Southern Regional Tax Conference

for Professional Tax Preparers

Agenda

2026

Location	Date
IP Casino@Biloxi	Friday, November 6 2026

07:30 am – 08:30 am	Registration/Coffee	
08:30 am – 08:40 am	Opening Remarks	
08:40 am – 10:20 am 01	Tax Professional Due Diligence IRS CE HOURS: 2 Program # A5BAX-E-00147-26-I	
10:20 am – 10:30 am	**Break**	
10:30 am – 12:10 pm 02	Schedule E in the Real World: Residential Rental Activities IRS CE HOURS: 2 Program # A5BAX-T-00146-26-I	
12:10 pm – 01:10 pm	Lunch - **(On your own)**	
01:10 pm – 02:50 pm 03	Home Sweet Tax Home: Principal Residence Tax Issues §121 IRS CE HOURS: 2 Program # A5BAX-T-00142-26-I	
02:50 pm – 03:00 pm	**Break**	
03:00 pm – 04:40 pm 04	2026 Federal Tax Update **Part 1 (continues Saturday, 4 CE total)** **No survey today.** **Scan once, on the back page, after Part 2.**	

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Southern Regional Tax Conference

for Professional Tax Preparers

Agenda

2026

Location	Date
IP Casino@Biloxi	Saturday, November 7 2026

07:30 am – 08:30 am	Registration/Coffee
08:30 am – 10:10 am	**2026 Federal Tax Update** **Part 2 (completes the 4 CE hours)** Program # A5BAX-U-00140-26-I
10:10 am – 10:20 am	**Break**
10:20 am – 12:00 pm	Reasonable Means Defensible: S Corporation Compensation IRS CE HOURS: 2 Program # A5BAX-T-00144-26-I
12:00 pm – 01:00 pm	Presentation by George Jones Southern HOT Lunch Buffet Sponsored by TPG Santa Barbara
01:00 pm – 02:40 pm	Get Your WISP Together! A Hands-On Tax Office Security Workshop IRS CE HOURS: 2 Program # A5BAX-T-00141-26-I
02:40 pm – 02:50 pm	**Break**
02:50 pm – 03:40 pm	Not a CPA or EA Yet? Here's How to Help Your Clients Anyway IRS CE HOURS: 1 Program # A5BAX-T-00143-26-I
03:40 pm – 04:15 pm	AFTR Overview – Anita Taylor, EA AFTR – 6 CE **(course completed online)** You must score 70% or better on the AFTR Comprehension Test. No survey here. Use the coupon below.

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TAX PROFESSIONAL DUE DILIGENCE





§6695(g) Due Diligence and Form 8867: 2026

Student Text for a 100-Minute Live Program (2 IRS CE Credit Hours, Ethics)

John Sheeley, EA, LTC (Oregon Licensed Tax Consultant), Tax Practice Pro, Inc., Chester, NY

- Current law as of October 23, 2026
- Tax Year 2026 returns filed in calendar year 2027

(01) Program # A5BAX-E-00147-26-I

Course Details	
Name of the CE Provider	AmData
Program name	Tax Professional Due Diligence
IRS program number	A5BAX-E-00147-26-I
CE	2
Prerequisite	None
Advanced Preparation	None
Program Level	**Basic**
Delivery Method:	Live in-person
Program Category	ETHICS Ethics - A progam that addresses ethics or professional conduct in connection with tax return preparation.



LEARNING OBJECTIVES

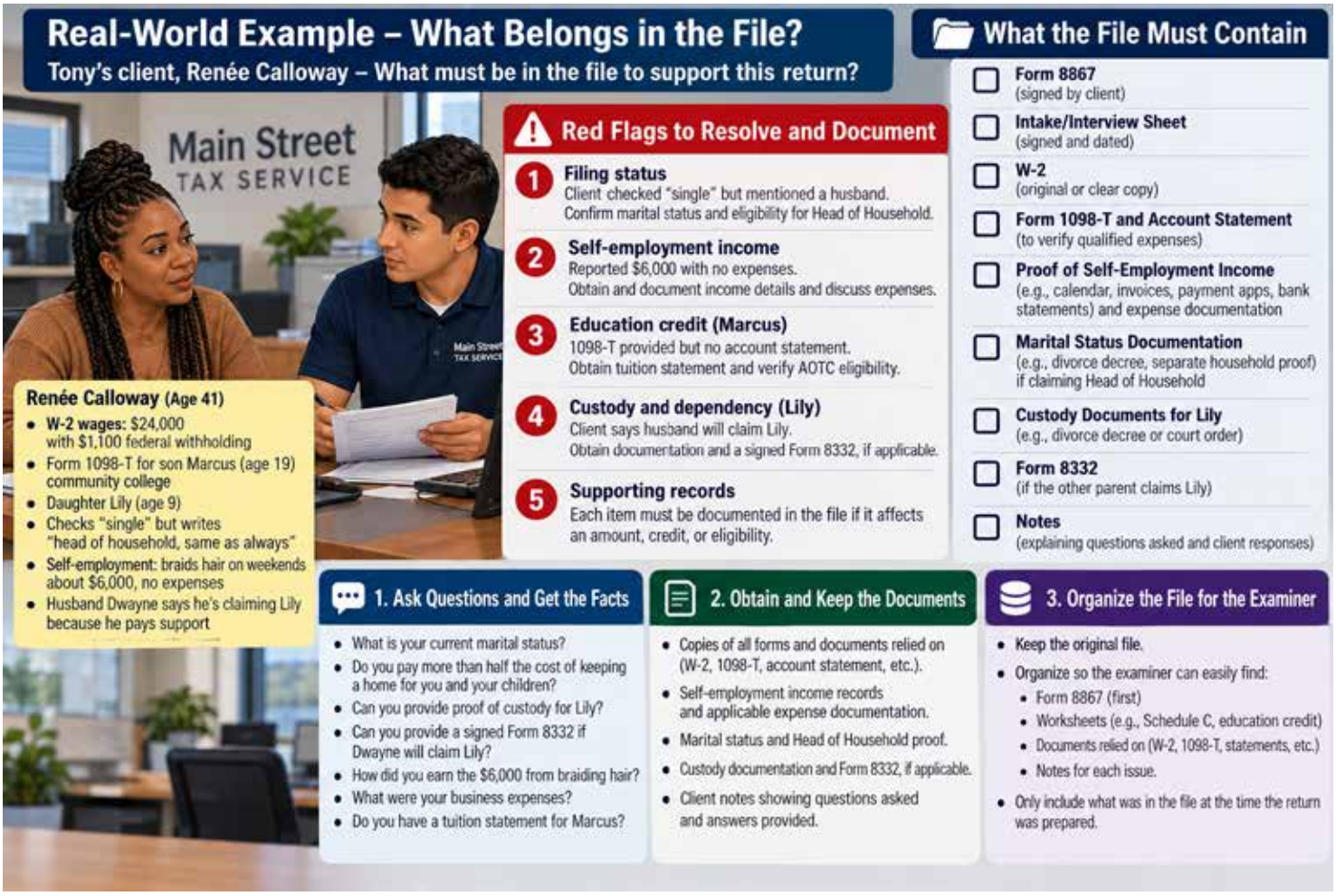
After completing this program, the participant will be able to do six things. **(1)** Identify the four benefit categories covered by I.R.C. § 6695(g) and compute the per-failure, per-return penalty for returns filed in 2026 and in 2027. **(2)** Explain the four due diligence requirements of Treas. Reg. § 1.6695-2(b) and apply them at the intake desk. **(3)** Recognize client information that is incorrect, inconsistent, or incomplete, make a reasonable inquiry, and document it at the time. **(4)** Complete Form 8867, including the draft November 2026 changes, and keep the required records for the required period. **(5)** Describe the firm-level penalty, the office-procedures exception, the IRS contacts before and after a due diligence visit, and the appeal routes. **(6)** Treat the 2026 identification rules

and the proposed “Federal public benefit” rules for refundable credits as due diligence inquiry points, without giving immigration advice.

ABSTRACT

Section 6695(g) is a penalty on preparers, not on clients, and it is assessed per benefit, per return. A single file claiming head of household status, the earned income credit, the child tax credit, and the American opportunity tax credit carries four separate exposures. An examiner who reviews a sample of files multiplies that exposure across the sample. This text explains what the regulation actually requires and what it does not. It then shows a repeatable intake routine for a seasonal storefront office: spot information that is incorrect, inconsistent, or incomplete; ask plain factual questions; and document the questions and answers when asked. The text traces that analysis through a single composite file. Renée Calloway, a separated mother of two with a W-2 job and a side braiding business, sits down at Main Street Tax Service in January 2027. Her file is prepared, reviewed, and then pulled in a due diligence visit the following November, and the closing section resolves what the examiner finds. The 2026 developments that change the intake conversation are covered from the preparer’s point of view: work-eligible social security number rules, the draft November 2026 Form 8867, and the proposed Schedule 3-A. The text distinguishes enacted law, final regulations, IRS guidance, and nonfinal developments, and ties each dollar figure to the controlling revenue procedure for the filing year.

THE FIRST CALL



It is the third Saturday of January 2027, and the waiting area at Main Street Tax Service is full. Darlene Pruitt has owned the storefront for eleven years. She holds an Annual Filing Season Program Record of Completion, employs four seasonal preparers, and files a little over 1,100 individual returns a season, most of them for wage earners with children. Her newest preparer, Tony Reyes, finished the software company’s training course in December and is working his first full season.

Tony's next client is Renée Calloway, age 41. She hands him a W-2 from the dental office where she works the front desk, showing $24,000 of wages and $1,100 of federal withholding. She has a Form 1098-T for her son Marcus, 19, who started at the county community college in August. Her daughter Lily is 9. On the intake sheet, Renée checked "single" and wrote "head of household, same as always." Near the bottom she added that she braids hair on weekends, "about $6,000, no expenses." As Tony starts typing, she adds that her husband Dwayne "said he's claiming Lily this year because he pays support."

Tony's software is ready to produce a return showing head of household status and the earned income credit for two children. It also shows the child tax credit for Lily, the credit for other dependents for Marcus, and the American opportunity tax credit for Marcus's tuition. The refund will be more than $9,000. Every box in the software interview has a default answer, and none of them requires Tony to type a word.

Several facts on Tony's screen do not line up. Renée checked "single" but referred to a husband. She reported a business with income and no expenses. She has a 1098-T but no account statement. She mentioned that the other parent intends to claim the same child. None of these facts makes the return wrong, but each one makes the information on the screen incorrect, inconsistent, or incomplete, and that is the trigger the regulation uses. This program answers the question Darlene would ask if she walked over to Tony's desk right now: *what does this file need to contain to hold up if the IRS pulls it next fall?*

Table 1. The composite file: Renée Calloway, Tax Year 2026 (facts as first presented)

Item	What the client provided	Why a reasonable preparer would look again
Filing status	Checked "single"; wrote "head of household, same as always"	Later refers to a husband; marital status is inconsistent
Wages	W-2, $24,000; withholding $1,100	None on its face
Schedule C	Hair braiding, "about $6,000, no expenses"	Zero expenses for a supply-intensive service is incomplete
Marcus, 19	Form 1098-T; full-time freshman since August 2026	Form 1098-T alone does not establish amount paid or eligibility
Lily, 9	Lives with Renée	Other parent says he will claim her; inconsistent
Identification	SSN cards for Renée, Marcus, and Lily presented	2026 rules require work-eligible SSNs for CTC and AOTC

Composite facts. Renée, Dwayne, Marcus, Lily, Darlene, Tony, and Main Street Tax Service are fictional and are used throughout this text.

Key terms and abbreviations used in this text

Term	Meaning
EIC (EITC)	Earned income credit, I.R.C. § 32
CTC / ACTC / ODC	Child tax credit; its refundable portion (additional child tax credit); credit for other dependents. All three are computed under § 24 and form one § 6695(g) benefit category
AOTC / LLC	American opportunity tax credit; lifetime learning credit (§ 25A). Only the AOTC is a § 6695(g) benefit
HOH	Head of household filing status (§ 2(b))
AFSP	IRS Annual Filing Season Program (Rev. Proc. 2014-42)
SSN / ITIN / ATIN / TIN	Social security number; individual taxpayer identification number; adoption taxpayer identification number; taxpayer identification number (any of the three)
EIN / EFIN / PTIN	Employer identification number; electronic filing identification number; preparer tax identification number
AGI / MAGI	Adjusted gross income; modified AGI as defined for the particular credit
SE tax / QBI	Self-employment tax; qualified business income (§ 199A)
MFJ / MFS	Married filing jointly; married filing separately
IRM / IDR	Internal Revenue Manual; information document request

Term	Meaning
WISP	Written information security program (FTC Safeguards Rule)
PRWORA / TANF	Personal Responsibility and Work Opportunity Reconciliation Act of 1996; Temporary Assistance for Needy Families
Contemporaneous	Recorded at the time the inquiry is made, not reconstructed later
Qualifying child vs. qualifying relative	Two separate statutory routes to dependency (§ 152(c) and § 152(d)), with different age, residency, support, and income tests
Custodial parent	For federal tax purposes, generally the parent with whom the child resides for the greater number of nights during the year (Treas. Reg. § 1.152-4(d)(1)); not necessarily the custody label in a state-court order
Tiebreaker rules	The § 152(c)(4) rules that decide who may treat a child as a qualifying child when more than one person could
Math-error adjustment	A summary IRS correction procedure under § 6213(b) and (g); it is a procedural category, not a finding of misconduct
IRS	Internal Revenue Service
CE	Continuing education
EA	Enrolled agent
CPA	Certified public accountant
FTC	Federal Trade Commission
GAO	U.S. Government Accountability Office
PATH Act	Protecting Americans from Tax Hikes Act of 2015
OPR	IRS Office of Professional Responsibility
DHS	Department of Homeland Security
Refundable / nonrefundable credit	A refundable credit can produce a refund beyond the tax owed; a nonrefundable credit can only reduce tax to zero
Phaseout	The income range over which a credit shrinks to zero
Payment app	A service such as Cash App used to receive customer payments; its history is a business record
Principal management	The owners or officers who run a firm or branch office
Subtitle A tax	Federal income tax, including self-employment tax
Deficiency procedures	The notice and Tax Court process for income tax deficiencies; they do not apply to preparer penalties
Protest	A written request for Appeals review, required when proposed preparer penalties exceed $25,000
Office-procedures exception	Relief for an isolated, inadvertent failure inside procedures that are reasonably designed and routinely followed
LTC	Licensed Tax Consultant (Oregon)

I. WHY ONE WEAK FILE BECOMES FOUR PENALTIES

A. The Statute and the Four Covered Benefits

Section 6695(g) penalizes a tax return preparer who fails to meet the due diligence requirements set by regulation. Those requirements apply when the preparer determines eligibility to file as head of household, or eligibility for, or the amount of, the credits under sections 24, 25A(a)(1), and 32.1 In storefront terms, the four covered benefits are head of household filing status, the child tax credit family, the American opportunity tax credit, and the earned income credit. The child tax credit family includes the child tax credit, the additional child tax credit, and the credit for other dependents.

1 I.R.C. § 6695(g)(1)–(2), https://www.law.cornell.edu/uscode/text/26/6695.

The statute grew in three steps. Congress created the penalty in 1997 for the earned income credit alone.1 The PATH Act added the child tax credit and the American opportunity tax credit for 2016 and later years.2 The 2017 tax act added head of household status for taxable years beginning after December 31, 2017.3 The regulation tracks that history: the head of household rules apply to returns for tax years beginning after December 31, 2017, prepared on or after November 7, 2018.4

The child tax credit, the additional child tax credit, and the credit for other dependents are all computed under section 24, and Form 8867 treats them as a single benefit in Part III.5 The regulation likewise describes one "CTC/ACTC under section 24" category.6 The practical consequence is that one preparer faces at most four § 6695(g) penalties on one return **(head of household, section 24, AOTC, and EIC)**, not six. The count is per benefit, not per requirement or per child. It does not cap firm liability under Treas. Reg. § 1.6695-2(c), another preparer's penalties, or § 6694 penalties.

B. The Penalty Amount Depends on the Year the Return Is Filed

The statutory base amount of $500 is indexed for inflation. The controlling amount is the one for the calendar year in which the return or refund claim is filed, not the tax year shown on the return.7 That distinction matters every fall: a 2025 return filed late in October 2026 carries the 2026 rate, while Renée's 2026 return, filed in February 2027, carries the 2027 rate.

Table 2. Section 6695 penalty amounts by calendar year of filing

Subsection and failure	Filed in 2026	Filed in 2027	Maximum for applicable calendar year or return period
§ 6695(a) failure to furnish copy to taxpayer	$65 per failure	$65 per failure	$32,500 (2026) / $33,000 (2027)
§ 6695(b) failure to sign	$65	$65	$32,500 / $33,000
§ 6695(c) failure to furnish identifying number	$65	$65	$32,500 / $33,000
§ 6695(d) failure to retain copy or list	$65	$65	$32,500 / $33,000
§ 6695(e) failure to file correct information returns	$65 per return and item	$65 per return and item	$32,500 / $33,000
§ 6695(f) negotiation of a client refund check	$650 per check	$665 per check	No limit
§ 6695(g) due diligence failure	$650 per failure	$665 per failure	No limit

Sources: Rev. Proc. 2024-40, § 2.55, 2024-45 I.R.B. 1100 **(returns filed in 2026)**; Rev. Proc. 2025-32, § 4.54, 2025-45 I.R.B. 695 **(returns filed in 2027)**.

The table rests on the two revenue procedures that set the filing-year amounts.8 IRM Exhibit 20.1.6-1 also lists the 2026 and 2027 amounts. The revenue procedures control those figures.9

1 Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1085(a)(2), 111 Stat. 788, 956, https://www.govinfo.gov/content/pkg/PLAW-105publ34/pdf/PLAW-105publ34.pdf.

2 Protecting Americans from Tax Hikes Act of 2015, Pub. L. No. 114-113, div. Q, § 207(a), (c), 129 Stat. 2242, 3082–83.

3 Pub. L. No. 115-97, § 11001(b), (c), 131 Stat. 2054, 2058–59 (2017).

4 Treas. Reg. § 1.6695-2(e), https://www.ecfr.gov/current/title-26/part-1/section-1.6695-2.

5 I.R.C. § 24(a), (d), (h)(4); Form 8867, Part III (Rev. Nov. 2026 draft), https://www.irs.gov/pub/irs-dft/f8867--dft.pdf.

6 Treas. Reg. § 1.6695-2(a)(1).

7 I.R.C. § 6695(g), (h)(1).

8 Rev. Proc. 2024-40, § 2.55, 2024-45 I.R.B. 1100, https://www.irs.gov/pub/irs-drop/rp-24-40.pdf; Rev. Proc. 2025-32, § 4.54, 2025-45 I.R.B. 695, https://www.irs.gov/pub/irs-drop/rp-25-32.pdf.

9 IRM Exhibit 20.1.6-1 (IRC 6695 Base and Inflation Rates), https://www.irs.gov/irm/part20/irm_20-001-006.

Caution: Do not teach from old slides

Many training decks still in circulation show older per-failure amounts. Verify the amount for the calendar year of filing in the controlling revenue procedure. For the 2027 filing season, the number is $665 per failure. Stale figures cost the instructor credibility, and they understate the exposure for the people in the room.

C. The Multiplication Effect

The regulation is explicit that "a separate penalty applies" for head of household status and for each applicable credit for which the requirements are not met.1 Its own examples show the arithmetic. A preparer who fails the requirements for both the CTC and the AOTC on one return faces two penalties. A preparer who fails the CTC but satisfies the AOTC faces one. A preparer who fails head of household status and the CTC but satisfies the AOTC faces two.2 Due diligence is measured benefit by benefit, and partial compliance earns partial relief.

Workpaper: Renée's file if prepared on the software defaults (filed February 2027)

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Benefits claimed on the return ......................... 4
  (HOH; EIC; CTC/ACTC/ODC as one category; AOTC)
Rate for returns filed in 2027 (Rev. Proc. 2025-32) .... $665
Exposure on this one return:      4 x $665 ............. $2,660

If the examiner's sample contains 25 files like it:
                                25 x $2,660 ........... $66,500
Same 25 files at the 2026 rate:  25 x 4 x $650 ......... $65,000

Statutory cap on 6695(g) penalties ..................... None

Conclusion: one weak routine, repeated across a sample, produces
a five-figure assessment against the individual preparer before
any firm-level exposure under Treas. Reg. 1.6695-2(c) is counted.
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The 25-file figure comes from the IRS's own description of a due diligence audit: the examiner reviews a minimum of 25 client returns and, if failures are found, may expand the review by another 25.3 That is an administrative description, not a statutory floor or ceiling, so an office should prepare for expansion rather than treat 25 as a limit. The same IRS page reports that the IRS proposed penalties on over ninety percent of the preparers it selected for examination. That figure describes a selected population, not all preparers, and the page's dollar illustration is stale; use the revenue procedures for current amounts.

