence. If the EITC is later disallowed, both §6695(g) and potentially §6694 penalties may apply.

2

Proper Head of Household Interview

Due Diligence Satisfied

- A taxpayer claims Head of Household with one qualifying child. The preparer asks about marital status, residency, support, and whether another taxpayer can claim the child.
- Rent receipts support the taxpayer's claim that she paid more than half of the household costs.

- **Result:** Form 8867 is completed, the interview is documented, and the information is consistent. Due diligence requirements are satisfied, providing a strong defense if the IRS later questions the filing status.

3

AOTC — Fifth-Year Student

Interview Prevents an Incorrect Credit

- A taxpayer asks to claim the American Opportunity Tax Credit for a 23-year-old daughter with $8,000 of tuition expenses.
- During the interview, the preparer learns the daughter has already claimed the AOTC for four prior tax years.
- **Due Diligence Result:** The AOTC has a four-year lifetime limit and is no longer available. A proper interview prevented an improper credit claim. The Lifetime Learning Credit may still be considered as an alternative.

Practitioner Tips

Use a standardized intake questionnaire covering EITC, CTC, ODC, AOTC, and HoH eligibility. Have the client sign and date it.

Train all staff on due diligence standards. The signing preparer remains responsible even when intake is performed by support staff.

Never bypass software worksheets. The built-in worksheets satisfy part of the due diligence computation requirement.

Investigate significant year-to-year changes such as new dependents, new HoH claims, or dramatic income changes.

For AOTC claims, always ask which year of school the student is in and whether the credit has been claimed previously.

Common Errors & Red Flags

- Not completing Form 8867 at all.
- Checking "Yes" boxes without conducting a genuine interview.
- Failing to retain Form 8867 and interview notes for three years.
- Claiming the AOTC without asking about prior years claimed.
- Accepting implausible income amounts that appear designed to maximize EITC.
- Claiming Head of Household without verifying residency requirements.

3.6 E-file requirements

Lesson at a Glance

[Image: E-File Requirements]

IRS Compliance · E-File Mandate

Electronic Filing Requirements for Tax Preparers

Paid tax return preparers who prepare **11 or more individual income tax returns per year** are generally required to file those returns electronically.

This mandate is governed by **Publication 1345**, Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns.

Key E-File Rules

- Preparers may not use pay stubs or substitute forms as the basis for a final return.
- Signature authorization forms must be obtained before transmitting any return.
- Rejected returns must be corrected and resubmitted within IRS-defined timeframes.

Form 8879

IRS e-file Signature Authorization used for standard individual income tax return e-filing.

Form 8878

E-file signature authorization for Form 4868 or Form 2350 extension requests.

Form 8948

Preparer Explanation for Not Filing Electronically when a specific return cannot be e-filed.

Form 8508

Request for Waiver from Filing Information Returns Electronically.

Practitioner Tip: For LearnDash, keep this section simple: no CSS blocks, no JavaScript, no grid layout, and no emoji icons. Use inline styles, flexbox, Font Awesome icons, and compact cards so the content renders consistently on the lesson page.

The Mandatory E-file Requirement

IRC §6011(e)

E-File Requirement

Scan or click to open

Treas. Reg. §301.6011-7

Specified Tax Returns

Scan or click to open

Under IRC §6011(e) and related Treasury regulations, paid preparers who reasonably expect to file 11 or more individual income tax returns during a calendar year must file all eligible individual returns electronically. This threshold applies to returns prepared in the preparer's firm — not just returns prepared by the individual preparer.

Exceptions to Mandatory E-file

A preparer may file a paper return without violating the mandatory e-file requirement in these situations:

- **Taxpayer opts out** — the taxpayer affirmatively chooses to file on paper. The preparer must attach Form 8948 to explain the paper filing and retain the taxpayer's signed statement of preference for paper.
- **Administrative exemption** — the return cannot be e-filed due to IRS system limitations or because the specific form is not accepted electronically for that year.
- **Undue hardship** — the preparer obtains a waiver from the IRS using Form 8508. Hardship waivers are rarely granted for established preparers.