D. No Reasonable-Cause Defense, and a Narrow Exception

The § 6695(a) through **(e)** penalties each excuse a failure "due to reasonable cause and not due to willful neglect." **Section** 6695(g) contains no such clause.4 The only regulatory relief is the office-procedures exception. The penalty will not apply to a particular return if the preparer shows two things. First, normal office procedures are reasonably designed and routinely followed to ensure compliance. Second, the failure on that return was isolated and inadvertent.5 The exception is built for the one file that a working system missed. It does not rescue a system that was never built, and it does not help a file that fails the same way as twenty others.

E. Who Gets Hurt: The Firm, the Preparer, and the Client

The storefront owner faces penalties as well as the individual preparer. A firm that employs a preparer subject to the § 6695(g) penalty is also subject to the penalty if, and only if, one of three things is true. First, a member of principal management **(or a principal officer)** of the firm or branch participated in the failure, or knew of it before the return was filed. Second, the firm failed to establish reasonable and appropriate compliance procedures. Third, the firm disregarded its own procedures through willfulness, recklessness, or gross

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1 Treas. Reg. § 1.6695-2(a)(1) (last sentence).

2 Treas. Reg. § 1.6695-2(a)(2)(i)–(iii) (Examples 1–3).

3 IRS, Auditing for Due Diligence Compliance (EITC Central), https://www.irs.gov/credits-deductions/individuals/earned-income-tax-credit/auditing-for-due-diligence-compliance.

4 Compare I.R.C. § 6695(a)–(e) (reasonable-cause exceptions), with id. § 6695(g) (none); IRM 20.1.6.5.7 (May 22, 2024).

5 Treas. Reg. § 1.6695-2(d) (first sentence).

indifference, including ignoring facts that would lead a person of reasonable prudence and competence to investigate.1 A firm penalized under that rule cannot use the isolated-and-inadvertent exception.2

Warning: Procedures are the firm's main protection
See Section I.E for the firm-liability tests. Written procedures and training records show what the office required and whether staff followed it. A firm penalized under paragraph (c) cannot use the isolated-and-inadvertent exception.

For the preparer, the penalty is often the smaller problem. The IRM directs return preparer coordinators to notify the e-file program of preparer penalties, and penalty history is a suitability factor that can lead to sanctions against an Electronic Filing Identification Number.3 When a preparer subject to Circular 230 is penalized, the IRM provides for consideration of a referral to the Office of Professional Responsibility.4 Repeated or egregious conduct can support a civil injunction barring the person from preparing returns.5 Separately, a preparer who understates a client's liability through an unreasonable position, or through willful or reckless conduct, faces the § 6694 penalty on top of any § 6695(g) penalty.6

The client bears consequences of her own. Disallowance of an EIC, CTC, or AOTC claim can increase tax or require repayment of an excessive refund. Interest generally accrues on unpaid additional tax. The client may also be barred from the credit for two years after a final determination of reckless or intentional disregard, or for ten years after a determination of fraud.7 After a credit is denied through the deficiency procedures, she must provide the additional information the IRS requires **(generally Form 8862)** before the credit can be allowed again.8 Due diligence protects the client as much as the office.

Example: 1-1: Two penalties, not three
Preparer Ana prepares a return claiming head of household status, the EIC, and the CTC for a 16-year-old son who earned substantial wages during the year. Her contemporaneous note documents the EIC residency, relationship, age, and tiebreaker inquiries. It contains no inquiry into who paid the household costs, and none into whether the son provided more than half of his own support. For the EIC, the qualifying-child test is applied without the self-support test (I.R.C. § 32(c)(3)(A), disregarding § 152(c)(1)(D)); for the CTC, which turns on dependency, it is not. Assume the remaining requirements were met and nothing else in the file established household costs or the son's support. On those facts, the HOH and CTC inquiries failed and the EIC inquiry did not. Under Treas. Reg. § 1.6695-2(a)(1), the exposure is 2 × $665 = $1,330 for a return filed in 2027. The EIC note avoids one penalty but does not carry over to the benefits it did not address.

Example: 1-2: The calendar decides the rate
In October 2026, a client brings in an unfiled 2025 return claiming the EIC. The return is e-filed on October 20, 2026. In February 2027, the same preparer files a 2025 Form 1040-X claiming the AOTC for the first time. Under § 6695(h), the late original return carries the 2026 rate of $650 per failure, and the amended return carries the 2027 rate of $665. Each rate follows the calendar year in which that return or claim was filed (Rev. Proc. 2024-40, § 2.55; Rev. Proc. 2025-32, § 4.54).

Warning: Never let a refund touch an account you control
Section 6695(f) imposes a separate per-check penalty ($650 for checks relating to returns filed in 2026, $665 for 2027) on a preparer who endorses or negotiates a client's refund check. The IRM treats directing a client's

1 Treas. Reg. § 1.6695-2(c)(1)–(3).
2 Treas. Reg. § 1.6695-2(d) (last sentence).
3 IRM 20.1.6.11.1 (Aug. 25, 2020) (penalties are a suitability factor; RPCs notify e-file coordinators); see Rev. Proc. 2007-40, §§ 6–7, 2007-26 I.R.B. 1488.
4 IRM 20.1.6.12.3 (Mar. 30, 2023) (assessed § 6695(a)–(g) penalties are discretionary OPR referrals; § 6694(b) is mandatory).
5 I.R.C. § 7407(a)–(b) (injunctions against tax return preparers).
6 I.R.C. §§ 6694(a)(1), (b)(1)–(2), 6696(a).
7 I.R.C. §§ 24(g)(1)(B), 25A(b)(4)(A)(ii), 32(k)(1)(B); see id. §§ 6601(a), 7405(b).
8 I.R.C. §§ 24(g)(2), 25A(b)(4)(B), 32(k)(2); see Form 8867, line 7b (Rev. Nov. 2026 draft).

refund into an account the preparer controls the same way, even when the client asks for it.1 Fee-collection arrangements belong with a bank product provider, not in the storefront's operating account.

II. THE ETHICS FRAME: WHAT DUE DILIGENCE IS AND IS NOT

A. Where the Rules Come From, and What Counts as Authority

Most of the confusion about due diligence comes from treating every source as if it carried the same weight. The statute imposes the penalty, and the regulation defines the four requirements. Those two sources are binding law. Form 8867 and its instructions are the means the regulation itself prescribes for completing Requirement 1.2 The instructions also give useful examples, but they do not add to or change the regulation. The Internal Revenue Manual tells examiners how to work cases. It explains what an examiner will look for, but it confers no rights on taxpayers and creates no obligations for them.3 IRS web pages, outreach slides, and software prompts are helpful summaries, not authority. Last come the stories that circulate among preparers, the rules of thumb that start "the IRS always" or "the IRS never." Some are good practice, and some are simply wrong.

Table 3. Weight of the sources a storefront preparer encounters

Source	Example	Weight	How to use it
Statute	I.R.C. § 6695(g), (h)	Binding	Defines the penalty and the four benefits
Regulation	Treas. Reg. § 1.6695-2	Binding	Defines the four requirements, firm rule, exception
Prescribed form and instructions	Form 8867; Instructions for Form 8867	Form is prescribed by the regulation; instructions are guidance	Complete the form accurately; use the examples as illustrations
Internal Revenue Manual	IRM 20.1.6	Internal procedure; not binding on taxpayers	Predicts how an examiner will work the case
IRS web pages and outreach	EITC Central, preparer letters	Informal	Current figures and process descriptions; verify against the sources above
Practitioner lore	"The IRS requires a copy of the Social Security card"	None	Test it against the regulation before you repeat it

The distinction affects what the office must do. When a client-facing document from the storefront says "the IRS requires us to photocopy your ID," the office has made a statement about federal law that the regulation does not support. IRS web pages describe where examiners tend to look, but they are not rules.4 Authority settles the question; experience and agency descriptions only predict how an examiner is likely to apply it.5

B. Circular 230, the AFSP, and the Unenrolled Preparer

Most people in a storefront room are unenrolled preparers. They are not attorneys, certified public accountants, or enrolled agents. The D.C. Circuit held in 2014 that the IRS lacks statutory authority under 31 U.S.C. § 330 to regulate unenrolled preparers merely because they prepare returns.6 Section 6695(g) is a statutory penalty that applies to every "tax return preparer," so that holding offers no shelter from it.7

Preparers who participate in the Annual Filing Season Program stand differently. As a condition of the Record of Completion, an AFSP participant consents to be subject to the duties and restrictions of Circular 230 subpart

1 I.R.C. § 6695(f); IRM 20.1.6.5.6 (Aug. 10, 2026).

2 Treas. Reg. § 1.6695-2(b)(1)(i) ("Form 8867 . . . or such other form . . . as may be prescribed").

3 Fargo v. Commissioner, 447 F.3d 706, 713 (9th Cir. 2006) (IRM "does not have the force of law and does not confer rights on taxpayers"), aff'g T.C. Memo. 2004-13.

4 IRS, Auditing for Due Diligence Compliance (EITC Central).

5 But cf. Mellencamp, J.C., *Authority Song*, on *Uh-Huh* (1983) ("I fight authority, authority always wins"), https://youtu.be/wsEwK69LXjQ.

6 Loving v. IRS, 742 F.3d 1013, 1017–18 (D.C. Cir. 2014), aff'g 917 F. Supp. 2d 67 (D.D.C. 2013).

7 I.R.C. §§ 6695(g), 7701(a)(36); Treas. Reg. § 301.7701-15(a).

B and § 10.51 for the entire period the record covers.1 Failure to comply can lead to revocation of the record.2 The AFSP also requires two hours of ethics or professional responsibility.3 The conference's third-party CE provider handles this program's approval and credit reporting.

Even where Circular 230 does not bind a preparer directly, its standards describe the conduct an examiner expects. Section 10.22 requires due diligence in preparing returns. Section 10.35 requires competence, meaning the knowledge, skill, thoroughness, and preparation necessary for the matter. Section 10.37 governs written advice.4 The closest parallel is § 10.34(d). A practitioner generally may rely in good faith, without verification, on information furnished by the client. The practitioner "may not, however, ignore the implications of information furnished to, or actually known by, the practitioner." The practitioner must make reasonable inquiries if the information appears incorrect, inconsistent with an important fact or another factual assumption, or incomplete.5 The § 1.6695-2(b)(3) knowledge standard uses nearly the same words. The two rules describe the same professional habit from two directions.

Practice Pointer: Good-faith reliance is the starting point, not the exception

Both Circular 230 § 10.34(d) and Treas. Reg. § 1.6695-2(b)(3) begin from reliance. The preparer is not an auditor and does not need documents for every fact. Reliance is not passive, however. The preparer must interview the client and ask enough questions to determine eligibility for each benefit (Form 8867, line 3), and must ask additional questions when information is incorrect, inconsistent, or incomplete. Teaching staff to "ask what the credit requires, believe reasonable answers, and ask more, and write it down, when something doesn't fit" is both accurate and respectful of the client.

C. Four Things Due Diligence Does Not Require

Category	Topic / Issue	Common Misconception or Trap	Compliant Practice / Requirement	Governing Authority
Section C: Due Diligence Scope	Legal Questions vs. Factual Inquiries	Asking legal conclusions **(e.g., 'Is Marcus your qualifying child?')**	Ask factual, observable life questions **(e.g., where child slept, school residency, age on Dec 31)**. Preparer determines § 152(c) eligibility.	IRC § 152(c); Treas. Reg. § 1.6695-2(b)
Section C: Due Diligence Scope	Photocopying Identification	Believing § 6695(g) requires collecting copies of SSN cards, licenses, or birth certificates	Treas. Reg. § 1.6695-2(b) has no ID harvesting mandate. Retain and protect only documents actually relied upon. Keep office/bank anti-fraud policies distinct.	IRC § 6695(g); Treas. Reg. § 1.6695-2(b)
Section C: Due Diligence Scope	Documentary Substantiation	Demanding documents for every single return and credit claim	Retention rule reaches only documents relied on. Substantiation is necessary only when resolving incorrect/inconsistent info or when explicitly required **(e.g., AOTC line 13b)**.	IRC § 6695(g); Form 8867 Line 13b
Section C: Due Diligence Scope	Personal Familiarity	Assuming personal/social familiarity **(e.g., fellow church member)** substitutes for asking questions	Personal knowledge does not substitute for due diligence. Preparers must make and contemporaneously document the exact same inquiries as for a stranger.	Treas. Reg. § 1.6695-2(b) Examples

1 Rev. Proc. 2014-42, § 4.05(4), 2014-29 I.R.B. 192, https://www.irs.gov/pub/irs-drop/rp-14-42.pdf.
2 Rev. Proc. 2014-42, § 7.01(1).
3 Rev. Proc. 2014-42, § 4.05(3)(a)–(b).
4 31 C.F.R. §§ 10.22(a)(1), 10.35(a), 10.37(a)(2).
5 31 C.F.R. § 10.34(d).

Category	Topic / Issue	Common Misconception or Trap	Compliant Practice / Requirement	Governing Authority
Section C: Workflow Routine	The Desk Mantra	Treating due diligence as auditing the client rather than eligibility determination	Determining eligibility, not auditing.' 3-step routine: Spot incorrect/ inconsistent details; ask plain factual questions; contemporaneously log question, answer, and outcome.	Form 8867 Practice Routine
Section D: Software & Records	Software Checkboxes	Relying on software checkboxes **(e.g., clicking 'Yes' for residency)** as proof of due diligence	Software records conclusions, not inquiries. Preparer must contemporaneously log who was asked, question asked, date, client response, and tax impact.	Form 8867 Line 4c; Treas. Reg. § 1.6695-2(b)(3)
Section D: Software & Records	Templates & Automated Notes	Using automated notes or intake templates without an actual interview taking place	Notes reflect conversations only if they actually took place. Signing and nonsigning preparers remain strictly liable for the due diligence performed.	Treas. Reg. § 1.6695-2
Section D: Audit Response	Post-Notice Reconstruction	Backdating or reconstructing notes after receiving IRS Letter 6199	Never backdate, overwrite, or present reconstructed notes as contemporaneous. Label later explanations honestly; rely on office-procedures defense if file is thin.	IRC § 7407(b)(1)(D); IRC § 7207; IRS Letter 6199
Section E: Privacy & Disclosure	Client File Confidentiality	Sharing info between related clients or using due diligence records without authorization	Unauthorized disclosure or use is subject to civil penalties **($250-$1,000/violation up to $50k)** and criminal misdemeanor charges. Conflicting claims make interests adverse.	IRC § 7216; IRC § 6713; Treas. Reg. § 301.7216-2(e)
Section E: Data Security	Safeguards & Document Retention	Viewing the 3-year retention rule as an automatic purge date or lacking security safeguards	Preparers are financial institutions under FTC Safeguards Rule and must maintain a written WISP. 3-year rule is a minimum security duty; legal holds require longer retention.	FTC Safeguards Rule; IRC § 6695(g)

Storefront offices often over-comply in ways that irritate honest clients and still leave the file exposed. Four misconceptions recur.

First, due diligence does not require asking clients legal questions. "Is Marcus your qualifying child?" asks the client to apply § 152(c), which is the preparer's job. The regulation asks the preparer to determine eligibility from facts. The useful questions are factual ones: where Marcus slept during the school year, whether he was away at school or living at home, and how old he was on December 31.1

Second, § 6695(g) does not require photocopying Social Security cards, driver's licenses, or birth certificates. Nothing in Treas. Reg. § 1.6695-2(b) requires the preparer to collect identity documents. Identity verification may be wise for identity-theft and fraud prevention, and a bank-product provider or state law may require it. Keep those reasons separate from § 6695(g) when explaining office policy to clients. Retention works the other way: a document the preparer relies on, such as an SSN card used for line 10a or 13a, must be kept and protected **(Section VI.A)**.2

1 Treas. Reg. § 1.6695-2(b)(1)(ii), (b)(3)(i); I.R.C. § 152(c)(1)(A)–(D), (c)(3).

2 Treas. Reg. § 1.6695-2(b)(4)(i)(C).

Third, due diligence does not require documents for every return. The retention rule reaches only documents the preparer relied on **(Section VI.A)**.1 Substantiation becomes necessary when it is the reasonable way to resolve information that is incorrect, inconsistent, or incomplete, or when the form asks about it directly, as line 13b does for the AOTC.2

Fourth, knowing the client personally is not a substitute for asking. The regulation addresses this directly. Suppose a preparer knows from social contacts that the client's niece and nephew lived with her for more than half the year. That preparer must still make and document the same inquiries as a preparer who has never met her.3 In a neighborhood storefront where the preparer attends church with half the clients, this example deserves extra time.

Practice Pointer: The desk mantra

"We are determining eligibility, not auditing the client." The three-step routine in this text is simple. Spot what is incorrect, inconsistent, or incomplete; ask a plain factual question; and write down the question, the answer, and what you did with it, at the time you asked. If the answer does not resolve the problem, the preparer may decline to claim the benefit or decline the engagement.

D. Software Defaults, Intake Sheets, and the File That Is "Fixed" Later

Tax software is designed to produce a return, not a defensible file. When the software asks "Did the child live with the taxpayer more than half the year?" and the preparer clicks "Yes," the software has recorded a conclusion. It has not recorded a question asked of the client, who answered it, or what the client said. Form 8867 line 4c asks for exactly those things: the questions asked, whom the preparer asked, when, the information provided, and its impact on the return.4 A standard intake questionnaire is a good starting point, and the regulation's own examples assume the preparer uses one. Examples 1, 3, and 5 through 8 require follow-up inquiries when the intake information raises a question.5

The same caution applies to any tool that drafts notes for the preparer. A note generated from a template, or a summary produced by an automated assistant, documents a conversation only if the conversation actually happened and the note reflects it. Signing and nonsigning preparers remain responsible for the due diligence work they perform. Do not send identifiable client information to an outside service until the disclosure is permitted and data safeguards are in place.

Warning: Never reconstruct or backdate notes after an IRS letter arrives

The regulation requires documentation made at the time of the inquiry.6 A note written after Letter 6199 arrives is not contemporaneous, however accurate it is. Preserve the original file exactly as it existed. Do not backdate a note, overwrite the original record, or present a later reconstruction as if it were contemporaneous. Knowingly presenting a reconstructed record as contemporaneous can support injunctive relief under § 7407(b)(1)(D). Willfully giving the IRS a note known to be false about a material matter can also violate § 7207.7 A clearly dated explanation prepared later, or a description of new procedures, is legitimate if it is labeled for what it is. It does not repair a missing contemporaneous record. If a file is thin, the honest course is to say so through a representative and rely on the office-procedures exception if it fits.

E. Client Information in the Due Diligence File

Due diligence produces more client information than a bare return, including household composition, custody arrangements, immigration-related identification status, school records, and bank statements. The file is still tax return information. Unauthorized knowing or reckless disclosure or use of that information can be a federal misdemeanor under § 7216. Statutory and regulatory exceptions apply, and some uses require the client's

1 Treas. Reg. § 1.6695-2(b)(4)(i)(C); Instructions for Form 8867 (Rev. Nov. 2025), Line 5, https://www.irs.gov/pub/irs-pdf/i8867.pdf.

2 Form 8867, line 13b (Rev. Nov. 2026 draft).

3 Treas. Reg. § 1.6695-2(b)(3)(ii)(F) (Example 6).

4 Form 8867, line 4c (Rev. Nov. 2026 draft).

5 Treas. Reg. § 1.6695-2(b)(3)(ii)(A), (C), (E)–(H) (Examples 1, 3, 8: "standard intake questionnaire"; Examples 5, 7: "standard intake interview").

6 Treas. Reg. § 1.6695-2(b)(3)(i) (last sentence) ("contemporaneously document").

7 I.R.C. §§ 7407(b)(1)(D), 7207 (willfully delivering a document known to be false); see 18 U.S.C. § 1001(a).

written consent in the prescribed form. The ordinary civil penalty is $250 for each prohibited disclosure or use, up to $10,000 per calendar year, with $1,000 and $50,000 for disclosures connected to identity theft **(§ 6713(b)**). The civil penalty has no knowing-or-reckless element; the § 7216 misdemeanor does.1 Knowing a fact from another client's file does not authorize using it freely. The related-taxpayer exception requires a listed relationship, nonadverse tax interests, and no prohibition by the first taxpayer **(Treas. Reg. § 301.7216-2(e)**). Competing claims to the same child can make interests adverse. Paid preparers are also financial institutions under the Federal Trade Commission's Safeguards Rule. They must maintain a written information security program covering how those records are collected, stored, and destroyed.2 A three-year due diligence retention policy is also a data-security obligation for at least that long. It is not an automatic purge date; legal holds and other duties can require longer retention.

III. 2026 FLASHPOINTS SEEN THROUGH A DUE DILIGENCE LENS

This program teaches the 2026 changes for one purpose: they change what a preparer must ask, determine, and document at the desk. The substantive credit rules are covered only as far as the intake conversation requires.

A. Work-Eligible Social Security Numbers: CTC/ACTC and, New for 2026, AOTC

For taxable years beginning after December 31, 2024, the child tax credit for a qualifying child requires two numbers on the return. The return must include the taxpayer's social security number **(on a joint return, that of at least one spouse)** and the child's social security number.3 For this purpose, a social security number counts only if it was issued to a U.S. citizen, or under the Social Security Act provision for work-authorized individuals, and before the due date of the return.4 A qualifying child who is shut out of the CTC by this rule is treated as a potential ODC dependent. The ODC still requires a timely TIN, citizenship, nationality, or residency, dependency, the phaseout, and tax to absorb a nonrefundable credit.5 Omitting a required SSN is a mathematical or clerical error that the IRS can correct summarily. A client who disputes the adjustment can request abatement within 60 days after the notice; the notice itself gives no Tax Court petition right **(§ 6213(b)**(1)–(2)).6

For taxable years beginning after December 31, 2025, the same work-eligible SSN definition applies to the American opportunity and lifetime learning credits. The return must include the SSN of the individual filing it and, if the student is someone other than the taxpayer or spouse, the student's SSN. For the AOTC, it must also include the employer identification number of each institution to which qualified expenses were paid.7 Omission of these items is likewise a math-error item.8 The draft 2026 Form 8863 instructions add a joint-return point. Only one spouse needs a valid SSN, even if the other spouse is the student and lacks one. A dependent student, however, must have a valid SSN.9

Timing is a separate test. Under § 24(e), no § 24 credit is allowed for a qualifying child whose TIN was issued after the due date of the return, or if the taxpayer's own TIN was issued after that date. The draft 2026 Schedule 8812 instructions read "due date" as including extensions for the CTC, the ACTC, and the ODC.10

For the 2026 tax year, the maximum CTC is $2,200 per qualifying child, the refundable portion **(ACTC)** is capped at $1,700 per child, and the ODC remains $500.11 The EIC rules differ. A qualifying child is counted only

1 I.R.C. §§ 7216(a)–(b), 6713(a)–(c); Treas. Reg. §§ 301.7216-2 (including (e)), 301.7216-3(a).

2 16 C.F.R. §§ 314.2 (definition of financial institution; tax preparation example), 314.3(a), 314.4; see IRS Pub. 4557 (Rev. 5-2024), https://www.irs.gov/pub/irs-pdf/p4557.pdf; IRS Pub. 5708 (Rev. 8-2024) (model WISP), https://www.irs.gov/pub/irs-pdf/p5708.pdf.

3 I.R.C. § 24(h)(7)(A), as amended by Pub. L. No. 119-21, § 70104(b), 139 Stat. 72 (2025).

4 I.R.C. § 24(h)(7)(B)(i)–(ii).

5 I.R.C. §§ 24(b), (c), (e), (h)(3)–(4), 152(b)(3); Instructions for Schedule 8812 (2026 draft), TIN Required by Due Date To Claim the ODC, https://www.irs.gov/pub/irs-dft/i1040s8--dft.pdf.

6 I.R.C. § 6213(b)(1)–(2), (g)(2)(I), as amended by Pub. L. No. 119-21, § 70104(e).

7 I.R.C. § 25A(g)(1)(A)–(C), as amended by Pub. L. No. 119-21, § 70606(a), 139 Stat. 72 (2025).

8 I.R.C. § 6213(g)(2)(J), as amended by Pub. L. No. 119-21, § 70606(b).

9 Instructions for Form 8863 (2026 draft), SSN requirements and joint-return Tip (p. 2), and Lines 21–22 (p. 8), https://www.irs.gov/pub/irs-dft/i8863--dft.pdf.

10 I.R.C. § 24(e)(1)–(2), (h)(7)(B)(ii); Instructions for Schedule 8812 (2026 draft), https://www.irs.gov/pub/irs-dft/i1040s8--dft.pdf.

11 Rev. Proc. 2025-32, § 4.05; I.R.C. § 24(h)(2), (4)(A), (5).

if the return includes the child's TIN. For that purpose, a TIN means an SSN issued on or before the due date, other than a number issued solely for non-work purposes.1

Limits that change the desk answer. The CTC and ODC phase out together. The credit is reduced by $50 for each $1,000, or fraction of $1,000, of modified AGI above $200,000 **($400,000 on a joint return) (§ 24(b), (h)**(3)). No single income ends the credit for every family.

The CTC applies only to a qualifying child under age 17 **(§ 24(c)**(1)). The ODC is nonrefundable; it reduces tax but cannot create a refund by itself.

The AOTC is 100% of the first $2,000 and 25% of the next $2,000 of qualified expenses, up to $2,500 per student **(§ 25A(b)**(1)). It cannot be claimed for a student for whom it was claimed in any four prior tax years. The student also must not have completed the first four years of postsecondary education before the beginning of the tax year **(§ 25A(b)**(2)(A), **(C)**).

The student must pursue a degree or other recognized educational credential and be enrolled at least half time for at least one academic period. A felony drug conviction by year-end disqualifies the student **(§ 25A(b)**(2)–(3)). The credit phases out between $80,000 and $90,000 of modified AGI **($160,000 to $180,000 joint) (§ 25A(d)**).

A married taxpayer must file jointly unless treated as unmarried under § 7703 **(§ 25A(g)**(6)). Up to 40% of the AOTC, a maximum of $1,000, is refundable **(§ 25A(i)**).

The age-related refundability restriction tests the taxpayer claiming the credit, not the dependent student **(§ 25A(i)**). Renée, age 41, claims the credit here. Marcus's age does not deny her the refundable portion.

The lifetime learning credit is 20% of up to $10,000 of expenses per return, a maximum of $2,000 **(§ 25A(c)**(1)). It shares the education phaseout and is not a § 6695(g) benefit.

Table 4A shows the 2026 EIC parameters **(Rev. Proc. 2025-32, § 4.06)**. The EIC is denied if investment income exceeds $12,200; investment income of exactly $12,200 does not bar it **(§ 32(i)**).

Table 4A. 2026 earned income credit parameters (Rev. Proc. 2025-32, § 4.06)

Qualifying children	Maximum credit	Phaseout begins (other / MFJ)	Phaseout complete (other / MFJ)
None	$664	$10,860 / $18,140	$19,540 / $26,820
One	$4,427	$23,890 / $31,160	$51,593 / $58,863
Two	$7,316	$23,890 / $31,160	$58,629 / $65,899
Three or more	$8,231	$23,890 / $31,160	$62,974 / $70,244

Table 4. Identification checkpoints for Tax Year 2026 returns (desk summary)

Benefit	Taxpayer and spouse rules (MFJ)	Child or student	Form 8867 line	Primary authority
CTC/ ACTC	**One spouse:** work-eligible SSN issued before due date; other spouse: SSN or ITIN issued by the due date (draft Schedule 8812 instructions)	Work-eligible SSN issued before due date	10a, 10b	§ 24(h)(7)
ODC	**Both spouses (MFJ):** SSN or ITIN issued by the due date (including extensions)	Dependent must have an SSN, ITIN, or ATIN issued by the due date (including extensions); must be U.S. citizen, national, or resident	10b	§ 24(e), (h)(4); § 152(b)(3)
AOTC/ LLC	Work-eligible SSN (one spouse suffices on MFJ, per draft instructions)	**Dependent student:** work-eligible SSN; school EIN for AOTC	13a, 13b (AOTC only; the LLC is not a § 6695(g) benefit)	§ 25A(g)(1)
EIC	**Taxpayer and, on MFJ, both spouses:** SSN valid for EIC (§ 32(m))	SSN valid for EIC to count as qualifying child	9a	§ 32(c)(1)(E), (c)(3)(D), (m)

1 I.R.C. § 32(c)(3)(D)(i), (m).

Benefit	Taxpayer and spouse rules (MFJ)	Child or student	Form 8867 line	Primary authority
HOH	No separate SSN test in § 2(b)	Qualifying person rules under § 2(b)	14	§ 2(b), § 7703(b)

Summary for intake purposes only; all other eligibility tests still apply. The CTC and ODC spouse rules follow the draft 2026 Schedule 8812 instructions, which are not final. "Work-eligible SSN" means an SSN issued to a citizen or under Social Security Act § 205(c)(2)(B)(i)(I), the work-authorized category.

Example: 3-1: The dependent student with an ITIN

Taxpayer Luis, a U.S. citizen, claims his 20-year-old daughter as a dependent. She is a full-time sophomore with $4,000 of tuition, and she has an ITIN rather than an SSN. For 2026, no AOTC is allowed for her expenses because a dependent student must have a work-eligible SSN under § 25A(g)(1)(A)(ii) and (C), and omission is a math-error item under § 6213(g)(2)(J). The due diligence point is that the preparer must check the student's identification before computing the credit, not after the software returns a reject. The file should show that the question was asked and how it was answered.

Example: 3-2: The joint return where the spouse is the student

Kim, who holds a work-eligible SSN, files jointly with her husband, who is the student and holds an ITIN. Under the draft 2026 Form 8863 instructions, the joint return can satisfy the SSN requirement through Kim alone. Because the instructions are still in draft, note that point in the file as a pre-publication item and confirm it against the final instructions before filing.

Example: 3-3: The SSN that arrives after the due date

A client's newborn has no SSN or other TIN issued by April 15, 2027, and the client does not extend. The SSN arrives in May. Under § 24(e)(1) and (h)(7)(B)(ii), neither the CTC nor the ODC is available for that child for 2026. The ODC also requires a dependent TIN issued by the due date (draft 2026 Schedule 8812 instructions). The ODC is not a fallback for a TIN that was late. Filing later, or amending, does not change the issuance date. The preparer's job is to spot the timing problem before April 15, discuss a timely extension, and document that conversation. Check the final 2026 instructions before filing. A Form 4868 extension filed by April 15, 2027 moves the due date for this test. The test is the date the SSN is issued, not the date the card arrives. The draft instructions also treat a timely ITIN or ATIN application that results in issuance as timely, and they contain a birth-and-death exception.

B. The Draft Form 8867, Rev. November 2026

The IRS posted a draft revision of Form 8867 dated November 2026. The form is marked as a draft not to be filed, and the numbering below should be treated as provisional until the final form is released.1 The changes are structural but meaningful. The knowledge questions are relettered, and two new identification questions are added.

Table 5. Form 8867 line changes, Rev. November 2024 to draft Rev. November 2026

Topic	Rev. Nov. 2024	Draft Rev. Nov. 2026	What changed
Information appears incorrect, incomplete, or inconsistent	4	4a	Relettered
Reasonable inquiries made	4a	4b	Relettered
Contemporaneous documentation	4b	4c	Relettered; content unchanged (questions, whom, when, information, impact)
Record retention cross-reference	5 (refers to 4b)	5 (refers to 4c)	Cross-reference updated
Prior disallowance / Form 8862	7, 7a	7a, 7b	Relettered
Taxpayer SSN eligible for CTC/ACTC	none	10a	New

1 Form 8867 (Rev. Nov. 2026) (draft), https://www.irs.gov/pub/irs-dft/f8867--dft.pdf.

Topic	Rev. Nov. 2024	Draft Rev. Nov. 2026	What changed
Each qualifying person is a dependent and a U.S. citizen, national, or resident	10	10b	Relettered
Taxpayer SSN eligible for AOTC	none	13a	New
Substantiation such as Form 1098-T or receipts	13	13b	Relettered

Source: Form 8867 **(Rev. Nov. 2026) (draft, created May 18, 2026; posted by the IRS July 8, 2026)**. As of October 23, 2026, the IRS draft index listed the Nov. 2026 Form 8867 and Nov. 2025 instructions. The final-product index listed the Nov. 2024 Form 8867 and Nov. 2025 instructions.

Line 13a, as drafted, asks only about the taxpayer's SSN. The statute also requires a work-eligible SSN for a dependent student and the school's EIN.1 A preparer who answers line 13a "Yes" without checking the dependent student's number has completed the form but has not determined eligibility. The form is a checklist; the statute and regulation are the standard.

C. The Proposed Schedule 3-A and the "Federal Public Benefit" Rules

On August 20, 2026, Treasury and the IRS proposed regulations under the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 **(PRWORA)**. Under the proposal, the "refunded portion" of four refundable credits would be a "Federal public benefit" available only to U.S. citizens, U.S. nationals, and "qualified aliens." The four credits are the EIC, the ACTC, the refundable AOTC, and the refundable adoption credit.2 The public hearing set for October 14, 2026 was cancelled because no one asked to testify.3 As proposed, each rule would apply to "taxable years ending on or after" the date final regulations are published.4 If final regulations are published on or before December 31, 2026, they would reach calendar-year 2026 returns filed in 2027. As of the date of this text, they have not been finalized.

Three of the four affected credits are § 6695(g) benefits, so the proposal enters the due diligence conversation. Several mechanics matter at the desk.

The refunded portion is measured against tax. It is the amount by which the sum of the affected refundable credits exceeds the taxpayer's subtitle A tax, reduced by the nonrefundable credits.5 Credits that only offset tax are not affected, and neither is a refund of income tax withheld under § 31.6

On a joint return, if one spouse is a citizen, national, or qualified alien, the other spouse is treated as a qualified alien.7

Status is tested on the date the taxpayer files the return that first claims the credit, whether that is an early return, a late return, or an amended return.8 A taxpayer who claims the credit on April 15 while not a qualified alien remains ineligible for the refunded portion even after becoming one and amending. A taxpayer who first claims the credit on an amended return filed after obtaining qualified status is eligible.9

"Qualified alien" is a defined term in 8 U.S.C. § 1641(b). It includes lawful permanent residents, asylees, refugees, and certain parolees admitted for at least one year. It also includes persons granted withholding of deportation or removal, certain conditional entrants, Cuban and Haitian entrants, and certain individuals covered by the Compacts of Free Association. Certain battered spouses and children qualify under § 1641(c).10 Many

1 I.R.C. § 25A(g)(1)(A)(ii), (B)–(C).
2 Notice of Proposed Rulemaking, REG-119882-25, 91 Fed. Reg. 53,812 (Aug. 20, 2026), https://www.federalregister.gov/documents/2026/08/20/2026-16985.
3 REG-119882-25, Hearing Cancellation, 91 Fed. Reg. 64,631 (Oct. 9, 2026), https://www.govinfo.gov/content/pkg/FR-2026-10-09/html/2026-20790.htm.
4 Prop. Treas. Reg. §§ 1.23-2(g), 1.24-3(g), 1.25A-7(g), 1.32-4(g), 91 Fed. Reg. at 53,822–27.
5 Prop. Treas. Reg. § 1.24-3(c)(1)–(2), 91 Fed. Reg. at 53,823.
6 Prop. Treas. Reg. § 1.24-3(f)(8) (Example 8).
7 Prop. Treas. Reg. § 1.32-4(b)(4).
8 Prop. Treas. Reg. § 1.24-3(e), 91 Fed. Reg. at 53,823; see id. at 53,817 (preamble).
9 Prop. Treas. Reg. § 1.24-3(f)(4)–(5) (Examples 4 and 5).
10 8 U.S.C. § 1641(b)(1)–(8), (c), https://www.law.cornell.edu/uscode/text/8/1641.

individuals who hold work-authorized SSNs, and so pass Form 8867 lines 10a and 13a, are not qualified aliens. A work-eligible SSN and qualified-alien status are different tests.

Workpaper: Prop. Treas. Reg. § 1.24-3(f)(7) (Example 7), restated

```
Refundable portion of CTC (ACTC) under § 24(d) ......... $  955
Earned income credit (§ 32) ............................ $2,272
Sum of PRWORA-affected refundable credits .............. $3,227
Less: subtitle A tax after nonrefundable credits ....... ($  706)
Federal public benefit (refunded portion)  3,227 - 706 . $2,521

If F is not a citizen, national, or qualified alien:
  F may not receive the $2,521 as a refund, credit, or offset.
  The credits still reduce F's $706 of tax to zero.
Under Example 8, a $250 § 31 withholding credit would be
refundable regardless of status (it is not a PRWORA credit).
```

The draft 2026 Schedule 3-A implements this computation. It totals the affected credits, subtracts the tax figure, and labels the excess "your federal public benefit." It then asks whether the taxpayer wants to receive it and whether the taxpayer or spouse is a U.S. citizen, U.S. national, or qualified alien.1 The status declaration is made under penalties of perjury.2

Reader note. The parallel EIC example in Prop. Treas. Reg. § 1.32-4(f)(7) uses an ACTC of $1,455 and reaches $3,021. It is a different example, not a correction of the § 1.24-3(f)(7) figures above.

Caution: Do not decide an unclear immigration status

A tax preparer can ask a factual question and record the client's answer: "Are you a U.S. citizen, a U.S. national, or a lawful permanent resident, refugee, or asylee?" A tax preparer should not decide which immigration category applies to a client. Do not guess at an unfamiliar immigration classification. Section 10.35 requires competence for practice before the IRS; it does not itself decide who is authorized to practice immigration law. When the answer is unclear, document the uncertainty and refer the client to a qualified immigration attorney. Do not guess a "Yes" on line 8.

Example: 3-4: The client with a pending green card

Yolanda holds a work-authorized SSN and has a pending application for adjustment of status. Her immigration attorney has advised her in writing that she is not currently a U.S. citizen or national and does not qualify under any category in 8 U.S.C. § 1641(b) or (c). She files as a single taxpayer and otherwise meets every EIC requirement. A pending application alone would not establish those facts; they come from her attorney, not the preparer. Assume the proposed rules are final for 2026. Status would be tested when she first files a return claiming the credit (Prop. Treas. Reg. § 1.32-4(e)). Suppose she claims the EIC on a return filed March 1, 2027, and her status has not changed. She cannot later receive the refunded portion of that credit for 2026, even by amending after approval (§ 1.32-4(f), Example 4). The proposal's examples show that a first claim made after status changes would be treated differently (Examples 3 and 5). They illustrate how the status test would work; they do not recommend filing late. The options to review are a timely extension, or a timely return without the credit followed by a timely amended claim. An extension of time to file is not an extension of time to pay, and the refund-claim deadline still applies.3 Explaining those options is tax advice. If the preparer gives it, the conversation and the client's decision belong in the file, and a written summary should meet 31 C.F.R. § 10.37. The preparer should not predict when, or whether, the immigration benefit will be approved.

IV. REQUIREMENTS 1 AND 2: FORM 8867 AND THE COMPUTATION WORKSHEETS

A. Who Completes Form 8867, and When

Requirement 1 has two parts. The preparer must complete Form 8867 based on information provided by the taxpayer or otherwise reasonably obtained or known by the preparer, and must then deliver it according to the

1 Schedule 3-A (Form 1040) (2026) (draft), Parts I–II, lines 1a–8, https://www.irs.gov/pub/irs-dft/f1040s3a--dft.pdf.

2 Prop. Treas. Reg. § 1.24-3(d).

3 Treas. Reg. § 1.6081-4(c) (extension does not extend time to pay); I.R.C. § 6511(a), (b)(2) (claim period and lookback, including any filing extension).

preparer's role. A signing preparer who e-files the return files Form 8867 electronically with it. A signing preparer who does not e-file gives the completed form to the taxpayer for inclusion with the filed return. A nonsigning preparer gives the completed form to the signing preparer.1 "Tax return preparer" includes both the signing preparer and a nonsigning preparer who prepares a substantial portion of the return.2 The regulation assigns the due diligence duty to whoever determines eligibility for, or the amount of, the particular benefit.3

In a storefront, those can be different people. The Form 8867 instructions give the example of one preparer who determines the EIC while a coworker determines the AOTC and signs the return. Two Forms 8867 are required, one from each preparer for that preparer's benefit, and the nonsigning preparer's form goes to the signing preparer to be filed. An electronically filed return can carry up to four Forms 8867.4 Actual duties, not job titles, decide who is a preparer. An employee who provides only typing, reproduction, or other mechanical assistance is not a tax return preparer.5 An intake specialist who conducts the eligibility interview and records the answers may be doing more than that. An office cannot create or remove anyone's penalty exposure by assigning internal labels, but it can make sure that the person who actually determines eligibility for each benefit completes the Form 8867 for that benefit.

B. Part I, Line by Line

Part I applies to every benefit claimed, and it is where most of the exposure sits. Table 6 states what each line requires under the draft November 2026 revision and what the file should contain for an honest "Yes."

Table 6. Form 8867 Part I (draft Rev. Nov. 2026): what an honest "Yes" requires

Line	Question (paraphrased)	What the file should show
1	Return based on current-year information from the taxpayer or reasonably obtained	Current-year documents and interview notes; no carry-forward of last year's answers without reconfirmation
2	Credit worksheets completed (N/A if HOH is the only benefit)	Software or IRS worksheets for EIC, Schedule 8812, Form 8863 retained
3	**Knowledge requirement:** interview, ask, contemporaneously document; review information	Interview notes tied to this client and this year
4a	Did any information appear incorrect, incomplete, or inconsistent?	An honest answer. "No" on every return in an office is itself a pattern
4b	Reasonable inquiries made	The follow-up questions actually asked
4c	Inquiries contemporaneously documented	Questions, whom asked, when, information provided, impact on the return
5	Record retention satisfied; list documents relied on	Every document listed must actually be in the retained file
6	Asked whether the taxpayer could substantiate if audited	Note of the conversation and the client's answer
7a / 7b	Prior disallowance; Form 8862 completed if required	Client's answer; Form 8862 where required
8	Questions asked to prepare a complete and correct Schedule C	Gross receipts and expense inquiry notes

Source: Form 8867 **(Rev. Nov. 2026) (draft)**, Part I; Instructions for Form 8867 **(Rev. Nov. 2025)**, Lines 1–8. Line text paraphrased; consult the final form.