No Pay Stub Filing Rule

[Image: No Pay Stub Filing Rule]

E-File Compliance Rule

No Pay Stub Filing Rule

- A preparer may **not** use a client's pay stub, W-2 substitute, or any document other than an official Form W-2 or other official information return as the basis for preparing a final income tax return.
- This rule prevents preparers from filing returns before clients receive official documents — a practice historically associated with refund fraud and Refund Anticipation Loan schemes.

Specifically Prohibited

- Preparing a final Form 1040 using only a pay stub — even if the client consents.
- E-filing a return before the taxpayer has received and reviewed the official Form W-2.
- Using year-end pay stub income figures when the official Form W-2 may differ because of pre-tax benefits, corrections, payroll adjustments, or other reporting changes.

E-file Signature Authorization

[Image: Mandatory E-File Signature Authorization]

E-File Signature Authorization

Forms 8879 and 8878

- Because a taxpayer cannot physically sign an electronic return, the IRS requires a separate signature authorization process before a return may be transmitted electronically.
- The taxpayer reviews the completed return and authorizes the preparer to transmit it by signing the appropriate IRS authorization form.

Form 8879

Standard e-file signature authorization for individual income tax returns, including Form 1040 and related schedules.

Form 8878

Authorization form used when electronically filing Form 4868 or Form 2350 extension requests on behalf of a taxpayer.

Form 8879 Requirements

- The preparer must provide the taxpayer with a completed copy of the return before Form 8879 is signed.
- The taxpayer must review the return before authorizing electronic transmission.
- The taxpayer signs using a 5-digit PIN under either the Self-Select PIN method or Practitioner PIN method.
- The preparer must obtain the signed Form 8879 before transmitting the return.

Record Retention Requirements

- Forms 8879 and 8878 are not submitted to the IRS.
- The preparer must retain the signed authorization form for 3 years from the return due date or filing date, whichever is later.
- Electronic signatures obtained through secure portals, DocuSign, or similar systems are acceptable.

Common Compliance Error

Transmitting a return before obtaining a signed Form 8879 is an e-file compliance violation. The authorization must be signed and retained before the return is electronically filed.

Timing — When to Obtain the Signature Form

Situation	Timing Requirement
Standard return (Form 8879)	Must be obtained before transmitting the return; the completed return must be provided to the taxpayer for review first
Extension (Form 8878)	Must be obtained before transmitting Form 4868 or Form 2350
Electronic signature	An e-signature on Form 8879 via a secure system is acceptable; must be obtained before transmission

Situation	Timing Requirement
Retention period	3 years from the return due date or filing date, whichever is later

Handling Rejected Returns

[Image: Rejected Returns]

Rejected Within 5 Days

Correct the error and retransmit the return as soon as possible.

If the corrected return is retransmitted within **5 days of the rejection notice**, the original timely filing date is preserved.

Cannot Be Corrected

File a paper return by the later of:

- The original due date, OR
- 10 calendar days after the IRS rejection notice.

Attach a brief explanation of the rejection and corrective actions taken.

Duplicate SSN Rejection

A return rejected because of a duplicate SSN generally cannot be retransmitted electronically.

- File a paper return.
- Notify the taxpayer immediately.
- Follow IRS identity theft procedures.

Form 8948 — Preparer Explanation for Not Filing Electronically

Form 8508 — Application for Waiver from Electronic Filing of Information Returns

E-File Exceptions & Waivers

Form 8948 vs. Form 8508

Form 8948

Preparer Explanation for Not Filing Electronically

Used when a return subject to the e-file mandate is filed on paper. The preparer must attach Form 8948 explaining why the return was not filed electronically.