Two lines deserve emphasis. Line 4a asks whether anything looked incorrect, incomplete, or inconsistent. Answer it honestly for each file. A pattern of identical "No" answers across an office is a reason to review the office's process: are preparers recognizing split-custody households, zero-expense Schedules C, and 1098-Ts

1 Treas. Reg. § 1.6695-2(b)(1)(i)(A)–(C), (ii).
2 I.R.C. § 7701(a)(36)(A); Treas. Reg. § 301.7701-15(b)(1)–(2).
3 Treas. Reg. § 1.6695-2(a)(1) (penalty applies to preparer who determines eligibility or amount).
4 Instructions for Form 8867 (Rev. Nov. 2025), General Instructions, "Example" and multiple-Forms-8867 discussion.
5 Treas. Reg. § 301.7701-15(f)(1)(viii).

without account statements? It is not a reason to change an answer without facts. Line 5 is covered in the warning below and in **Section** VI.A.1

⊗ Warning: The Line 5 trap
Never list a document on line 5 unless a copy is in the retained file. "Lease, school records, birth certificates" typed into the box out of habit, with none of them saved, is a certification the file cannot support. If you did not rely on documents, say so.

C. Parts II Through V: The Benefit-Specific Questions

The benefit-specific parts test whether the preparer knew the substantive rule well enough to ask the right question. Each line ties to a statutory element.

Table 7. Form 8867 Parts II–V (draft Rev. Nov. 2026) and the rule behind each line

Line	Benefit	Question (paraphrased)	Substantive rule
9a	EIC	Eligible for EIC with the number of qualifying children claimed, or without one	I.R.C. § 32(b), (c)(1), (c)(3)
9b	EIC	Asked whether child lived with taxpayer over half the year, even if taxpayer supported child	§ 32(c)(3)(A); § 152(c)(1)(B)
9c	EIC	Explained the tiebreaker rules when a child qualifies for more than one person	§ 152(c)(4)
10a	CTC/ACTC	Taxpayer's SSN eligible for CTC/ACTC (new)	§ 24(h)(7)
10b	CTC/ACTC/ODC	Each qualifying person is a dependent and a U.S. citizen, national, or resident	§ 24(c), (h)(4); § 152(b)(3)
11	CTC/ACTC	Explained child must live with taxpayer over half the year unless custodial parent released claim	§ 152(c)(1)(B), (e)
12	CTC/ACTC/ODC	Explained rules for divorced, separated, or apart parents, including Form 8332	§ 152(e)(1)–(2); Treas. Reg. § 1.152-4(e)
13a	AOTC	Taxpayer's SSN eligible for AOTC (new)	§ 25A(g)(1)(A)
13b	AOTC	Substantiation such as Form 1098-T and/or receipts provided	§ 25A(b), (f)(1); § 6050S
14	HOH	Unmarried or considered unmarried on last day of year; paid over half the cost of keeping up a home for a qualifying person	§ 2(b)(1); § 7703(b)

Line 12 is where separated families create the most confusion. The special rule for children of divorced or separated parents applies only if its prerequisites are met. The child must get over half of his or her support from parents who are divorced, legally separated, separated under a written agreement, or living apart at all times during the year's last six months. The child must also be in the custody of one or both parents for more than half the year.2 When the rule applies, the custodial parent may sign a valid release **(Form 8332 or a conforming written declaration)**. The release lets the noncustodial parent claim the dependency-related benefits for which that parent otherwise qualifies: the CTC or ODC and, potentially, the AOTC.3 A release does not transfer head of household status or the EIC. Those remain available to the custodial parent only if that parent independently qualifies.4

Line 14 asks two questions in one. "Considered unmarried" is defined in § 7703(b). A married individual who files a separate return qualifies if three conditions are met. First, her home is, for more than half the year, the principal place of abode of a child she may claim as a dependent **(or could claim except for a § 152(e)** release). Second, she furnishes over half the cost of maintaining the household. Third, her spouse was not a member of the household during the last six months of the year.5 The "cost of keeping up a home" includes

1 Treas. Reg. § 1.6695-2(b)(4)(i)(C); Form 8867, line 5 (Rev. Nov. 2026 draft).
2 I.R.C. § 152(e)(1)(A)–(B).
3 I.R.C. §§ 152(e)(2), 24(h)(4), 25A(g)(3); Treas. Reg. § 1.152-4(e)(1)–(2). A declaration executed in a taxable year beginning on or before July 2, 2008, may qualify under the prior rules; see § 1.152-4(e)(5).
4 See I.R.C. §§ 2(b)(1)(A)(i) (qualifying child determined without regard to § 152(e)), 32(c)(3)(A).
5 I.R.C. § 7703(b)(1)–(3); see id. § 2(c).

rent or mortgage interest, real estate taxes, insurance, repairs, utilities, and food eaten in the home. It excludes clothing, education, medical treatment, vacations, life insurance, and transportation.1

Caution: Public assistance and the cost of keeping up a home
Older training materials teach that TANF and similar public-assistance payments count toward the total cost of the home but are never treated as paid by the taxpayer. The current Publication 501 follows proposed Treasury regulations that can treat certain governmental payments, such as TANF, used by the recipient to support another person as support provided by the recipient.2 That is narrower than a blanket rule. Identify the program, the intended beneficiary, and how the funds were used, and do not assume every public-assistance payment is treated the same way. Check the final 2026 Publication 501 before relying on either treatment.

Example: 4-1: The noncustodial parent and the split benefits
Andre and Carla divorced in 2023. Their 10-year-old son received all of his 2026 support from the two of them, and he lived with Carla for 300 nights and with Andre for the rest of the year, so § 152(e)(1) applies. Carla signs Form 8332 for 2026. Andre's preparer may claim the CTC for the son on Andre's return if the child and Andre meet the § 24(h)(7) SSN rules, with Form 8332 attached. Andre may not claim HOH or the EIC on the basis of that child. Carla's preparer may claim HOH and the EIC for Carla, if she otherwise qualifies, but not the CTC. Each preparer's file needs the custody facts and the status of Form 8332, and each preparer answers line 12 based on the explanation actually given to that client.

Example: 4-2: Two people, one child, the tiebreaker
A grandmother, Ruth, and her daughter, Nia (age 24, unmarried), live together with Nia's 4-year-old son all year. Nia's son's father does not live with them. Ruth's AGI is $38,000; Nia's is $16,000. Assume the boy is a qualifying child of each of them. Under § 152(c)(4)(A)(i), if both claim him, the parent prevails. If the parent does not claim him, Ruth may treat him as her qualifying child only if her AGI is higher than the highest AGI of any parent who could claim him (§ 152(c)(4)(C)). Here it is: $38,000 versus $16,000. Whoever claims the child takes the child-related benefits together. The family cannot assign the CTC to one adult and HOH or the EIC to the other on the basis of the same child (IRS Pub. 501 (2025), Qualifying Child of More Than One Person). The preparer's line 9c answer depends on whether the tiebreaker rules were explained, and the note should record which adult is claiming the child. If the same office prepares both returns, it should have a conflict-and-privacy procedure. Knowledge from one file can be "known by" the preparer (Treas. Reg. § 1.6695-2(b)(3)(i)). Using or disclosing one client's information for another client, however, is limited by § 7216.

D. Requirement 2: The Computation Worksheets

Requirement 2 is short. The preparer must complete the worksheets in the Form 1040, Schedule 8812, and Form 8863 instructions that apply to each credit, or the preparer's own worksheets providing the same information, and must keep them.3 Software-generated worksheets satisfy the requirement if they are retained. A worksheet, however, is only as good as its inputs. Renée's file illustrates the point. Her return, run on Tony's first-pass inputs, produces worksheets that are internally correct but are computed from incomplete facts.

1 IRS Pub. 501 (2025), Head of Household, Keeping Up a Home, https://www.irs.gov/pub/irs-pdf/p501.pdf.
2 IRS Pub. 501 (2025), Keeping Up a Home and Support Test notes; see REG-137604-07, 82 Fed. Reg. 6370 (Jan. 19, 2017).
3 Treas. Reg. § 1.6695-2(b)(2)(i), (b)(4)(i)(B); Form 8867, line 2 (Rev. Nov. 2026 draft). IRS Publication 1040 (2026) (draft dated Aug. 28, 2026), https://www.irs.gov/pub/irs-dft/p1040--dft.pdf.

Workpaper: Renée, first pass: draft-table teaching calculation (do not transfer to a return)

```
Schedule C: gross receipts $6,000; expenses $0; net profit ..... $ 6,000
SE tax:  6,000 x 0.9235 = 5,541.00; x 15.3% ..................... $   847.77
Deduction for 1/2 SE tax (847.77 / 2, rounded) ................. $   424
AGI:  24,000 + 6,000 - 424 ..................................... $29,576
Earned income for EIC/ACTC (wages + Sch. C net profit - 1/2 SE) .. $29,576

EIC, 2 qualifying children (draft Pub. 1040 (2026), EIC Table):
  Income $29,576; row $29,550-$29,600; two children; unmarried
  column (also covers HOH and considered-unmarried filers)
  EIC (draft IRS table) ....................................... $ 6,119

AOTC, Marcus (Form 1098-T box 1 only): $4,600, capped at $4,000
  100% x 2,000 + 25% x 2,000 = ................................ $ 2,500
  Refundable 40% (sec. 25A(i)) ................................ $ 1,000
  Nonrefundable 60% ........................................... $ 1,500

Income tax: 29,576 - 24,150 = 5,426; QBI ded. = lesser of
  20% x (6,000 - 424) = 1,115 or 20% x 5,426 = 1,085; taxable
  income 4,341; HOH table tax 433 (row $4,300-$4,350),
  fully offset by AOTC ........................................ $     0
ACTC, Lily: lesser of $1,700 or 15% x (29,576 - 2,500) ......... $ 1,700
Refundable credits: EIC 6,119 + ACTC 1,700 + AOTC 1,000 ........ $ 8,819
Estimated refund: 8,819 + withholding 1,100 - SE tax 848 ....... $ 9,071
```

Workpaper: Renée, corrected after inquiry: draft-table teaching calculation (do not transfer to a return)

```
Schedule C after inquiry: gross $6,000; supplies $1,150; county
  permit $250; expenses $1,400; net profit ..................... $ 4,600
SE tax:  4,600 x 0.9235 = 4,248.10; x 15.3% ..................... $   649.96
Deduction for 1/2 SE tax (649.96 / 2, rounded) ................. $   325
AGI and earned income:  24,000 + 4,600 - 325 ................... $28,275

EIC, 2 qualifying children (draft Pub. 1040 EIC Table):
  Income $28,275; row $28,250-$28,300; two children; unmarried
  EIC (draft IRS table) ....................................... $ 6,393

AOTC, Marcus: box 1 tuition $4,600 + required books $300
  - Pell grant (box 5) $1,200 = qualified expenses ............. $ 3,700
  100% x 2,000 + 25% x 1,700 = ................................ $ 2,425
  Refundable 40% (2,425 x 0.40) ............................... $   970
  Nonrefundable 60% (2,425 - 970) ............................. $ 1,455

Income tax: AGI 28,275 - HOH std. ded. 24,150 = 4,125;
  QBI ded. = lesser of 20% x (4,600 - 325) = 855 or 20% x 4,125
  = 825; taxable income 4,125 - 825 = 3,300; HOH table tax
  (row $3,300-$3,350) ......................................... $   333
  AOTC nonrefundable applied (limited to tax) ................. ($  333)
  Remaining income tax; CTC $2,200 and ODC $500 nonrefundable
  portions unused ............................................. $     0
ACTC, Lily: lesser of $1,700 or 15% x (28,275 - 2,500) = 3,866 .. $ 1,700

Refundable credits: EIC 6,393 + ACTC 1,700 + AOTC 970 .......... $ 9,063
Estimated refund: 9,063 + withholding 1,100 - SE tax 650 ....... $ 9,513
```

Table 8. Renée's first pass vs. corrected file: draft-table teaching calculations (not filing-ready)

Item	First pass	Corrected	Change
Schedule C net profit	$6,000	$4,600	($1,400)
Earned income	$29,576	$28,275	($1,301)
EIC (draft IRS table)	$6,119	$6,393	+$274
ACTC (Lily)	$1,700	$1,700	$0
AOTC refundable	$1,000	$970	($30)
AOTC total	$2,500	$2,425	($75)
Income tax before credits (draft Tax Table)	$433	$333	($100)

Item	First pass	Corrected	Change
Nonrefundable AOTC used	$433	$333	($100)
Refundable credits total (EIC + ACTC + refundable AOTC)	$8,819	$9,063	+$244
SE tax	$848	$650	($198)
Estimated refund (credits + $1,100 withholding – SE tax)	$9,071	$9,513	+$442

Whole-dollar teaching calculations using the draft 2026 IRS Tax Table and EIC Table, not filing-ready results. Source: IRS Publication 1040 **(2026)**, draft dated Aug. 28, 2026, posted Sept. 16, 2026; Tax Table printed p. 3; EIC Table printed p. 20; https://www.irs.gov/pub/irs-dft/p1040--dft.pdf. Drafts are not for filing. Omitted or simplified: any permissible allocation of the Pell grant to actual nonqualified expenses, and state items. Check the final 2026 tables and instructions before filing an actual return. The 2026 credit amounts are from Rev. Proc. 2025-32, §§ 4.05–4.06.

Due diligence is not anti-client. Asking about Renée's braiding expenses lowered her SE tax and her earned income, which in her phaseout range raised her EIC; the draft-table refund increased by $442. The supported inputs are now corrected. The final 2026 tables and instructions must still be checked before an actual return is filed. The AOTC error ran the other way. Using box 1 of the Form 1098-T without asking about the Pell grant in box 5 overstated qualified expenses. The regulation's own AOTC example holds that a Form 1098-T, standing alone, does not contain all the information needed to determine eligibility or the amount of the credit.1 Both corrections came from a question, not from a document request.

Because Renée has no net capital gain, the QBI lines apply 20% of QBI, capped at 20% of taxable income **(I.R.C. § 199A(a)**(1)–(2)). The 2026 minimum deduction of $400 for at least $1,000 of active QBI **(§ 199A(i)**) does not change either result.

Credit order follows the Credit Limit Worksheet in the draft 2026 Form 8863 instructions: the nonrefundable education credit is applied against tax first. Here it absorbs all of Renée's income tax **($433 on the first pass, $333 corrected)**, so none of the nonrefundable CTC **($2,200)** or ODC **($500)** is used. Lily's refundable ACTC is then figured on Schedule 8812, subject to its own limits; it is $1,700 in both passes.

The workpapers show AGI and earned income as equal because each is wages plus net Schedule C profit less half of SE tax. Nothing is counted twice.

Marcus was a full-time student from August through December, five calendar months under § 152(f)(2). That dependency test differs from the AOTC half-time test, which needs only one academic period.

Caution: The Pell grant is a planning question, not only a subtraction

A student may, in some cases, treat a scholarship or Pell grant as applied to non-qualified costs such as room and board. That amount is then included in the student's income, which preserves more qualified expenses for the AOTC. Whether that is permitted and beneficial depends on the grant's terms and the student's own tax position (see IRS Pub. 970). This text uses the simple subtraction. The amount allocated cannot exceed the student's actual nonqualified expenses paid in the year, and the grant terms must permit that use. The student must include the allocated amount in income. Marcus is an adult, so he must agree and report it. The analysis covers the family's combined result, not the parent's credit alone, and belongs in the file.

V. REQUIREMENT 3: THE KNOWLEDGE STANDARD

A. The Rule Itself

Requirement 3 is the central requirement of § 6695(g). The regulation provides that the preparer must not know, or have reason to know, that information used in determining eligibility for, or the amount of, a covered benefit is incorrect. The preparer "may not ignore the implications of information furnished to, or known by, the tax return preparer." The preparer must also make reasonable inquiries if a reasonable and well-informed preparer, knowledgeable in the law, would conclude that the information furnished appears to be incorrect, inconsistent, or incomplete. Finally, the preparer must contemporaneously document in the files any inquiries made and the responses.2

1 Treas. Reg. § 1.6695-2(b)(3)(ii)(H) (Example 8).

2 Treas. Reg. § 1.6695-2(b)(3)(i).

Three points are easy to lose. It is objective, because the test is what a reasonable and well-informed preparer would conclude, not what this preparer happened to notice. It includes information "known by" the preparer from any source, including a prior year's file, another family member's return, or what the client mentioned while signing. And it has two parts that must both be satisfied: making the inquiry and documenting it at the time. An inquiry that happened but was not written down fails the second part.

Table 9. The "three I's": what triggers an inquiry

Trigger	Meaning	Storefront examples
Incorrect	Information conflicts with a fact the preparer knows or can see	1098-T for a school the student says she never attended; W-2 employer that does not match the client's description of her job
Inconsistent	Information conflicts with other information in the file or with common experience	22-year-old claiming 10- and 11-year-old sons; "single" on the intake sheet and a husband mentioned at the desk; two adults in one household each claiming the same child
Incomplete	A fact needed to determine eligibility or amount is missing	Schedule C with income and no expenses; 1098-T without amounts paid or scholarships; "lived with me" with no information about the other parent

B. The Regulation's Eight Examples

The regulation illustrates the standard with eight examples. Some versions in circulation present them out of order or merge them with the Form 8867 instructions' examples. The official sequence is below.

Table 10. Treas. Reg. § 1.6695-2(b)(3)(ii) Examples 1–8 (official order)

Example	Paragraph	Facts	Holding
1	(A)	22-year-old Q claims two sons, ages 10 and 11	Ages are inconsistent; preparer must inquire about relationship and document
2	(B)	Same Q, next year; prior-year inquiry established the boys were legally adopted	No additional inquiry needed on relationship
3	(C)	18-year-old R, with an infant, lives with R's parents part of the year; $10,000 W-2	Ask whether R is her parents' qualifying child for EIC or their dependent for CTC, and document the answers. Example 4 addresses information already established from the parents' return
4	(D)	Same as 3; preparer also prepared R's parents' return and determined R cannot be claimed	No additional inquiry needed on that point
5	(E)	S claims niece and nephew who lived with S part of the year	Must inquire into residency, support, and household facts; document
6	(F)	Same as 5; preparer knows S socially and believes children lived with S over half the year	Social knowledge does not excuse the inquiry; must still ask and document
7	(G)	50-year-old W, never married, no children, reports $10,000 of self-employment income and no business expenses	Must inquire whether business income and expenses are correct to determine EIC eligibility; document
8	(H)	32-year-old Y provides a Form 1098-T showing University M billed $4,000	1098-T does not contain all information needed to determine AOTC eligibility or amount; must inquire and document

Source: Treas. Reg. § 1.6695-2(b)(3)(ii)(A)–(H) **(eCFR, current)**. Facts condensed. The Instructions for Form 8867 contain separate examples **(including a 25-year-old with children ages 10 and 12 and a $12,000 lawn-care business with no expenses)**; label those as Form 8867 instruction examples, not regulation examples.

The examples show how an intake interview or questionnaire can reveal missing or inconsistent facts. Examples 1, 3, 5, 6, 7, and 8 require inquiries. Examples 2 and 4 show when the preparer already has enough information.

Once a question has been resolved through sufficient documented inquiry, or the preparer already holds the answer from another return it prepared, the regulation does not require the same inquiry again. Common sense, and Form 8867 line 4a's reference to information "reasonably known to you," still call for a fresh question when the facts have changed.1

C. The Desk Interview: Questions That Work

The best due diligence questions are factual, open-ended, and specific to the benefit. Table 11 gives an original question set for each benefit, written for the storefront desk. It supplements the intake sheet; it does not replace the preparer's judgment about when to ask more.

Table 11. Storefront follow-up question sets (supplement to the intake sheet)

Benefit	Factual follow-up questions
Schedule C (EIC earned income)	How do customers pay you, and do you have the app or bank history? What do you buy to do the work, and where? Do you pay for space, a booth, a license, or a phone? Do you have any records, even bank or card statements? How did you arrive at the income figure?
HOH	Where did you live during the year, and who else lived there and when? Are you married, separated, or divorced, and when did your spouse last live in the home? Who paid the rent or mortgage, utilities, and groceries, and roughly how much? Did anyone else, or any program, help pay?
EIC qualifying child	Where did the child sleep most nights? Was the child away for school, a hospital stay, or a visit, and for how long? Does the other parent or anyone else plan to claim the child? Is the child married or filing a return?
CTC/ACTC/ODC	What identification number does each child have, and when was it issued? Has anyone signed a Form 8332 or a written release for this child? Where does the child live, and is the child a U.S. citizen, national, or resident?
AOTC	How much did you actually pay, and when? Did the student receive any grants or scholarships? Is the student pursuing a degree or other recognized educational credential and enrolled at least half time? How many prior years has anyone claimed this credit for this student? Has the student been convicted of a felony drug offense? Can you show me the student account statement?
Identification (2026)	**Does the SSN card carry a legend? "Not valid for employment" fails the work-eligible test. "Valid for work only with DHS authorization" is not an automatic bar; for the EIC, confirm the authorization is still valid (Pub. 596). When was each SSN issued? (If the proposed PRWORA rules are final:**) Is the taxpayer or spouse a U.S. citizen, U.S. national, or a qualified alien under 8 U.S.C. § 1641(b) or (c)?

Question sets are practitioner guidance, not regulatory requirements. AOTC elements: I.R.C. § 25A(b)(2)(A)–(D); 2026 SSN and EIN rules: § 25A(g)(1).

How the question is asked matters as much as what is asked. Clients who receive refundable credits often feel accused by follow-up questions, and a client who feels accused gives shorter answers. Experienced storefront preparers soften the conversation by attributing the questions to the system rather than to suspicion. The four openers below are offered as models.

Practice Pointer: Four ways to ask without accusing

"The IRS requires me to ask everyone who claims this credit a few more questions, so bear with me."
"The checklist I have to complete asks me whether I checked this, so let me make sure I have it right."
"These credits depend on specific facts, so I write down how we determined them in case anyone ever asks."
"I'm not doubting you. If the IRS writes to you two years from now, this note records the facts we used."

D. What a Contemporaneous Note Looks Like

The Form 8867 line 4c description is the best model for a note: the questions asked, whom the preparer asked, when, the information provided, and the impact on the return.2 A practical formula is: date, preparer initials, who answered, what looked off, the exact question, the factual answer, and what the preparer did with it.

1 Treas. Reg. § 1.6695-2(b)(3)(ii)(B), (D); Form 8867, line 4a (Rev. Nov. 2026 draft).

2 Form 8867, line 4c (Rev. Nov. 2026 draft); Instructions for Form 8867 (Rev. Nov. 2025), Lines 3 and 4.

Warning: The note that will be penalized

"Client says kids lived with her. Braiding income $6,000. HOH. 1098-T reviewed." This note records conclusions, not inquiries. It does not show that anyone noticed the zero expenses, the husband, the other parent's claim, or the missing scholarship information, or that any question was asked about them.

Practice Pointer: Renée's note as Tony should have written it

01/16/2027, 11:40 a.m., TR (interviewer), Renée Calloway answering in person.
(1) Intake says "single"; client mentioned husband. Q: "Are you married, separated, or divorced?" A: Married, not divorced. Dwayne moved out 02/28/2026, lives with his brother on Elm St.; has not stayed overnight since. Q: "Who paid rent and bills after he left?" A: She did; he paid Jan.–Feb. rent ($2,300) directly to the landlord. Rent $1,150 x 12 = $13,800; utilities ~ $2,700; groceries ~ $6,600; renter's insurance $240; total ~ $23,340. Client share $21,040 (90%). Public assistance: none. Impact: considered unmarried under § 7703(b); HOH supported.
(2) Client said Dwayne "is claiming Lily." Q: "Has Lily lived with you or with him?" A: With her every night of 2026. Q: "Have you signed any IRS form or written release for him?" A: No. Explained that, absent a signed Form 8332, the parent the child lived with claims her, and that the IRS may contact both parents if he claims her. Impact: Lily claimed by client; line 12 explanation given.
(3) Schedule C, $6,000 gross, $0 expenses. Q: "How do clients pay you?" A: Cash App and cash; showed Cash App history totaling $5,640 plus about $360 cash. Q: "What do you buy for the work?" A: Braiding hair and supplies used on clients; showed debit card history at beauty supply store. Q: "Was any of that for your own or your family's use?" A: No; personal purchases are on a different card. Business purchases total $1,150. Q: "Any license or fees?" A: County permit, $250; receipt shown. Copies of statements and receipt retained. Impact: expenses $1,400; net $4,600.
(4) 1098-T for Marcus: box 1 $4,600; box 5 $1,200. Q: "Did Marcus receive grants?" A: Pell grant. Q: "Any required books?" A: $300, receipts shown. Q: "Prior AOTC claims?" A: None; first year. Q: "Who paid the fall tuition, and when?" A: Pell grant $1,200; Renée paid $3,400 in August 2026; account statement shows both. Q: "Any 529 plan money, employer help, or other aid?" A: None. Spring 2027 tuition not billed or paid in 2026. Q: "Degree program, at least half time?" A: Associate degree, full time from late August through December. Q: "Any felony drug conviction?" A: No. Student account statement reviewed; school EIN on 1098-T. Impact: qualified expenses $3,700.
(5) Marcus and Lily, qualifying-child facts. Q: "Where did each child live in 2026?" A: Both lived with Renée all year in the United States; Marcus commutes to campus. Q: "Did either child pay more than half of his or her own living costs?" A: No; Marcus earned about $2,100 from a summer job, spent on his car and phone. Q: "Is either child married or filing a joint return?" A: No. Q: "Has the IRS ever denied any of these credits for you?" A: No (line 7a).
(6) SSN cards reviewed and copied for Renée, Marcus, Lily; no work-restriction legend; all issued years ago. Citizenship: all U.S. citizens per client. Line 6: client says she can provide the lease, the Cash App history, and the school statement if audited.
Form W-2 reviewed and copy retained; $24,000 of wages used in the credit worksheets and $1,100 of federal withholding used on the return.
Retained copies: Form W-2; Cash App history; debit card statement; county permit receipt; Form 1098-T; student account statement; book receipts; SSN cards.

The corrected note is long, and it does not need to be elegant. It needs to show that a reasonable preparer saw what was on the desk, asked about it, and acted on the answer. Notes kept in the software's note field, on a scanned intake sheet, or in a dated document management entry all work if they are retained and can be produced.

Example: 5-1: The church friend

Mrs. Okafor has prepared Deacon Harris's return for nine years. This year he claims his two grandchildren, who moved in with him in March. She knows the family and is sure the children have lived with him since spring. Under Treas. Reg. § 1.6695-2(b)(3)(ii)(F) (Example 6), her personal knowledge does not substitute for documented inquiry. She should ask the residency questions (the move-in date and where the parents live) and the support and tiebreaker questions (whether either parent lived in the home or plans to claim the children). She should also ask the household-cost questions for HOH, then write the answers down.

Example: 5-2: The returning client whose facts have not changed

Last year, Tony's colleague documented that client Jamal legally adopted his partner's son, with a copy of the adoption decree in the file. This year, Jamal returns with the same household. Under Treas. Reg. § 1.6695-2(b)(3)(ii)(B) (Example 2), the relationship question need not be re-asked, but residency for 2026 must still be confirmed and noted. The prior-year file should be referenced in the current note ("relationship established 2025 file, adoption decree retained").

Example: 5-3: The round number

A client reports Schedule C gross receipts of exactly $18,000 for "cleaning houses" and no expenses. A round number is not wrong in itself, and gross receipts are only a starting point. EIC earned income is net earnings from self-employment, after expenses and the deduction for half of SE tax (I.R.C. § 32(c)(2)(A)). A reasonable preparer would ask how the figure was calculated, whether there are records, and what expenses were incurred, then document the answers (Treas. Reg. § 1.6695-2(b)(3)(ii)(G), Example 7). Resolve the business income and expense facts before filing. Leaving the EIC off the return does not repair an unsupported Schedule C. If a complete and correct return cannot be prepared, decline the engagement.

VI. REQUIREMENT 4: THE THREE-YEAR RECORDKEEPING RULE

A. What Must Be Kept

The regulation requires the preparer to retain three categories of material. The first is a copy of the completed Form 8867. The second is a copy of each completed computation worksheet, or the preparer's own computation record. The third is a record of how and when the information used for the form and worksheets was obtained, including who furnished it. That record includes a copy of any document the taxpayer provided that the preparer relied on.1 The knowledge requirement separately requires the contemporaneous record of inquiries and responses.2 The Form 8867 instructions combine these into a list of five records to keep: Form 8867, the worksheets, copies of documents relied on, the how-when-from-whom record, and the record of additional questions and answers.3

Table 12. The five records and where each comes from

Record	Regulatory source	Renée's file
1. Form 8867	§ 1.6695-2(b)(4)(i)(A)	Completed preparer copy, with the line 15 certification completed; use the applicable final revision when filing
2. Computation worksheets	§ 1.6695-2(b)(4)(i)(B)	EIC worksheet, Schedule 8812 worksheets, Form 8863 worksheet
3. Copies of documents relied on	§ 1.6695-2(b)(4)(i)(C)	Form W-2, Cash App history, debit-card statement, county permit receipt, 1098-T, student account statement, book receipts, SSN cards (Renée, Marcus, Lily)
4. How, when, and from whom information was obtained	§ 1.6695-2(b)(4)(i)(C)	**Interview header:** date, time, interviewer, Renée in person
5. Inquiries and responses	§ 1.6695-2(b)(3)(i)	Tony's numbered note (Section V.D)

The rule is narrower than many offices assume. It requires copies of documents the preparer relied on, not every document the client could have produced. In Renée's file, the lease was discussed but not relied on; her rent figure came from the interview. The lease does not need to be in the file and should not be listed on line 5. The Cash App history was relied on, so a copy must be kept.

1 Treas. Reg. § 1.6695-2(b)(4)(i)(A)–(C).
2 Treas. Reg. § 1.6695-2(b)(3)(i) (last sentence).
3 Instructions for Form 8867 (Rev. Nov. 2025), General Instructions, items 4(a)–(e), and Document Retention.

B. The Three-Year Clock

The records must be kept for three years from the latest of the applicable dates. The first date is the return's due date, determined without extensions. For a signing preparer who e-files, the second date is the date the return was filed. For a signing preparer who does not e-file, it is the date the return was presented to the taxpayer for signature. For a nonsigning preparer, it is the date that preparer submitted the relevant portion to the signing preparer.1

Workpaper: Retention dates for three Main Street Tax Service files

```
Renée Calloway, TY 2026, e-filed February 6, 2027
  (A) Due date without extension ..... April 15, 2027
  (B) E-file date ..................... February 6, 2027
  Latest date ......................... April 15, 2027
  Retain through ...................... April 15, 2030

Client B, TY 2026, on extension, e-filed August 2, 2027
  (A) April 15, 2027;  (B) August 2, 2027
  Latest date ......................... August 2, 2027
  Retain through ...................... August 2, 2030

Client C, TY 2025 Form 1040-X, e-filed February 20, 2027
  (A) Due date of the 2025 return ..... April 15, 2026
  (B) Claim filed ..................... February 20, 2027
  Latest date ......................... February 20, 2027
  Retain through ...................... February 20, 2030
```

The retention period and the § 6695 assessment period are both three years, but they are separate clocks with different starting dates. The assessment period runs from the date the return or claim was filed.2 For Renée's return, filed February 6, 2027, the ordinary assessment period ends February 6, 2030, while the retention period runs from the April 15, 2027 due date and ends April 15, 2030. Keep records longer if an examination, litigation, or another obligation requires it. A storefront that purges files every two years destroys the very records that would defend it while the IRS can still assess.

C. Electronic Records

Records may be kept on paper or electronically in the manner prescribed by IRS guidance.3 The principal guidance requires an electronic storage system that transfers hard-copy records accurately and completely and has reasonable controls over integrity and accuracy. The system must also index, store, preserve, retrieve, and reproduce the records, and produce legible, readable copies.4 In practice, that means readable scans, a naming convention that ties each document to the client and year, and a tested backup. It also means an access-control and disposal policy that matches the office's written information security program.

D. Procedures That Protect the Office: Training and the Engagement Letter

Sections I.D and I.E explain the penalty rules. Here is how the office shows its procedures actually work. The regulation does not prescribe the length of an office manual. As a practical matter, a short manual can work if it covers the required procedures.5 It should assign responsibility for each benefit and require benefit-specific follow-up questions when the three I's are present. It should also say where and how notes are recorded, set a review step before filing, and provide a retention and disposal schedule. Training records showing that seasonal staff were taught the manual, and periodic file reviews showing that it was followed, are what convert a manual into evidence.

An engagement letter can reinforce the process with clients. The clause below is a model and should be adapted to the office.

Due diligence clause (model). Federal law requires us to ask reasonable questions and keep records of your answers when your return claims certain benefits. These are the earned income credit, the child tax credit or credit for other dependents, the American opportunity tax credit, and head of household filing status. We may

1 Treas. Reg. § 1.6695-2(b)(4)(ii)(A)–(D).
2 I.R.C. § 6696(d)(1).
3 Treas. Reg. § 1.6695-2(b)(4)(iii).
4 Rev. Proc. 97-22, § 4.01, 1997-13 I.R.B. 9, https://www.irs.gov/pub/irs-irbs/irb97-13.pdf.
5 Treas. Reg. § 1.6695-2(c)(2), (d).

ask you questions that seem personal or detailed. We are not doubting you; we are required to ask, and your answers document how we determined your eligibility if the IRS later examines your return. If we cannot obtain information we need to determine that you qualify for a benefit, we may not claim that benefit on your return, or we may decline to complete the return. Copies of documents you provide that we rely on will be kept in our files for at least three years, with the safeguards described in our privacy notice.

Caution: Consent for uses beyond preparing the return
Retaining due diligence records to support the return is part of preparing it. Using client information for any other purpose requires the client's written consent, in the form prescribed by Treas. Reg. § 301.7216-3, unless a statutory or regulatory exception applies. Other purposes include marketing and disclosure to a third party not involved in the preparation. Keep the due diligence clause separate from any § 7216 consent. The model clause is not itself a consent.

VII. WHEN THE IRS COMES CALLING

A. The Escalation Ladder

The IRS uses several types of educational and enforcement contact with preparers. It states that it does not use every tier for every preparer, so no preparer is entitled to receive each warning before an examination; follow the deadline on the actual letter received.1 Before or during the filing season, a preparer whose returns show error patterns in the four benefits may receive one or more letters. These include Letter 5025-F, which warns that the preparer's returns appear inaccurate and that an audit could bring penalties. They also include Letter 4858 **("You May Not Have Met Your Due Diligence Requirements")**, and Letter 5364 **("Missing Form 8867")**. The IRS may also notify the preparer's clients directly with Letter 6138 **("You Need to Make Sure your Tax Return is Accurate")**. Letter 5138 **("Return Preparer Client Audit Notification")** tells the preparer that clients' returns are under examination.2

A knock and talk visit is an educational, pre-filing-season visit introduced by Letter 6223 and confirmed by Letter 6224, which tells the preparer what to have ready. The IRS describes it as optional and states that it does not result in penalties. It also states that it continues to monitor the preparer's returns afterward and may conduct a due diligence audit if accuracy does not improve.3 A preparer who treats a knock and talk visit casually invites closer attention the following season.

A due diligence visit is an examination of the preparer. The IRS conducts these visits before the filing season based on prior-year returns. A visit may be face to face **(initiated by Letter 6199, Due Diligence Visit Request)** or by correspondence **(initiated by Letter 6222, Correspondence Due Diligence IDR)**. Each letter asks for a response within 14 days. For a face-to-face visit, the examiner confirms the appointment with Letter 6200. During the filing season, the IRS may conduct visits without advance notice to preparers who have previously received a letter. During the audit, the IRS also checks the preparer's PTIN compliance and the preparer's own personal and business filing compliance.4

The program is cost-effective for the government, which suggests it will continue. GAO reported that, from fiscal years 2017 through 2020, the IRS estimated these visits protected about $118 million of revenue per year at an average cost of about $3.3 million per year.5

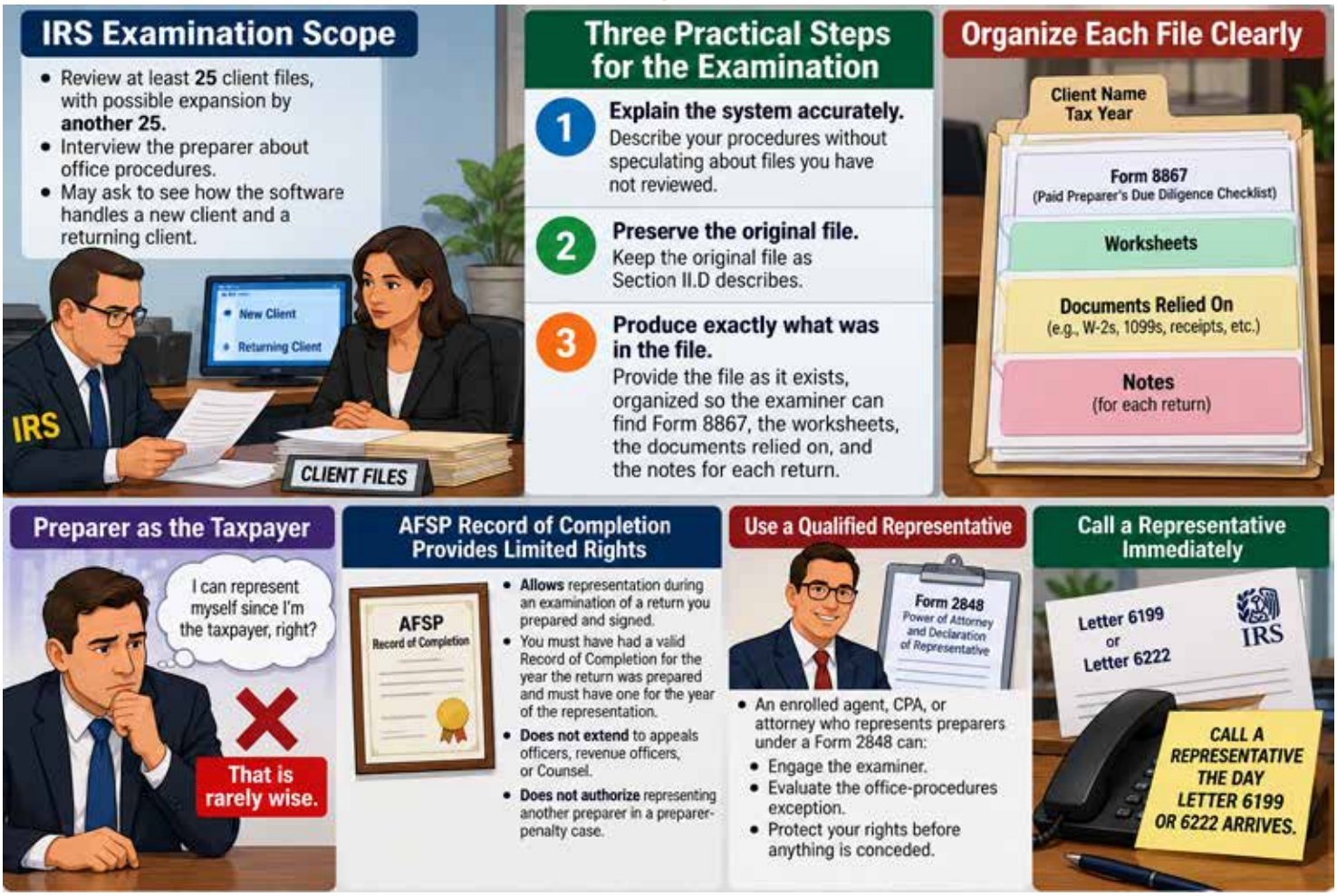
1 IRS, Auditing for Due Diligence Compliance (EITC Central) ("we don't use all of them for every preparer").
2 IRS, Letters or phone calls about due diligence and filing errors (EITC Central), https://www.irs.gov/credits-deductions/individuals/earned-income-tax-credit/reaching-out-to-paid-preparers.
3 IRS, Knock and Talk (EITC Central), https://www.irs.gov/tax-professionals/eitc-central/knock-and-talk.
4 IRS, Auditing for Due Diligence Compliance (EITC Central), https://www.irs.gov/credits-deductions/individuals/earned-income-tax-credit/auditing-for-due-diligence-compliance.
5 U.S. Gov't Accountability Off., GAO-22-105978, Management Report: IRS Should Test Videoconference Visits with Paid Preparers (2022), https://www.gao.gov/products/gao-22-105978.

Table 13. IRS preparer contacts: what each one means

Letter or contact	What it is	Penalty possible at this stage?	Suggested response
5025-F; 4858	Warning of inaccurate returns / possible due diligence failures	Not by the letter itself	Review procedures and a sample of files now; document improvements
5364	Form 8867 missing from returns	Not by the letter itself	Fix the software/filing process; confirm Form 8867 is transmitted
6138 (to clients)	IRS tells your clients their returns may be inaccurate	No	Expect client calls; do not amend reflexively without facts
5138	Your clients' returns are under examination	Not against you by this letter	Assist clients within your authority; review the affected files
6223 / 6224	Knock and talk visit introduction / confirmation	No (per IRS)	Accept, prepare, and treat as serious
6199 / 6200	Face-to-face due diligence visit request / appointment confirmation	Yes	Engage a representative immediately; respond within 14 days
6222	Correspondence due diligence IDR	Yes	Engage a representative immediately; respond within 14 days
1125 with Form 5816	Transmittal of proposed preparer penalties (30-day letter)	Proposed	Request supervisory conference and/or Appeals by the deadline

Letter titles from IRS EITC Central pages cited in this section and IRM 20.1.6.16.1. Response suggestions are practitioner guidance.

B. During the Visit



The IRS describes a review of at least 25 client files, with possible expansion by another 25. The examiner will also interview the preparer about office procedures. The examiner may also ask to see how the software handles a new client and a returning client. For the examination, follow three practical steps. Explain the system accurately without speculating about files you have not reviewed. Preserve the original file as **Section** II.D describes. Produce exactly what was in the file, organized so that the examiner can find Form 8867, the worksheets, the documents relied on, and the notes for each return.