- Taxpayer elected to file on paper and the choice is documented.
- Return type is not supported by IRS e-file for the current year.
- Genuine documented technical difficulty prevented e-filing.
- Unusual circumstances prevent the e-file system from processing the return.

Form 8508

Waiver from Electronic Filing of Information Returns

Used by filers of information returns such as W-2s, 1099s, and similar forms when they cannot comply with electronic filing requirements.

- Applies to information returns only.
- Does **not** apply to individual income tax returns.
- Must be filed at least **45 days before** the information return due date.
- Use Form 8948, not Form 8508, for individual income tax return e-file exceptions.

Exam Tip: Remember the distinction: **Form 8948** is for individual income tax returns that are paper-filed despite the e-file mandate. **Form 8508** is for information return filers requesting a waiver from electronic filing.

3.7.1 Annual Filing Season Program Requirements

IRS Continuing Education Program

Annual Filing Season Program (AFSP)

Voluntary IRS Program

- The Annual Filing Season Program is a voluntary IRS continuing education program for non-exempt, non-credentialed tax return preparers.
- Completing the AFSP earns a Record of Completion.
- Participants may be included in the IRS public directory and receive limited representation rights before the IRS.

2026 Filing Season CE Requirement

- Non-exempt participants must complete **18 hours of continuing education**.
- The 18-hour requirement includes this **6-hour Annual Federal Tax Refresher (AFTR)** course.

Rev. Proc. 2014-42

Governs the Annual Filing Season Program and Record of Completion requirements.

Publication 5227

Provides participant information for preparers pursuing the AFSP Record of Completion.

Publication 5646

Explains exempt status details and how AFSP requirements apply to different preparer categories.

TY2026 AFSP CE Requirements

CE Component	Hours Required	Satisfied By
Annual Federal Tax Refresher (AFTR) course	**6 hours**	This course — must include 100-question comprehension test
Ethics CE	**2 hours**	Any IRS-approved Ethics course
Federal tax law topics	**10 hours**	Any combination of IRS-approved Federal Tax Law Topics courses
TOTAL	**18 hours**	All completed by December 31 of the calendar year

Who Is Exempt from the AFTR Course

Who Is Exempt from the AFTR Course

These practitioners are exempt because they are already subject to higher-level CE requirements or licensing standards.

Attorneys

Licensed to practice law and represent clients in legal matters.

CPAs

Licensed accounting professionals who prepare, review, and advise on tax and financial matters.

Enrolled Agents

Federally authorized tax practitioners with unlimited IRS representation rights.

ERPAs

Specialists authorized to represent clients before the IRS on retirement plan matters.

Enrolled Actuaries

Professionals who perform actuarial work for qualified retirement plans.

RTRPs

Preparers who completed the IRS registration program before it was enjoined.

Feature	AFSP Participant	CPA / Enrolled Agent (EA)
IRS Directory Listed?	**Yes**	**Yes**
Prepare Tax Returns?	**Yes**	**Yes**
Represent Audits?	**Limited** *(Only returns you signed)*	**Unlimited** *(Any return)*
Appeals & Collections?	**No**	**Yes**

What the AFSP Record of Completion Provides

- **IRS Directory Listing:** Participants appear in the free public directory at IRS.gov/chooseataxpro — searchable by name, city, state, and zip code. The directory is the primary tool taxpayers use to find qualified preparers. Being listed provides a significant credibility advantage over non-AFSP preparers who do not appear in the directory.
- **Limited Representation Rights:** AFSP participants may represent clients before IRS Revenue Agents, Customer Service Representatives, and similar personnel during the examination of a tax return the AFSP participant prepared and signed. These rights are more limited than EA or CPA representation rights — AFSP participants cannot represent clients in appeals or collection matters.

How to Obtain the Record of Completion

How to Receive the AFSP Record of Completion

The IRS issues the Record of Completion automatically once all AFSP requirements are met.

Complete CE

Complete all 18 required CE hours, including this AFTR course, before December 31.

Check PTIN

Ensure all CE credits are reported to the IRS through your PTIN account.

Consent

Consent to Circular 230 through the IRS PTIN system.

Record Issued

The IRS automatically issues the Record of Completion once all requirements are met.

3.7.2 Circular 230 and consent to be subject to Circular 230 rules

Lesson at a Glance

31 CFR Part 10

What Is Circular 230?

The Rules for Practice Before the IRS

- Circular 230 (**31 CFR Part 10**) is the body of regulations governing practice before the Internal Revenue Service.
- It establishes ethical standards, professional responsibilities, and conduct requirements for tax practitioners who interact with the IRS on behalf of taxpayers.

Who Is Subject to Circular 230?

Attorneys

CPAs

Enrolled Agents

AFSP Participants

What Does "Practice Before the IRS" Mean?

- Preparing and filing federal tax returns and related documents.
- Communicating with the IRS on behalf of a taxpayer.
- Representing taxpayers during examinations and audits.
- Representing taxpayers in collection matters.
- Representing taxpayers before IRS Appeals.

Why Circular 230 Matters for AFSP Participants

- AFSP participants must consent to be subject to Circular 230.
- Without that consent, the preparer cannot receive an AFSP Record of Completion.
- Consent to Circular 230 is also required before the preparer can exercise the limited representation rights available under the AFSP.

Key Duties Under Circular 230 for Tax Return Preparers

Section	Duty	Practical Meaning
§10.22	Diligence as to accuracy	Exercise due diligence in preparing returns and representations to clients and the IRS. Do not sign returns you know are incorrect.
§10.29	Conflicting interests	Do not represent clients whose interests directly conflict without full disclosure and consent from all affected parties.
§10.34	Standards for returns	Do not take a return position with no reasonable basis. Do not sign a return containing a position you know or should know is unreasonable.
§10.35	Competence	Have the knowledge, skill, thoroughness, and preparation necessary to provide the service you are rendering.
§10.51	Disreputable conduct	Conviction of certain crimes, willful failure to file, misappropriation of client funds, and false statements to the IRS are grounds for sanctions.

Consent to Circular 230 — The AFSP Requirement

AFSP Participants

The Consent Requirement

Consent to Circular 230

Required before the AFSP Record of Completion is issued

- Non-credentialed tax return preparers who wish to participate in the AFSP must agree to be subject to the duties and restrictions relating to practice before the IRS as set forth in **Circular 230 (31 CFR Part 10)**.
- This consent is provided electronically through the **IRS PTIN system** when the practitioner completes the AFSP continuing education requirements and applies for the Record of Completion.
- Without this consent, the **AFSP Record of Completion** will not be issued, and the practitioner will not appear in the IRS public directory with the AFSP designation.

OPR Enforcement and Sanctions

Office of Professional Responsibility

Circular 230 Enforcement and Sanctions

The IRS Office of Professional Responsibility (OPR) enforces Circular 230 and may impose sanctions on practitioners who violate professional conduct standards. The infographic below summarizes the primary disciplinary actions available to OPR.

[Image: Penalties for Violating Circular 230]

Censure

A formal public reprimand issued by OPR for misconduct.

Suspension

Temporary loss of the right to practice before the IRS.

Disbarment

Permanent removal from practice before the IRS.

Monetary Penalties

Financial penalties may be imposed on practitioners and firms.

Practical Application for AFSP Participants

Circular 230 in Practice

Practical Application for AFSP Participants

What Consent Means in Daily Practice

Professional responsibilities for AFSP participants

Exercise due diligence when preparing returns, reviewing documents, and verifying information provided by clients.

Do not take frivolous tax positions or recommend positions that lack a reasonable basis under the law.

Never knowingly sign or submit a return that contains false, misleading, or incomplete information.

Maintain client confidentiality and protect taxpayer information from unauthorized disclosure.