The preparer is the taxpayer in a preparer-penalty case and may appear on his or her own behalf after presenting satisfactory identification.1 That is rarely wise. An AFSP Record of Completion confers only limited representation rights. The holder may represent a taxpayer during an examination of a return the holder prepared and signed. The holder must have had a valid Record of Completion for the year the return was prepared and must have one for the year of the representation. Those rights do not extend to appeals officers, revenue officers, or Counsel, and they do not authorize representing another preparer in a preparer-penalty case.2 An enrolled agent, CPA, or attorney who represents preparers under a Form 2848 can engage the examiner and evaluate the office-procedures exception before anything is conceded. Call a representative the day Letter 6199 or 6222 arrives.

Practice Pointer: What the representative will ask for first

Gather the written due diligence procedures in effect during the season under review, the training records for each preparer, and the list of returns in the sample with who prepared each. For each file, gather Form 8867, the worksheets, the documents relied on, and the notes, exactly as they existed when the return was filed.

C. Proposed Penalties and Appeal Rights

If the examiner proposes penalties, the preparer receives Letter 1125 with Form 5816, Report of Tax Return Preparer Penalty Case. The preparer may first request a conference with the supervisor of the person who signed the letter. If the total proposed penalties are $25,000 or less, the preparer may request Appeals consideration by letter or with Form 12203. If they exceed $25,000, a formal written protest is required, including a declaration under penalties of perjury.3 Pre-assessment Appeals consideration is available for § 6695 penalties under the IRM. If a penalty is assessed first, for example on a short statute, the IRM provides a post-assessment Appeals hearing when there was no prior one. That hearing does not extend refund deadlines. Examiners will not send a case to Appeals with less than 365 days remaining on the assessment statute, and they may ask the preparer to extend it on Form 872-D.4 There is no deficiency petition to the Tax Court to contest a § 6695 penalty, because the deficiency procedures do not apply.5 After assessment, the preparer pays the penalty and files a refund claim on Form 6118 within three years from the time the penalty was paid.6 Where payments are made in installments or on different dates, track each payment date. The regulation measures timeliness from each payment, while the current Form 6118 instructions refer to full payment. Do not assume installments restart the clock. A separate Form 6118 is filed for each § 6695(g) penalty, even when several were charged.7 The § 6694(c) 15-percent payment procedure applies only to § 6694 penalties, not to § 6695.8 No refund suit may be brought without a prior claim. A suit in a federal district court or the Court of Federal Claims generally cannot begin until six months after the claim is filed, unless the IRS decides it sooner. It generally must begin within two years after the IRS mails a notice of disallowance by certified or registered mail. Reconsideration by the IRS does not extend that two-year period. A written agreement can extend it, and

1 31 C.F.R. § 10.7(a) (individuals may appear on their own behalf).
2 Rev. Proc. 2014-42, § 6.01.
3 IRS, Appeal of Due Diligence Penalties (EITC Central), https://www.irs.gov/credits-deductions/individuals/earned-income-tax-credit/appeal-of-due-diligence-penalties; IRS Pub. 5.
4 IRM 20.1.6.16.1 (May 22, 2024); IRM 20.1.6.16.2; IRM 20.1.6.18; I.R.C. § 6696(d)(1).
5 I.R.C. § 6696(b). Collection due process rights can arise later if the IRS takes collection action; whether the underlying penalty can be contested there depends on whether the preparer had a prior opportunity to dispute it. I.R.C. § 6330(c)(2)(B); Treas. Reg. § 301.6330-1(e)(3), Q&A-E2.
6 I.R.C. § 6696(d)(2); Treas. Reg. § 1.6696-1(g)(1)(i)(A), (g)(1)(ii) (payment is made when received or credited).
7 Form 6118 (Rev. July 2018), p. 2 (type J filed separately). Consolidated claims cover only § 6695(a)–(e). Treas. Reg. § 1.6696-1(c)(2), (g)(1)(i)(B).
8 I.R.C. § 6694(c)(1).

a written waiver of the disallowance notice starts it **(§ 6532(a)**(2)–(3)).1 A controversy practitioner should manage these deadlines.

Two procedural points belong in every representative's checklist. First, the initial determination of most penalties must be personally approved in writing by the examiner's immediate supervisor **(or a designated higher-level official)**. For a penalty not subject to pre-assessment Tax Court review, such as § 6695(g), the current regulation requires that approval before the penalty is assessed. The representative should ask for the written approval and its date, without assuming that the first examination contact is the deadline.2 Second, the office-procedures exception is applied return by return. A file that fails in isolation within an otherwise compliant sample is the case the exception was written for.

Example: 7-1: Which appeal path?

An examiner proposes 9 penalties at $665 against preparer Lena, for returns filed in 2027: 9 × $665 = $5,985. That is $25,000 or less, so Lena may request Appeals consideration by letter or with Form 12203. Her colleague faces 40 penalties: 40 × $665 = $26,600, which exceeds $25,000, so a formal written protest with the penalties-of-perjury declaration is required.

VIII. DESK REFERENCE AND PRE-SEASON CHECKLIST

Table 14. 2026–2027 numbers at a glance

Item	Amount	Authority
§ 6695(g) penalty, returns filed in 2026	$650 per failure; $2,600 maximum per preparer per four-benefit return	Rev. Proc. 2024-40, § 2.55
§ 6695(g) penalty, returns filed in 2027	$665 per failure; $2,660 maximum per preparer per four-benefit return	Rev. Proc. 2025-32, § 4.54
§ 6695(a)–(e), returns filed in 2027	$65 per failure; $33,000 cap per subsection for the applicable calendar year or return period	I.R.C. § 6695(a)–(e); Rev. Proc. 2025-32, § 4.54
2026 standard deduction	**Basic amounts:** MFJ $32,200; HOH $24,150; single/MFS $16,100 (dependent and other limits apply)	Rev. Proc. 2025-32, § 4.14
2026 qualifying-relative gross income limit	Gross income less than $5,300	Rev. Proc. 2025-32, § 4.23; § 152(d)(1)(B)
2026 EIC maximum	$664 (0 children); $4,427 (1); $7,316 (2); $8,231 (3+)	Rev. Proc. 2025-32, § 4.06
2026 EIC investment income limit	Credit denied if investment income exceeds $12,200	Rev. Proc. 2025-32, § 4.06; § 32(i)
2026 CTC / ACTC / ODC	$2,200 / $1,700 / $500	Rev. Proc. 2025-32, § 4.05; § 24(h)
2026 AOTC	Up to $2,500 per eligible student; up to 40% refundable	§ 25A(b)(1), (i)
2026 adoption credit	Maximum $17,670 (phaseout MAGI $265,080–$305,080); refundable portion up to $5,120	Rev. Proc. 2025-32, § 4.04; § 23(a)(4), (b)

Amounts shown are maximums, not automatic entitlements. Eligibility, income phaseouts, identification rules, and refundable-credit limits still apply.3

Table 15 restates the four requirements as a pre-season checklist for the storefront owner. Each item maps to the regulation or to a provision discussed above.

1 I.R.C. §§ 6532(a)(1)–(4), 7422(a); Treas. Reg. § 1.6696-1(j)(1), (j)(2)(i); 28 U.S.C. §§ 1346(a)(1), 1491(a)(1).

2 I.R.C. § 6751(b)(1); Treas. Reg. § 301.6751(b)-1(b), (f) (penalties assessed on or after Dec. 23, 2024).

3 No refundable AOTC for a child subject to § 1(g), § 25A(i) (last sentence). E.g., CTC/ODC phaseout above $200,000 MAGI ($400,000 MFJ), § 24(b), (h)(3); AOTC phaseout $80,000–$90,000 ($160,000–$180,000 MFJ), § 25A(d); AOTC four-year, half-time, and felony-drug limits, § 25A(b)(2)–(3).

Table 15. Pre-season due diligence checklist for the storefront owner

Item	Done when	Authority
Reasonable and appropriate procedures (written form recommended)	Procedures identify who determines each benefit, follow-up triggers, note format, review step, retention	§ 1.6695-2(c)(2), (d)
Staff training documented	Each preparer trained on the manual and the 2026 changes; attendance kept	§ 1.6695-2(d)
Software set up for notes and Form 8867	Note field required for 4a "Yes"; Form 8867 transmits; draft-to-final 8867 update installed	§ 1.6695-2(b)(1), (b)(3)
Line 5 discipline	Only retained documents listed	§ 1.6695-2(b)(4)(i)(C)
Pre-filing review	Second look at files claiming all four benefits or with Schedule C	§ 1.6695-2(d)
2026 identification checks	SSN type and issue date for CTC/AOTC; dependent student SSN; school EIN	§§ 24(h)(7), 25A(g)(1)
Schedule 3-A readiness	Status of REG-119882-25 confirmed; intake question on citizen/national/qualified-alien status ready if final	Prop. Treas. Reg. §§ 1.24-3, 1.32-4
Retention and security	Three-year schedule from latest § 1.6695-2(b)(4)(ii) date; WISP updated	§ 1.6695-2(b)(4)(ii); 16 C.F.R. § 314.3(a)
Refund handling	No client refund routed to any account the office controls	§ 6695(f)
Response plan	Representative identified before any letter arrives	IRM 20.1.6.16.1

RENÉE'S CASE, RESOLVED

In November 2027, Darlene Pruitt opened Letter 6199. She called her representative, an enrolled agent who handles preparer examinations, that afternoon. The representative responded within the 14 days, scheduled the visit, and asked for the four items in the Practice Pointer in **Section** VII.B. When the examiner selected the sample from returns filed in the 2027 season, Renée Calloway's return was in it.

The representative began with the question a hostile examiner would ask: what would this file have looked like if Tony had filed his first pass? The answer is in the workpaper below. Every one of the four benefits on Renée's return had an unresolved trigger. The marital-status inconsistency and the household-cost question went to HOH. The zero-expense Schedule C went to the EIC **(Treas. Reg. § 1.6695-2(b)**(3)(ii)(G), Example 7). The other parent's stated claim went to the CTC/ODC category. The Form 1098-T without scholarship information went to the AOTC **(Example 8)**.

Workpaper: The file that was not filed: Tony's first pass

```
Benefit       Trigger present             Inquiry/notes  Result
HOH           "Single" vs. husband;       None           Failure
              household costs unknown
EIC           $6,000 Sch. C, $0 expenses  None           Failure
CTC/ACTC/ODC  Other parent "claiming"     None           Failure
AOTC          1098-T only; box 5 ignored  None           Failure
-------------------------------------------------------------
Failures on this return ....................... 4
Rate, returns filed in 2027 (Rev. Proc. 2025-32, sec. 4.54) $665
Exposure: 4 x $665 ............................ $2,660
Firm exposure under 1.6695-2(c) depends on its procedures;
if (c) applies, the firm cannot use the 1.6695-2(d) exception.
```

The file that was actually filed is different, because Darlene caught the first pass at her pre-filing review step and sent Tony back to the client. On the stipulated facts it documents, the modeled file shows no failure. That assumes the final Form 8867 revision is used, the filing calculations are finalized, and retention continues. Requirement 1 is met because the signing preparer e-filed the completed Form 8867 with Renée's return and retained a copy. Its answers are honest: line 4a "Yes," lines 4b and 4c "Yes" with the numbered note, and line 5 listing only the documents actually retained. Requirement 2 is met by the software worksheets computed from corrected inputs. Requirement 3 is met by Tony's note, which identifies each trigger, records the questions and answers with date, time, interviewer, and respondent, and states the effect on the return. Requirement 4 is met

by a retained file containing every listed document, including Renée's Form W-2, kept on the office's backed-up document system with a retention date of April 15, 2030. On HOH, the note establishes the § 7703(b) elements, not just Dwayne's departure. She files separately, and Dwayne was not a member of the household after February 28, 2026. Lily and Marcus lived in her home all year, and she paid about 90 percent of the household costs. On the CTC and ODC, it records that both children lived with Renée all year and that neither provided over half of his or her own support or filed a joint return. It also records that no Form 8332 was signed and that the line 12 explanation was given. On the EIC, the Schedule C income and expenses were reconstructed from records the client produced. On the AOTC, the note records who paid the tuition and when, full-time enrollment from August through December, and no other aid. The Pell grant was subtracted, the required books were added, and the 2026 identification and school-EIN requirements were checked.

Table 16. The file that was filed: Renée's return against the four requirements

Benefit	Requirement 1 (Form 8867)	Requirement 2 (worksheets)	Requirement 3 (knowledge)	Requirement 4 (records)	Result
HOH	Part V, line 14	N/A (HOH alone needs no worksheet)	Note items 1, 5	Note retained	No failure shown on stipulated facts
EIC	Part II, lines 9a–9c	EIC worksheet	Note items 2, 3, 5, 6	Form W-2, payment-app history, card statement, permit receipt, SSN cards	No failure shown on stipulated facts
CTC/ ACTC/ ODC	Part III, lines 10a–12	Schedule 8812 worksheets	Note items 2, 5, 6	Form W-2 (earned income for ACTC), SSN cards; note retained	No failure shown on stipulated facts
AOTC	Part IV, lines 13a–13b	Form 8863 worksheet	Note items 4, 5, 6	1098-T, account statement, book receipts, SSN cards	No failure shown on stipulated facts

Failures shown on the stipulated facts: 0. Modeled exposure: $0, a conditional teaching result, not an assurance. Requirement-to-record mapping follows Treas. Reg. § 1.6695-2(b)(1)–(4).

Two other files in the sample were not as clean. In one, a preparer had resolved a residency question in conversation but had not written it down, and every other file that preparer prepared in the sample was complete. The representative argued the office-procedures exception for that single return: written procedures reasonably designed, training records, a pre-filing review step routinely followed, and one isolated and inadvertent lapse. In the other, a preparer had copied the prior year's household answers forward without reconfirming them, and the client's adult son had moved back in during 2026. The preparer knew of the move but left the household-cost questions unresolved. The move alone did not end HOH status. The representative conceded that file on HOH and argued that the EIC inquiry on the same return had been made and documented. Because § 6695(g) is assessed benefit by benefit, the concession cost one penalty, not four.

Four habits at the desk kept Renée's file from becoming a penalty. Tony noticed what did not fit, asked a factual question, wrote down the answer at the time, and kept what he relied on. Those habits, together with a complete Form 8867, the worksheets, and the retained records, are what the four requirements call for. For the people in a storefront room, the frightening part of § 6695(g) is the multiplication, and the remedy is a repeatable routine applied to every file.

SCHEDULE E IN THE REAL WORLD: RESIDENTIAL RENTAL ACTIVITIES



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(02) Program # A5BAX-T-00146-26-I

Course Details	
Name of the CE Provider	AmData
Program name	**Schedule E in the Real World:** Residential Rental Activities
IRS program number	A5BAX-T-**00146-26**-I
CE	2
Prerequisite	Basic understanding of individual income tax principles and joint tax filing. **Field of Study:** Taxes
Advanced Preparation	None
Program Level	Basic
Delivery Method:	Live in-person
Field of Study:	Federal Tax Law Topics/Federal Tax Related Matters - A program designed to enhance professional knowledge in Federal Tax related matters.



ABSTRACT

This student text accompanies a 100-minute live program on the federal income tax treatment and reporting of residential rental activities on Schedule E **(Form 1040)**, Part I. It is written for working preparers who sit across the desk from landlords every filing season: people who know the Form 1040 well but who see rental property in all of its untidy variety, from the former home that became a rental when the family moved, to the beach condo listed on a booking platform, to the spare bedroom rented to a traveling nurse.

Definitions:

- **Fact-Driven Education:** This program is focused on providing accurate, up-todate information about tax laws, regulations, and administrative updates as they stand today.
- **Non-Political Content:** All discussions are strictly factual and are not intended to express or imply any political opinions or preferences.
- **Commitment to Professionalism:** Our shared responsibility as tax professionals is to understand and apply the law, ensuring compliance and effective client representation.

Focus on Practice: This program prioritizes practical, actionable knowledge to support your work, free from bias or interpretation beyond what the law provides.

THE FIRST CALL

Rosa Delgado calls the office on a Tuesday in late January 2027 about the couple's 2026 return. She and her husband Kevin have been clients for years, always a simple joint return: two W-2s, a mortgage, the standard deduction. This year will be different, and she wants to get ahead of it.

For this illustration, assume the Delgados moved into a larger house on March 31, 2026. Rather than sell their old home at 214 Maple Street, they held it out for rent on April 1, 2026, and signed a one-year lease with a tenant who moved in May 1, 2026. The tenant paid the first month's rent, the last month's rent, and a security deposit at signing. Kevin is handling the landlord duties himself.

The Delgados also own a beach condo they bought in 2021. It has been listed on a short-term booking platform since the summer they bought it, and for five years it was reported on a Schedule E prepared by another office. Rosa has a binder of that preparer's returns. In 2026 the condo was booked for 168 nights across 41 separate guest stays. The family used it themselves for nine nights over the Fourth of July. Rosa handles guest messages, pricing, restocking, and coordinating a cleaning company that turns the unit over between guests; she has kept a calendar of her time. In March they replaced the condo's furniture for $9,000. The platform did not send a Form 1099-K.

Rosa's question is the one storefront preparers hear every season in some form: "Everybody online says an Airbnb can lower your taxes. The condo lost money this year once you count everything. Can we use that loss against our wages? And while you're at it, was the old preparer doing this right?"

Answering her takes nearly the whole of this program. The condo's average guest stay is about four days, which changes how the passive activity rules see it. Rosa's calendar may or may not establish material participation. The nine personal nights change how the mortgage interest is split, and change whether the personal share is deductible at all. The furniture purchase raises a bonus depreciation question that recent legislation reopened. The Maple Street house is a converted residence, which brings its own basis rule. And the binder from the prior preparer contains five returns that never claimed a dollar of depreciation on the condo, which matters now and will matter more on the day the condo is sold.

We will return to the Delgados throughout the text, and resolve their file in the final section.

I. INTRODUCTION

A. Scope, Audience, and the Tax Year

This text is written for experienced preparers who are not necessarily enrolled agents, CPAs, or attorneys. It assumes the reader has prepared many Forms 1040 and knows the shape of Schedule E. It does not assume the reader has worked with Form 8582, Form 3115, or the tangible property regulations, and it defines the vocabulary of those areas before using it.

The scope is federal. State conformity to the federal depreciation, passive loss, and § 199A rules varies; those differences are outside this program and should be checked state by state. Federal classification also does not answer state or local questions. For any short-term rental, separately confirm, for the jurisdiction where the property sits, lodging or occupancy tax registration and remittance, whether a platform collects as a marketplace facilitator, local licensing or permit requirements, and whether the owners must file a nonresident income tax return. None of those obligations follows from the federal analysis in this text.

The baseline year is tax year 2026, the returns attendees will prepare in the 2027 filing season. Because the 2025 reconciliation act, Public Law 119-21 **(commonly called the One Big Beautiful Bill Act, or OBBBA)**, changed several rental-related figures and rules mid-stream, 2025 figures are shown alongside 2026 figures where they differ. The table below collects the figures used throughout the text.

Table 1. Current-law figures used in this text (tax years 2025 and 2026)

Item	2025	2026	Authority
Standard mileage rate, business	70¢ per mile	72.5¢ (Jan. 1–June 30); 76¢ (July 1–Dec. 31)	Notice 2025-5; Notice 2026-10; Ann. 2026-11

Item	2025	2026	Authority
Form 1099-NEC / 1099-MISC threshold (payments to service providers)	$600	$2,000 (indexed after 2026)	I.R.C. § 6041(a), (h); Rev. Proc. 2025-32, § 2.15
Form 1099-K federal threshold (third-party networks)	More than $20,000 and more than 200 transactions	Same	I.R.C. § 6050W(e)
Bonus depreciation	100% for qualified property acquired after Jan. 19, 2025 (election for 40%); prior phase-down for earlier acquisitions	**100% for qualified property acquired after Jan. 19, 2025 (written-binding-contract rules apply):** recovery period 20 years or less, original use or qualifying used property, not required to use ADS, no election out for the class. Acquired before Jan. 20, 2025: verify the applicable percentage separately	I.R.C. § 168(k)(1), (2)(A), (2)(D), (2)(E)(ii); Pub. L. 119-21, § 70301; Notice 2026-11
Section 179 dollar limit / phase-out start	$2,500,000 / $4,000,000	$2,560,000 / $4,090,000	Rev. Proc. 2025-32, §§ 3.02, 4.24
Section 199A threshold (MFJ / other)	$394,600 / $197,300	$403,500 / $201,750 (MFS $201,775)	Rev. Proc. 2024-40, § 2.27; Rev. Proc. 2025-32, § 4.26
Section 199A phase-in range (MFJ / other)	$100,000 / $50,000	$150,000 / $75,000	I.R.C. § 199A(b)(3)(B), (d)(3)
Section 199A minimum deduction	Not applicable	$400 (if at least $1,000 of active QBI)	I.R.C. § 199A(i)
Excess business loss threshold (MFJ / other)	$626,000 / $313,000	$512,000 / $256,000	Rev. Proc. 2024-40, § 2.32; Rev. Proc. 2025-32, § 4.31
Passive loss special allowance and phase-out	$25,000; phased out between $100,000 and $150,000 MAGI	Same (not indexed)	I.R.C. § 469(i)(2), (3)(A)
De minimis safe harbor (no AFS / with AFS)	$2,500 / $5,000 per invoice or item	Same	Treas. Reg. § 1.263(a)-1(f)(1); Notice 2015-82

The 2026 Form 1040 instructions, Schedule E instructions, and related forms were not final when this text was prepared. Line references follow the 2025 forms, which the 2026 drafts are expected to track; confirm against the final 2026 forms before filing season.