Keep current with continuing education requirements and ongoing tax law changes to maintain professional competence.

Avoid conduct that brings disrepute to the tax preparation profession or undermines public confidence in the tax system.

Key Point: AFSP participants receive more limited representation rights than enrolled agents, attorneys, and CPAs. However, once they consent to Circular 230, the professional conduct standards are the same. Limited representation does not mean limited ethical responsibilities.

3.7.3 Limited representation

What AFSP Participants Can Do During an Examination

An AFSP participant who prepared and signed a return may:

- Represent the taxpayer before Revenue Agents, Customer Service Representatives, and similar IRS examination personnel
- Speak on the client's behalf, provide documents, and respond to IRS inquiries about the return
- Present the preparer's position and explain entries on the return

What AFSP Participants Cannot Do

An AFSP participant who prepared and signed a return may:

- Represent a client before the IRS Office of Appeals
- Represent a client in collection matters (liens, levies, installment agreements)
- Represent a client in any matter involving a return they did not prepare
- Appear before the U.S. Tax Court (attorneys only)
- Represent a client before the IRS Office of Professional Responsibility

When to Refer to a Credentialed Practitioner

[Image: When-to-Refer-to-a-Credentialed-Practitioner-scaled.webp]

An AFSP participant must refer the client to an EA, CPA, or Attorney when: the IRS examination results in a deficiency the client wants to appeal; the matter involves IRS collection enforcement; the client receives a Notice of Deficiency and has Tax Court rights; or the matter is beyond the scope of the return the AFSP participant prepared. Making a timely referral is itself a professional responsibility

```
 attempting to represent a client in a matter beyond your authorization is a
Circular 230 violation.
```

Worked Examples

AFSP Limited Representation Rights

Worked Examples

1

Valid Limited Representation

Examination of a Return She Prepared

- Sandra holds a current AFSP Record of Completion and prepared and signed the Garcias' TY2026 Form 1040.
- The IRS selects the return for examination and the Garcias execute Form 2848 authorizing Sandra to represent them.
- **Result:** Sandra may communicate directly with the IRS examiner, submit documentation, and advocate for the correct tax treatment because she prepared and signed the return. Her authority ends if the matter moves to Appeals.

2

Appeals Is Outside the Scope

Representation Rights End

- Robert successfully represents a taxpayer during an examination, but the IRS upholds an additional assessment.
- The client wants Robert to continue representing them before the IRS Appeals Office.
- **Result:** AFSP representation rights do not extend to Appeals. Robert must refer the client to an EA, CPA, or attorney. He may assist by briefing the new representative and providing the examination file.

3

Return Not Prepared by AFSP Participant

No Representation Authority

- Maria is an AFSP participant and is asked to represent her brother during an IRS examination of a return prepared by another preparer three years earlier.
- Maria did not prepare or sign the return under examination.
- **Result:** Maria's AFSP status does not authorize representation. Her brother must represent himself or retain a credentialed practitioner. Maria may provide informal assistance but cannot appear before the IRS as his representative.

Practitioner Tips

Know the hard boundary at IRS Appeals. AFSP authority ends with the examination phase.

Maintain referral relationships with EAs, CPAs, and tax attorneys for Appeals, Collection, and Tax Court matters.

Clearly explain your representation limits to clients before an examination begins.

Use the correct AFSP designation on Form 2848. Misrepresenting yourself as an EA, CPA, or attorney is a Circular 230 violation.

Common Errors & Red Flags

- Attempting to represent a taxpayer before IRS Appeals.
- Representing a taxpayer regarding a return not prepared and signed by the AFSP participant.
- Contacting the IRS before obtaining a valid Form 2848 authorization.
- Assuming representation rights continue after the AFSP Record of Completion expires.
- Using an incorrect designation on Form 2848 and presenting yourself as a credentialed practitioner.

3.8 Tax Pro Account and Individual Online Account

Lesson at a Glance

[Image: IRS Tax Pro Account and Individual Online Account]

IRS Digital Services

Tax Pro Account & Individual Online Account

- The IRS offers two powerful online self-service portals that practitioners and taxpayers should know and use: the **Tax Pro Account** and the **Individual Online Account**.
- These tools reduce phone calls, eliminate long hold times, and provide immediate access to important tax information.

Tax Pro Account

For Tax Professionals

- Manage client authorizations electronically.
- Access client transcripts and tax information.
- Review client payment history.
- Respond to certain IRS notices online.

Individual Online Account

For Taxpayers

- View tax records and account information.
- Review payment history and balances due.
- Monitor IRS notices and correspondence.
- Download transcripts and tax documents.

Reference Publications

Publication 5533
Individual Online Account guidance and features.

Publication 5533-A
Tax Pro Account guidance and practitioner features.

Practitioner Tip: Encourage every client to create an Individual Online Account before a problem arises. When notices, identity verification requests, or payment issues occur, clients with existing online access can resolve matters much faster than those trying to establish access after receiving an IRS notice.

What Is the Tax Pro Account

IRS Digital Tool

What Is the Tax Pro Account?

The IRS Tax Pro Account is a secure online portal for tax professionals with active PTINs.

Authorize Access

Use digital authorization instead of paper Form 2848 or Form 8821 in many situations.

Real-Time Processing

Authorizations made through Tax Pro Account are processed much faster than paper forms.

View Client Info

Access transcripts, payment history, and balance due information after authorization.

Withdraw Access

Withdraw previously granted authorizations directly through the account.

Check PTIN & CE

View your own PTIN information and continuing education records.

IRS Correspondence

Access pending IRS correspondence for clients when proper authorization is in place.

How Tax Pro Account Authorizations Work

Digital Authorization

Real-Time Client Approval

- When a practitioner uses the **Tax Pro Account** to request authorization, the request is transmitted electronically through the IRS system.
- The client receives a notification in their **Individual Online Account** and can approve or deny the authorization request in real time.
- Once approved, the authorization immediately appears in both the client's account and the practitioner's Tax Pro Account.

Why Practitioners Prefer This Method

No Paper Forms

Eliminates printing, signing, and mailing authorization forms.

No Mailing Delays

No waiting days or weeks for IRS processing.

Immediate Access

Authorization becomes active as soon as the client approves.

Traditional Process	Tax Pro Account Process
Complete paper Form 2848 or 8821	Initiate authorization request online in Tax Pro Account
Client signs and returns to practitioner	Client approves through their Individual Online Account
Mail or fax to IRS CAF Unit	Authorization processed in real time — no mailing
Processing: 5–10 weeks	Processing: immediate upon client approval

Individual Online Account (Taxpayer)

IRS Digital Services

Individual Online Account (Taxpayer)

The IRS Individual Online Account allows taxpayers to securely access their own tax information at IRS.gov/account. Practitioners should encourage clients to create their account and become familiar with the available tools.

View Balance Due

Taxpayers can view current balances, penalties, and total amounts owed.

Download Transcripts

Access up to 10 years of account, return, wage & income, and record of account transcripts.

Payment History

Review prior payments and view scheduled future payments.

Payment Plans

Set up, review, or modify IRS installment agreements online.

Approve Authorizations

Approve Tax Pro Account authorization requests from their preparer digitally.

IRS Notices

Access digital copies of IRS notices and correspondence letters.

IP PIN Access

View and retrieve the taxpayer's Identity Protection PIN for filing season.

Practical Value for Practitioners:

Before calling the IRS for a client's transcript or balance, instruct the client to access their Individual Online Account and download the wage and income transcript directly. This takes minutes instead of the 30–60 minute phone wait that is common during filing season. For practitioners with Tax Pro Account access, transcripts for authorized clients are also available directly.