B. A Word on Authority

A preparer who answers a landlord's question is choosing among sources of very different weight, and the difference matters both to the answer and to the preparer's own exposure. At the top sits the Internal Revenue Code. Below it are Treasury regulations, final and temporary, which carry the force of law within their authority; a few of the rules in this text still live in temporary regulations issued in the late 1980s that have never been finalized, and they remain binding. Proposed regulations are not binding on taxpayers, though they show the government's position and are often followed in practice. Revenue rulings and revenue procedures published in the Internal Revenue Bulletin bind the IRS and may be relied on by taxpayers in like facts. Regular Tax Court opinions and appellate decisions are precedent.

Several sources this text uses are not precedent, and are labeled each time they appear. Chief Counsel Advice may not be used or cited as precedent.1 Tax Court summary opinions, issued in small-tax-case procedure, are

1 I.R.C. § 6110(k)(3).

not precedent for any other case.1 IRS FAQs posted on irs.gov are not published in the Bulletin and are not authority. Audit Technique Guides are examiner training material. IRS publications and form instructions are indispensable for filing mechanics, but they are not law, and the IRS is not bound by them. These sources are used here to show how the IRS reads the rules in examination, which is often exactly what a storefront preparer needs to know, but they should never be the only support for a return position.2 A practitioner who leans on a blog post or an AI summary against a regulation will learn the outcome of that contest the hard way.3

C. Professional Responsibility at the Schedule E Desk



Rental returns are where diligence obligations become concrete, and it matters which rules bind whom. Internal Revenue Code preparer requirements, including §§ 6694 and 6713, apply according to their terms to every paid preparer. Circular 230 duties apply to attorneys, CPAs, enrolled agents, and other practitioners, and to persons who undertake covered practice; merely preparing a return for compensation is not, by itself, practice before the IRS, and Annual Filing Season Program participants consent to specified Circular 230 duties.4 Those duties include due diligence in preparing returns and in determining the correctness of representations made to clients and to the IRS,5 and the knowledge, skill, thoroughness, and preparation needed for the matter, or acquiring it, or referring the work out.6 Every preparer should meet these standards as sound practice, whether

1 I.R.C. § 7463(b).

2 See Treas. Reg. § 1.6662-4(d)(3)(iii) (list of authorities for substantial-authority purposes).

3 But cf. Mellencamp, J.C., *Authority Song*, on *Uh-Huh* (1983) (on the outcome of contests with authority), https://youtu.be/wsEwK69LXjQ.

4 Loving v. IRS, 742 F.3d 1013 (D.C. Cir. 2014); IRS Office of Professional Responsibility, Issue No. 2026-5 (Feb. 17, 2026); Rev. Proc. 2014-42, 2014-29 I.R.B. 192.

5 31 C.F.R. § 10.22(a)(1)–(3) (Circular 230, diligence as to accuracy).

6 31 C.F.R. § 10.35(a) (competence).

or not Circular 230 reaches the engagement. Several topics in this text, Form 3115 in particular, are ones where the honest answer at a storefront office may be to refer the engagement or bring in a reviewer. Under § 6694(a), an undisclosed position needs substantial authority; a properly disclosed position needs a reasonable basis; and a position with respect to a tax shelter or a reportable transaction to which § 6662A applies needs a reasonable belief that it is more likely than not to be sustained on its merits. Under § 6694(a)(3), no unreasonable-position penalty is imposed if the understatement was due to reasonable cause and the preparer acted in good faith; that exception does not apply to the willful or reckless conduct penalty under § 6694(b), and if both penalties apply to the same return, the § 6694(b) penalty is reduced by the § 6694(a) penalty paid. Adequate disclosure generally means disclosure on the return under § 1.6662-4(f), on Form 8275 or 8275-R or as permitted by the annual adequate-disclosure revenue procedure. A signing preparer may also meet the standard by furnishing the client a return containing that disclosure and, for penalties other than the substantial-understatement penalty, by advising the client of the applicable penalty standards and documenting that advice contemporaneously; nonsigning preparers follow separate rules. A workpaper memo alone is not disclosure. Disclosure lowers the preparer standard to reasonable basis; it does not rescue a position lacking a reasonable basis, and the taxpayer's own penalty standards must be analyzed separately.1 Reliance on a prior preparer's schedules or a client's spreadsheet satisfies due diligence only if the reliance is reasonable after appropriate inquiry.2 A covered practitioner who gives a client written advice about a federal tax matter, such as a memo explaining whether the condo activity is nonpassive, must comply with Circular 230 § 10.37. That includes an Annual Filing Season Program participant, whose consent extends to the Circular 230 subpart B duties, of which § 10.37 is one. Preparers outside its coverage should use those standards as sound practice without treating that recommendation as an extension of OPR jurisdiction.3

For a particular position, the preparer penalty applies to the one individual within the firm who is primarily responsible for it. The signing preparer is generally presumed to be that person, but a nonsigning preparer in the same firm who gave the advice, such as the reviewer of a Form 3115, can be treated as primarily responsible instead; within the same firm the penalty is not imposed on both the signer and a nonsigning individual for that position.4 Identifying the responsible individual does not end the analysis: the firm that employs the individual, or of which the individual is an owner, may also be subject to the penalty under the conditions in the regulations.5 The penalty for an understatement due to an unreasonable position is the greater of $1,000 or 50 percent of the income derived **(or to be derived)** by the preparer with respect to the return; for willful or reckless conduct it is the greater of $5,000 or 75 percent.6 Software defaults, a client's spreadsheet, or a prior preparer's schedules do not shift that responsibility. And a practitioner who knows that a client has not complied with the revenue laws, or has made an error or omission on a return, must promptly advise the client of it and of its consequences under the Code and regulations.7 Document the notice, the proposed permissible correction, and the client's decision. The duty to advise is not authority to amend a return or to disclose the matter to the IRS.

Rental files are also dense with client data: leases with tenant names, closing disclosures, bank statements, and platform reports. A preparer who knowingly or recklessly discloses or uses return information other than as permitted by § 7216(b) and the regulations under it faces criminal exposure, and § 6713 imposes a civil penalty for improper disclosure or use; statutory and regulatory exceptions exist, so obtain written consent for any use or disclosure not clearly covered by one,8 and paid preparers are subject to the FTC Safeguards Rule and its written information security plan requirement.9 A § 7216 consent must be obtained before the disclosure or use; it must be knowing and voluntary, signed and dated, name the preparer and the taxpayer,

1 I.R.C. § 6694(a)(2)–(3), (b)(3); Treas. Reg. § 1.6694-2(d)(2)–(3).
2 31 C.F.R. § 10.22(b); see 31 C.F.R. § 10.34(d).
3 31 C.F.R. § 10.37(a)(1)–(2) (written advice); Rev. Proc. 2014-42, 2014-29 I.R.B. 192; IRM 25.20.3.1.1(3).
4 Treas. Reg. § 1.6694-1(b)(1)–(4).
5 Treas. Reg. §§ 1.6694-1(b)(5), 1.6694-2(a)(2), 1.6694-3(a)(2).
6 I.R.C. § 6694(a)(1), (b)(1).
7 31 C.F.R. § 10.21.
8 I.R.C. §§ 6713(a), 7216(a)–(b); Treas. Reg. §§ 301.7216-2 (permitted disclosures and uses), 301.7216-3(a) (written consent).
9 16 C.F.R. §§ 314.3(a), 314.4 (Safeguards Rule program and elements); see IRS Pub. 4557.

specify the information, and describe the purpose and, for a disclosure, the recipient. Uses and disclosures require separate consent documents, Form 1040 consents must follow the IRS-prescribed format, and disclosure of Social Security numbers to a preparer outside the United States requires additional safeguards. A general engagement-letter clause is generally insufficient, for example, to send a rental file to an outside Form 3115 reviewer.1 Finally, unenrolled preparers should keep the limits of their practice rights in view. Annual Filing Season Program participants may represent clients only in limited circumstances involving returns they prepared and signed.2 A rental client who receives an examination notice or wants a method change negotiated may need an enrolled practitioner.

II. THE SCHEDULE E HEADER, SHORT-TERM RENTALS, AND RENTAL INCOME

A. Who Files Part I, and the Header Lines

Schedule E, Part I is where an individual reports income and expense from rental real estate held directly, including property held in a single-member LLC that is disregarded for federal tax purposes. A partnership or S corporation reports rental real estate activity on Form 8825; a nonrental trade or business lodging operation owned by the entity is reported in the entity's ordinary business income and deductions, not automatically on Form 8825.3 Classify the activity under § 469 first; individual Schedule C/E routing does not substitute for entity-return classification. The owner reports the resulting Schedule K-1 items in Schedule E, Part II. Each Schedule E page holds three properties in columns A, B, and C. A landlord with more than three properties attaches additional pages, but completes the summary lines **(23a through 26)** on only one of them.4

Line 1a asks for the physical address of each property, including city, state, and ZIP code. Line 1b asks for a property-type code: 1 for a single-family residence, 2 for a multi-family residence, 3 for a vacation or short-term rental, 4 for commercial, 5 for land, 6 for royalties, 7 for self-rental, and 8 for other.5 The code is not cosmetic. Code 7 flags property rented to a business in which the taxpayer materially participates, which triggers the self-rental recharacterization rule discussed in Part VI, and code 3 signals to an examiner that the personal-use rules and the short-term rental analysis are in play.

Line 2 asks for fair rental days and personal use days for each dwelling-unit property, and contains the QJV box. Those day counts drive the allocation of expenses and the vacation-home limit discussed in Part IV, so they are not a formality either. The QJV box lets a married couple filing jointly, who are the only owners of a rental real estate business not held in a state-law entity and who both materially participate, elect to be treated as a qualified joint venture rather than a partnership.6 The spouses do not file separate Schedules E. Instead, each spouse reports his or her interest as a separate property on line 1 of the joint Schedule E, checks the QJV box on line 2 for each, and enters his or her share of income and expenses on lines 3 through 22 for that separate property interest.7 Each spouse must independently materially participate, without the spousal attribution that applies elsewhere in § 469.8 Spouses who simply co-own a rental as tenants by the entirety, without the activity rising to a partnership, generally report it together on their joint Schedule E without a QJV election. Married owners of an LLC in a community-property state have a separate path to disregarded-entity treatment.9

Practice Pointer: The Delgados' header
The Maple Street house is code 1, with 245 fair rental days (May 1 through December 31) and zero personal use days for the rental period. Keep the 90 actual principal-residence days (January 1 through March 31) in the file separately: the qualified-rental-period rule explained in Part IV disregards them only for the § 280A(c)(5) residence test, and conversion-year expenses are still allocated by period. Confirm how these days are entered against the final 2026 Schedule E line 2 instructions and the software. The beach condo is code 3, with 168 fair rental days and 9 personal use days. The Delgados own both

1 Treas. Reg. § 301.7216-3(a)–(c).
2 Rev. Proc. 2014-42, 2014-29 I.R.B. 192 (Annual Filing Season Program; limited representation).
3 Instructions for Form 8825, "Don't report on Form 8825."
4 Instructions for Schedule E (Form 1040) (2025), Part I.
5 Instructions for Schedule E (Form 1040) (2025), line 1b.
6 I.R.C. § 761(f)(1)–(2).
7 Instructions for Schedule E (Form 1040) (2025), line 2 (QJV).
8 I.R.C. § 761(f)(2)(B).
9 Rev. Proc. 2002-69, § 4, 2002-2 C.B. 831.

properties together and file jointly. For this text, assume their arrangement is mere co-ownership of property and not a partnership under federal law. If the facts showed a jointly operated business rising to a partnership, a QJV election would be unavailable unless each spouse independently materially participates (Kevin's 30 hours cannot borrow Rosa's for this purpose), and a Form 1065 analysis would be required. Classification turns on federal law, not on state title form or an LLC label.1

B. Short-Term Rentals: Two Separate Tests

Every short-term rental requires two independent analyses that new preparers routinely blur. The first asks whether the activity is a "rental activity" for the passive activity loss rules of § 469. The second asks whether the net income is self-employment income, which determines whether it belongs on Schedule C **(with self-employment tax)** or Schedule E **(without it)**. The answer to one does not determine the answer to the other. The IRS said as much in a 2021 Chief Counsel memorandum, which is not precedent but which states the examination position clearly: whether an activity is a rental activity under § 469 "is not determinative" of whether the rental exclusion from self-employment income applies.2

Test A: Is it a "rental activity" under § 469? The statute defines a rental activity as any activity where payments are principally for the use of tangible property.3 Rental activities are passive by definition, without regard to how many hours the owner works.4 The temporary regulations then remove several arrangements from the definition. The two that matter at a storefront office are an average period of customer use of seven days or less, and an average period of customer use of 30 days or less where significant personal services are provided by or on behalf of the owner.5 A third removes any arrangement in which extraordinary personal services are provided, regardless of stay length, such as a hospital or boarding school.6 Services needed to permit lawful use of the property, construction of improvements, and services similar to those commonly provided with long-term rentals of high-grade residential or commercial property **(common-area cleaning, routine repairs, trash collection, security)** are excluded in deciding whether personal services are significant.7

When an arrangement falls out of the rental-activity definition, it is not automatically nonpassive. The exception removes the activity from the rental-activity definition for § 469 only; it does not by itself establish a § 162 trade or business, self-employment income, § 199A eligibility, or the building's recovery period. For a qualifying nonrental trade or business activity, passive status then turns on whether the owner materially participates under the seven tests discussed in Part VI.8 Determine § 162 status separately, on continuity, regularity, and profit motive. That is the mechanism behind what social media calls the "short-term rental loophole," and it cuts both ways: the same exclusion that opens the door to nonpassive treatment also closes the $25,000 active-participation allowance, which is available only for rental real estate activities.9

Test B: Is the net income self-employment income? Rentals from real estate are excluded from net earnings from self-employment.10 The regulations draw the line at services rendered to the occupant. Payments for the use of entire residences or units in multiple-housing buildings are generally rentals from real estate. But where services are rendered "primarily for [the occupant's] convenience" and are "other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only," the payments are not rentals from real estate; maid service is the regulation's example, while heat, light, cleaning of public areas, and trash collection are not services to the occupant.11 The Schedule E instructions translate the rule into a filing instruction: if the landlord provided significant services to the renter, such as maid service, the activity goes on Schedule C, not Schedule E.12

1 I.R.C. § 761(f)(1); Treas. Reg. § 301.7701-1(a)(2).
2 CCA 202151005 (Nov. 19, 2021) (non-precedential, I.R.C. § 6110(k)(3)).
3 I.R.C. § 469(j)(8).
4 I.R.C. § 469(c)(2), (4).
5 Temp. Treas. Reg. § 1.469-1T(e)(3)(ii)(A)–(B).
6 Temp. Treas. Reg. § 1.469-1T(e)(3)(ii)(C), (v).
7 Temp. Treas. Reg. § 1.469-1T(e)(3)(iv)(A)–(B).
8 I.R.C. § 469(c)(1); Temp. Treas. Reg. § 1.469-5T(a); Treas. Reg. § 1.469-4(b)(1).
9 I.R.C. § 469(i)(1).
10 I.R.C. § 1402(a)(1).
11 Treas. Reg. § 1.1402(a)-4(c)(1)–(2).
12 Instructions for Schedule E (Form 1040) (2025), Part I (Schedule C vs. Schedule E).

The 2021 Chief Counsel memorandum applied that rule to two short-term rentals, each with a seven-day average stay and an owner who materially participated. A furnished vacation property with daily maid service, toiletries, beach equipment, and prepaid ride-share vouchers produced self-employment income, because the services went beyond what was required to maintain the space for occupancy. A furnished room and bath cleaned between guests did not, because cleaning to bring the space to a suitable condition for the next occupant is not furnished primarily for the occupant's convenience. The memorandum's standard asks whether the services are not clearly required to maintain the space and are substantial enough that the compensation for them "can be said to constitute a material portion of the rent."1 The memorandum assumes a § 162 trade or business and no personal use. Its services analysis informs the § 1402 question; it does not determine § 162 or § 199A status and does not dispose of a separate § 280A analysis.

Caution: Two different service standards
The "significant personal services" test under the § 469 regulations and the "services rendered to the occupant" test under the § 1402 regulations use different words, sit in different regulations, and serve different purposes. Do not reason from one to the other. In particular, the self-employment rule has no 30-day cutoff: a landlord who provides maid service to tenants staying 45 days can still have self-employment income, even though that arrangement remains a rental activity for § 469.

Computing the average period of customer use. The operative rule is in the final regulations. Each period during which a customer has a continuous or recurring right to use the property, whether under one agreement or renewals of it, is one period of customer use; two independent bookings with no continuing or recurring entitlement, such as a July stay and a December stay, are two periods. A continuous or recurring right under one agreement or its renewals may be a single period despite separate invoices or booking records, so determine the legal right first. For a single class of property, divide the total days in the periods of customer use that end during the year **(or include the last day of the year)** by the number of those periods, using reasonable estimates for a stay that crosses year-end.2 There is no rounding: an average of 7.4 days is more than seven days. Property may be grouped into classes, but items whose daily rent differs significantly may not share a class, and multiple classes are combined using weighted average-use factors; this is rarely relevant to a single-unit landlord.3

Example 1. Average period of customer use

```
Facts: Whole-house rental, 170 nights booked in 39 separate stays.
Step 1. Total days in rental periods ....................... 170
Step 2. Number of rental periods (stays) ..................... 39
Step 3. Average period of customer use = 170 / 39 = 4.3590 days
        (displayed as 4.36; the test applies the unrounded quotient)
Conclusion: 4.36 is 7 days or less. Not a "rental activity" under § 469.
If it is a trade or business (a separate § 162 question), it is
passive unless the owner materially participates.

Delgado condo: 168 nights / 41 stays = 4.0976 days (displayed as
4.10). Same conclusion.
```

The table below combines the two tests. Answer the two service columns separately; a Yes in one does not imply a Yes in the other. Every row except the last assumes no extraordinary personal services and no other exception to the rental-activity definition. "Yes" in the NESE column means inclusion in net earnings from self-employment, not positive tax liability; actual tax depends on annual net earnings **(no self-employment tax if they are under $400)** and other statutory rules.4 The table assumes the individual is not a real estate dealer. In the table, note 1 means: not a rental activity under § 469; passive unless the owner materially participates, with § 162 status determined separately. Note 2 refers to the NESE explanation above. REP means real estate professional.5 It reconciles a contradiction in one widely used instructor text, whose narrative placed the first tier on Schedule C even though its own table placed it, correctly, on Schedule E.

1 CCA 202151005, Conclusions 1–2 (non-precedential).
2 Treas. Reg. § 1.469-1(e)(3)(iii)(C)–(D).
3 Treas. Reg. § 1.469-1(e)(3)(iii)(A)–(B), (E)–(F).
4 I.R.C. § 1402(b)(2); Treas. Reg. § 1.1402(a)-4(a).
5 Temp. Treas. Reg. § 1.469-1T(e)(3)(ii)(C)–(F).

Table 2. Short-term rental classification: § 469 and self-employment tests (answer each service column separately)

Average stay	Significant personal services, Temp. Reg. § 1.469-1T(e)(3)(iv)?	Services rendered to the occupant, Reg. § 1.1402(a)-4(c)(2)?	Where reported	In NESE, not excluded as rent? (note 2)	§ 469 status	$25,000 allowance?
7 days or less	Either	No (turnover cleaning, utilities, trash, routine repairs)	Schedule E	No	Not a rental activity (note 1)	No
7 days or less	Either	Yes (daily maid service, meals, concierge)	Schedule C	Yes	Not a rental activity (note 1)	No
More than 7 days, through 30 days	Yes	Yes	Schedule C	Yes	Not a rental activity (note 1)	No
More than 7 days, through 30 days	Yes	No	Schedule E	No	Not a rental activity (note 1)	No
More than 7 days, through 30 days	No	Yes	Schedule C	Yes	Rental activity; passive absent REP status	Yes, if active participation
More than 7 days, through 30 days	No	No	Schedule E	No	Rental activity; passive absent REP status	Yes, if active participation
More than 30 days	Not relevant	Yes (maid service or similar)	Schedule C	Yes	Rental activity; passive absent REP status	Yes, if active participation
More than 30 days	Not relevant	No	Schedule E	No	Rental activity; passive absent REP status	Yes, if active participation
Any average stay, with extraordinary personal services (e.g., hospital, boarding school)	Not applicable (extraordinary services control)	Determine separately	Determine Schedule C or E and SE treatment separately	Determine separately	Not a rental activity (note 1)	No

The table does not include a building life column, because the recovery period for a short-term rental building turns on a separate question, whether the units are used on a transient basis, which is taken up in Part V.