[Image: ID.me Identity Verification]

IRS Online Services

Identity Verification with ID.me

- Both the **Tax Pro Account** and the **Individual Online Account** require identity verification before access is granted.
- The IRS uses **ID.me** as its third-party identity verification partner to confirm the identity of taxpayers and tax professionals.

What Is Required for Verification?

Photo ID

Driver's license, passport, or state-issued identification card.

Selfie Verification

Selfie upload or live video verification call.

Verification Codes

Mobile phone number or email address for security codes.

One-Time Setup Process

- Identity verification is generally completed only once.
- After verification, taxpayers and practitioners use their ID.me credentials to access IRS online services.
- The process typically takes 15–30 minutes and should be completed carefully without rushing.

Practitioner Uses for the Individual Online Account

Verify estimated tax payments that may not yet appear in tax software or IRS transcripts.

Download prior-year transcripts needed for mortgage applications, financial aid, or other documentation.

Establish and manage an Identity Protection PIN (IP PIN) to help prevent tax-related identity theft.

Approve digital power of attorney and tax information authorization requests from practitioners.

Review IRS notices and account activity before contacting the practitioner for assistance.

[Image: cantfind_.svg]

Wage and Income Transcripts are a practitioner's best friend for late filers.

A client who cannot locate their prior-year W-2s, 1099s, and other income documents can obtain a complete listing through a Wage and Income Transcript — typically available by July 1 of the following year for the prior tax year. This is far faster than waiting for document re-orders from employers.

IRS Publication 5533

IRS Guidance Resource

IRS Publication 5533 — Tax Pro Account

Publication 5533 is the IRS guide to using the Tax Pro Account portal. It explains account setup, authorization procedures, transcript access, and common practitioner questions.

Account Setup

Explains how practitioners create and verify a Tax Pro Account through IRS identity verification.

Authorization Procedures

Covers digital POA and Tax Information Authorization procedures through Tax Pro Account.

Transcript Access

Shows how practitioners retrieve transcripts and client account information after authorization.

Frequently Asked Questions

Includes troubleshooting guidance and answers to common Tax Pro Account issues.

Practitioner Tip

Every practitioner who plans to use Tax Pro Account should read Publication 5533 and complete the IRS self-study Tax Pro Account module available through IRS.gov before filing season begins.

Worked Examples

IRS Online Accounts

Worked Examples

1

Digital POA — Faster Authorization

Maria and Her CPA

- Maria needs to authorize her CPA to represent her before the IRS regarding a notice.
- The CPA initiates a digital POA request through the Tax Pro Account.
- **Result:** Maria receives a notification in her Individual Online Account, reviews the authorization, and approves it electronically the same day. The authorization

immediately appears in the CPA's Tax Pro Account. The traditional paper Form 2848 process could have required 5–10 business days through CAF processing.

2

Reconstructing Missing Income

Robert's Delinquent Returns

- Robert is three years behind on filing and cannot locate any W-2s or Forms 1099.
- The practitioner has an active Form 8821 authorization and accesses Wage and Income Transcripts through the Tax Pro Account.
- **Result:** The transcripts provide W-2, 1099-INT, 1099-DIV, SSA-1099, and other IRS-reported information for TY2023, TY2024, and TY2025. The practitioner can prepare all three returns without contacting employers or financial institutions individually.

3

Verifying Estimated Tax Payments

Sandra's Payment History

- Sandra made four quarterly estimated tax payments during TY2026.
- Her practitioner cannot locate confirmation numbers for two of the payments.
- **Result:** Sandra logs into her Individual Online Account and views her payment history. All four payments appear with exact dates and amounts. She provides the information to her practitioner, allowing the TY2026 return to be completed accurately without additional IRS research.

AFTR Exam Tip: Digital authorization through the Tax Pro Account is generally much faster than the traditional paper Form 2848 process. Individual Online Accounts are especially useful for verifying estimated tax payments, reviewing notices, obtaining transcripts, and approving practitioner authorization requests.