C. Forms 1099-K and 1099-MISC

Platform reporting changed twice in four years and then reverted. The 2021 legislation that would have lowered the Form 1099-K threshold to $600 was repealed retroactively in 2025, and the statute again requires a third-party settlement organization to report only when gross payments exceed $20,000 and the number of transactions exceeds 200.1 Bookings and reportable transactions are not necessarily the same count **(installments, modifications, and separately processed fees can each be transactions)**, so a host with 41 bookings will usually, but not necessarily, fall below the transaction test, and many short-term rental clients will arrive with no Form 1099-K at all. The $20,000/200 threshold applies to third-party network transactions; payment card transactions have no de minimis threshold. Platforms may still issue forms below the federal threshold, voluntarily or under state reporting rules. None of this changes taxability: rent is gross income whether or not any information return is filed.2

When a Form 1099-K does arrive, it reports gross payments, which typically include cleaning fees charged to guests and may include amounts the platform withheld for its own service fees. Reconcile the form to the platform's annual earnings report, report the host's gross rental income on Line 3, and deduct otherwise allowable host service fees **(Line 8 or Line 19)** and cleaning costs. Analyze occupancy taxes separately under the jurisdiction's legal-incidence and collection rules, as described below. Reconcile platform tax amounts separately. Who bears an occupancy tax, and in what capacity the host or the platform receives and remits it, depends on the law of the jurisdiction where the property sits. Whether amounts received as an agent or conduit are the host's rental income is a separate gross-income question that requires research under the jurisdiction's law; do not gross up income and claim an offset solely because a platform statement labels an amount occupancy tax. A deduction for the tax itself belongs only to the person on whom it is imposed.3 Property managers who collect rent for a landlord commonly report it on Form 1099-MISC, box 1.

Information reporting runs in the other direction, too. A landlord engaged in a trade or business who pays a service provider at or above the threshold in aggregate during the calendar year, by cash, check, or direct transfer, generally must file Form 1099-NEC: $600 for payments made in 2025 and $2,000 for payments made in 2026, indexed for inflation after 2026.4 Obtain a Form W-9 and classify the payee by tax status, not by name. Payments made by payment card or through a third-party payment network are within the § 6050W regime and generally are not also reported by the payer on Form 1099-NEC. That remains true even if the settlement organization files no Form 1099-K because the payee is below the $20,000 and 200-transaction threshold, because that threshold is disregarded for this coordination rule. Ordinary checks and direct bank transfers are not, by themselves, third-party network transactions.5 For 2026, attorneys' fees for services of $2,000 or more are reported on Form 1099-NEC, box 1a, including payments to incorporated firms; gross proceeds paid to an attorney in connection with legal services, but not for the attorney's services, remain subject to the $600 threshold on Form 1099-MISC, box 10.6 Confirm against the final 2026 instructions when released. The obligation becomes important in the § 199A discussion in Part VII.

D. The Fourteen-Day Rule

If a dwelling unit is used by the taxpayer as a residence during the year and is actually rented for fewer than 15 days, no deduction attributable to the rental use is allowed, and the rental income is excluded from gross income.7 Practitioners sometimes call this the "Masters rule," after Augusta-area homeowners who rent their houses during tournament week. The rule is generous but narrow. It applies only to a dwelling unit the taxpayer

1 I.R.C. § 6050W(e), as amended by Pub. L. 119-21, § 70432(a).
2 I.R.C. § 61(a)(5).
3 Treas. Reg. § 1.164-1(a) (taxes deductible only by the person on whom imposed).
4 I.R.C. § 6041(a), (h), as amended by Pub. L. 119-21, § 70433; Rev. Proc. 2025-32, § 2.15, 2025-45 I.R.B. 695.
5 Treas. Reg. § 1.6041-1(a)(1)(iv); Instructions for Forms 1099-MISC and 1099-NEC (Rev. Dec. 2026).
6 I.R.C. § 6045(f); Instructions for Forms 1099-MISC and 1099-NEC (Rev. Dec. 2026), Payments to attorneys.
7 I.R.C. § 280A(g).

uses as a residence under § 280A(d)(1), meaning personal use of more than the greater of 14 days or 10 percent of fair-rental days. Mortgage interest and real estate taxes on the home remain deductible on Schedule A under their own rules.

⊗ **Warning: The fourteen-day rule is not a "two-week rental" rule**
The exclusion applies only to a dwelling unit used as the taxpayer's residence. Renting vacant land for a festival, a commercial storefront for a weekend event, or an investment house the owner never lives in is fully taxable, however few days it is rented. A Form 1099-K may still arrive for an excluded home rental; no specific IRS instruction for reconciling it was located for this text, so document the exclusion and the day counts in the workpapers.

Example 2. Fourteen-day rule

```
Facts: Taxpayers live in their home all year except tournament week,
when they rent it for 7 days at $12,000 total.
Step 1. Used as a residence? Yes (personal use far exceeds 14 days).
Step 2. Rented fewer than 15 days? Yes (7 days).
Conclusion: $12,000 excluded from income; no rental deductions;
nothing reported on Schedule E. Interest and taxes stay on Schedule A.

Contrast: Same owners lease their entire vacant commercial lot for 3
days to an unrelated festival operator for $5,000 and provide no
services. Not a dwelling unit used as a residence.
Conclusion: $5,000 is taxable rent (Schedule E, Line 1b code 5).
If the owners themselves operate the parking, analyze Schedule C and
self-employment tax under Treas. Reg. § 1.1402(a)-4(c)(2).
```

E. What Goes on Line 3

Line 3 reports rents received. Most individual landlords use the cash method, but the regulation on advance rent overrides the method: "Except as provided in section 467 and the regulations thereunder and except as otherwise provided by the Commissioner in published guidance, . . . gross income includes advance rentals, which must be included in income for the year of receipt regardless of the period covered or the method of accounting employed by the taxpayer."1 **Section** 467 does not apply to rental agreements with aggregate payments of $250,000 or less, which covers typical residential leases.2 The same regulation treats a payment received from a tenant to cancel a lease as gross income in the year received, because it substitutes for rent; the Supreme Court reached the same result for a lease-cancellation payment and held it ordinary income.3

Security deposits require attention to the lease's terms, not the label on the check. A deposit the landlord expects to return is not income when received. If the landlord keeps part of it because the tenant damaged the unit or did not pay rent, that part is income in the year it is kept. A deposit that the lease says will be applied as the final month's rent is advance rent and is income when received.4 A refunded deposit is not deductible unless it was included in income in an earlier year.

When a tenant pays an expense that is the landlord's obligation and deducts it from rent, the payment is rental income to the landlord, and the landlord deducts it if it is otherwise a deductible rental expense. When the landlord receives property or services instead of money, the fair market value is rental income.5 A lease with an option to buy produces rent until the option is exercised, unless the arrangement is in substance a sale from the start.

Table 3. Line 3 situations

Situation	Line 3	Offsetting deduction
First and last month's rent received at signing	Both months, in the year received	None

1 Treas. Reg. § 1.61-8(b).
2 I.R.C. § 467(d)(2).
3 Treas. Reg. § 1.61-8(b); *Hort v. Commissioner*, 313 U.S. 28, 31 (1941).
4 IRS Pub. 527, ch. 1 (Security deposits) (2025).
5 IRS Pub. 527, ch. 1 (Expenses paid by tenant; Property or services) (2025).

Situation	Line 3	Offsetting deduction
Refundable security deposit	Nothing when received; amount kept, in the year kept	No offset is created by the retention itself; the cost of repairing the damage is deductible (or capitalized) under the ordinary rules when paid. A refund is not deductible unless previously included
Deposit to be applied as final month's rent	Full amount when received (advance rent)	None
Lease cancellation payment	Full amount when received	None
Tenant pays $400 plumber and deducts it from rent	Full rent, including the $400	$400 on Line 14 (repairs)
Tenant pays $300 for the landlord's personal wine order and deducts it	Full rent, including the $300	None (personal expense)
Tenant paints the unit in exchange for one month's $1,800 rent (assume the work is worth $1,800)	$1,800	$1,800 on Line 14 if standalone turnover painting not part of a betterment, restoration, or adaptation; otherwise capitalize
Landlord swaps one month of condo rent ($2,000) for a week at tenant's cabin (assume the cabin week's fair market value equals the $2,000 rent)	$2,000	None (personal vacation)

The last two rows of the table, both drawn from a widely used instructor text and known as "The Case of Wine" and "The Big Bear Cabin Swap," illustrate the same principle from opposite directions. Barter does not change whether income exists; it changes only the form in which it arrives. Whether there is an offsetting deduction depends entirely on whether the thing received would have been a deductible rental expense had the landlord paid cash. Standalone turnover painting usually is, although painting that directly benefits or is incurred by reason of an improvement is capitalized with it;1 a week of vacation is not. In the swap, the cabin owner who used the condo has the mirror-image problem if the cabin is a rental: the week given in exchange is rental income to the cabin owner. Barter produces rental income measured by the fair market value each owner receives. Day counts are separate and run unit by unit. Under § 280A(d)(2)(B), the days the tenant occupies the condo under the swap arrangement are personal-use days of the condo, unless § 280A(d)(3)(A) applies because the condo is rented at a fair rental for use as the tenant's principal residence **(Part IV)**. If the cabin is a rental, the landlord's week there counts as personal-use days of the cabin, not of the condo. In this example the condo occupancy is one month and the cabin occupancy is one week; the two units do not share a day count. Apply § 280A separately to each unit.2

Example 3. Delgado Maple Street, Line 3 for 2026

```
Lease signed April 2026; monthly rent $2,400; tenant in May 1.
At signing: first month $2,400 + last month $2,400 + deposit $2,400.
Step 1. Rent for May through December: 8 months x $2,400 ... $19,200
        (the first-month payment is May's rent and is within the $19,200)
Step 2. Last month's rent (April 2027), received 2026 ..... $ 2,400
Step 3. Security deposit (refundable; not applied to rent) ... $     0
Line 3, Maple Street ..................................... $21,600
```

III. DEDUCTIBLE OPERATING EXPENSES

A. Co-Owners and Partial Interests

Co-owners who hold rental property as tenants in common, without an agreement that makes them partners, each report their share of the income and deductions on their own Schedule E. The share follows ownership,

1 Treas. Reg. § 1.263(a)-3(g)(1)(i).
2 I.R.C. § 280A(d)(2)(B), (d)(3)(A).

not who wrote the checks. A recurring storefront problem is the co-owner who covers more than his share because the other owner cannot.

Example 4. "John and Joe": one owner covers the deficit

```
Facts: John and Joe own a rental 50/50 as tenants in common.
Rents $18,000; operating expenses and interest $22,000.
Joe has no money, so John pays the entire $4,000 shortfall. John
and Joe sign a note under which Joe must repay John's $2,000
advance with interest.
Step 1. Each owner's share of rents: $18,000 x 50% ........ $ 9,000
Step 2. Each owner's share of expenses: $22,000 x 50% ..... $11,000
Step 3. Each owner's net (before depreciation): ........... ($ 2,000)
Step 4. Because Joe is obligated to repay, John's payment is a loan
        to Joe, and Joe is treated as paying his $2,000 share with
        borrowed funds. John gets no additional deduction; Joe keeps
        his own.
Conclusion: Both report a $2,000 loss before depreciation. John has a
receivable from Joe; Joe's loss is subject to his own basis, at-risk,
and passive limits.
```

Real estate taxes add a timing wrinkle. A widely used instructor example, "Bob and Sam," has Bob pay the full $6,000 tax bill online in December, with Sam reimbursing him the next year, and concludes that each deducts $3,000 for the year Bob paid. The controlling regulation states the general rule that taxes "are deductible only by the person upon whom they are imposed."1 The instructor's result treats Bob's payment of Sam's share as a loan to Sam, applied on Sam's behalf, which is a defensible reading where the right of reimbursement exists and is documented. It is a facts-dependent conclusion, not a universal rule.

Caution: Co-owner tax payments

Allocate rental items consistently with ownership and the applicable payment and liability rules. For taxes, a co-owner's deduction also turns on the person on whom the tax is imposed, actual payment, any joint or several liability under the applicable state or local law, and bona fide reimbursement or loan facts. Paying another owner's share does not automatically establish a loan; where there is no expectation of reimbursement, the payment may be a gift or a contribution, and the deduction analysis changes. Document the reimbursement arrangement in the file, and research the specific facts before taking any position other than pro-rata.

Tax software adds its own trap. Many programs apply the ownership-percentage field on Schedule E to income and expenses but do not carry it into the depreciation module, so a 50-percent owner can end up claiming 100 percent of the building's depreciation. A practical workaround is to enter only the client's dollar share of every item at 100 percent and label the property clearly, for example "123 Maple St **(50% share)**," so that the depreciation schedule, the Form 4562, and the Schedule E all describe the same half interest. Whatever method the software requires, tie the depreciation back to the client's share before signing.

B. The Expense Lines

The expense lines are familiar, and most of them need little comment: advertising **(Line 5)**, cleaning and maintenance **(Line 7)**, commissions **(Line 8)**, insurance **(Line 9)**, legal and other professional fees **(Line 10)**, management fees **(Line 11)**, repairs **(Line 14)**, supplies **(Line 15)**, and utilities **(Line 17)**. Two points are worth emphasizing. First, the portion of a return-preparation fee allocable to Schedule E, Part I is a rental expense reported on Line 10, not a nondeductible personal expense; rental deductions, including § 212 expenses attributable to property held for the production of rents, are allowed above the line. Rev. Rul. 92-29 reaches the same result for the Schedule C portion of a return. Allocate the remainder of the fee separately.2 Second, rental expenses must be ordinary and necessary expenses of producing rental income; a landlord's personal costs do not become rental expenses because they are paid from the rental account.3

Line 16, taxes. Real estate taxes on rental property are deducted on Schedule E, where they are not subject to the state-and-local-tax limitation that applies on Schedule A; that limitation does not reach taxes paid in

1 Treas. Reg. § 1.164-1(a) (flush language following para. (a)(5)).

2 I.R.C. § 62(a)(4); Instructions for Schedule E (Form 1040) (2025), line 10; IRS Pub. 527 (2025); Rev. Rul. 92-29, 1992-1 C.B. 20.

3 I.R.C. §§ 212, 262(a).

carrying on a trade or business or a § 212 activity.1 A cash-method landlord deducts taxes in the year paid, so a December payment of the next installment can move the deduction forward. Watch for special assessments billed on the property tax statement. Assessments for local benefits that tend to increase the value of the property, such as sidewalks or sewer lines, are not deductible taxes and are capitalized, but separately identified amounts allocable to maintenance, repair, or interest may be deductible.2 Obtain the allocation; the label on the bill is not dispositive. Property-assessed clean energy **(PACE)** financing for solar panels or other improvements is often repaid through a line on the tax bill; the principal portion is repayment of a loan, not a tax, and is not deductible on Line 16. The improvement it financed is capitalized and depreciated, and any interest component is analyzed as interest.

Line 19, homeowners' association dues and special assessments. Regular monthly dues on a rental condominium are deductible. Special assessments require a look at what the association is spending the money on. An assessment after a storm requires the same analysis as any repair: obtain the project scope, any insurance proceeds, and whether the owner claimed a casualty loss. Amounts that restore damage for which a casualty loss or basis adjustment was taken, or that replace a major component or substantial structural part, are capitalized; routine repairs of common elements may be deductible.3 An assessment to fund a capital improvement, such as a new roof or a clubhouse, is capitalized and recovered through depreciation. An assessment to purchase land is added to the owner's basis in nondepreciable land.4 Ask for the association's assessment letter and the project scope; the association's label does not decide the question.

C. Auto and Travel (Line 6), Commuting, and the Home Office

A landlord may deduct the cost of local transportation and travel to collect rent, manage, inspect, or maintain rental property, using either actual expenses or the standard mileage rate: 70 cents per mile for 2025, and for 2026, 72.5 cents per mile for January through June and 76 cents per mile for July through December.5 The choice is not unrestricted. The standard mileage rate is available for an owned vehicle only if it was used in the first year the vehicle was placed in service for business, and for a leased vehicle only if it is used for the entire lease period; actual expenses are required if more than four vehicles were used simultaneously.6 Check the vehicle's depreciation history before offering the choice, and do not deduct fuel or depreciation in addition to the standard rate. Vehicle information goes on Form 4562, Part V. Travel away from home is deductible when its primary purpose is rental business, and personal days must be carved out.

The trap is commuting. Trips between a landlord's home and a rental property are generally nondeductible commuting unless an exception applies.7 Under the IRS's general ruling on local transportation, travel between a residence and a work location is deductible if **(1)** the residence is the taxpayer's principal place of business under § 280A(c)(1)(A), in which case transportation to another work location in the same trade or business is deductible, whether that other location is regular or temporary; **(2)** the location is a temporary work location outside the metropolitan area where the taxpayer lives and normally works; or **(3)** the taxpayer has one or more regular work locations away from the residence and travels to a temporary work location in the same trade or business.8 A work location is temporary only if work there is realistically expected to last, and does in fact last, one year or less; if the expectation changes, the location is temporary only until the change. The test turns on the expected duration of work at the location, not on the length of an individual trip. How those rules apply to a landlord's rental properties is fact-dependent. *Curphey v. Commissioner* specifically supports deductible business transportation between a qualifying home office and the taxpayer's rental properties.9 Apply Rev. Rul. 99-7 separately to other home-to-location trips, including its temporary-location conditions. No separate published ruling applying those temporary-location exceptions to the particular rental facts illustrated here was identified; document the business purpose of each trip. A home office used regularly and exclusively as the

1 I.R.C. § 164(b)(6) (flush language).
2 I.R.C. § 164(c)(1); Treas. Reg. § 1.164-4(b)(1).
3 Treas. Reg. § 1.263(a)-3(k)(1)(iii), (vi), (k)(4).
4 See I.R.C. §§ 263(a)(1), 1016(a)(1); IRS Pub. 527, ch. 4 (Condominiums) (2025).
5 Notice 2025-5; Notice 2026-10, § 3; Announcement 2026-11, 2026-29 I.R.B. 49.
6 Instructions for Schedule E (Form 1040) (2025), line 6.
7 IRS Pub. 527, ch. 1 (Local transportation expenses) (2025).
8 Rev. Rul. 99-7, 1999-1 C.B. 361 (holdings 1–3).
9 *Curphey v. Commissioner*, 73 T.C. 766 (1980) (home-office deduction; local transportation between the home office and the rental properties).

principal place of business for managing rental properties can make home-to-property trips deductible business travel, and in *Curphey* the Tax Court allowed the home-office deduction itself for a taxpayer whose rental activity rose to the level of a trade or business.1 The prerequisite is a trade or business. A single long-term rental that the owner visits a few times a year may not qualify, and *Curphey* involved an owner actively managing several properties. Where the facts support it, the home-office amount is reported on Line 19 with a supporting worksheet; Form 8829 itself is built for Schedule C.

Example 5. Split-rate mileage for 2026

```
Facts: Landlord with a qualifying home office logs 1,200 business
miles to her rentals in 2026: 500 miles January-June, 700 July-December.
Step 1. 500 miles x $0.725 ............................... $362.50
Step 2. 700 miles x $0.760 ............................... $532.00
Line 6 (standard mileage) ................................ $894.50
Without a qualifying home office, home-to-property trips are generally
commuting unless another Rev. Rul. 99-7 exception applies; test the
temporary-work-location exceptions before excluding them. For this
example, assume no other exception applies.
```

Caution: The Delgados and Line 6

Kevin drives from the new house to Maple Street for showings and repairs, and the family drives to the condo several times a year. Assume no portion of either home, whether a room or a separately identifiable area, is used regularly and exclusively as the principal place of business for the rentals.2 Assume the home-to-Maple trips do not qualify under another Rev. Rul. 99-7 exception; no deduction for those trips is included in the illustration. The condo trips are a closer case and require separating rental-business trips from personal ones; none are claimed in the resolution of their file.

D. Mortgage Interest, Tracing, and Points

Mortgage interest on a rental is deducted on Schedule E without the acquisition-debt ceiling that applies to qualified residence interest on Schedule A. Interest on a rental that is a trade or business is also subject to the business interest limitation unless the taxpayer meets the gross receipts test **($3`2,000,000 for 2026)** and is not a tax shelter; most individual landlords qualify, but confirm before claiming large interest deductions. The real-property election out of that limitation is beyond the scope of this program.3 Line 12 is for interest reported to the taxpayer on Form 1098. Line 13 is for other interest, such as seller financing or a Form 1098 issued in a co-owner's or former spouse's name; attach the recipient's name, address, and identifying number where the instructions require it, to head off a matching notice.4 Private mortgage insurance on a rental loan is deductible as an ordinary rental expense.5

Whether interest belongs on Schedule E at all depends on the interest tracing rules, and they surprise clients. Debt is allocated to expenditures "in accordance with the use of the debt proceeds," and the allocation "is not affected by the use of an interest in any property to secure the repayment of such debt."6 What the loan bought controls; what property secures it does not. Debt used to repay other debt inherits the allocation of the debt it repaid.7 Repayments of a debt allocated to more than one use are applied first to the portion allocated to personal expenditures.8

1 I.R.C. § 280A(c)(1)(A).
2 I.R.C. § 280A(c)(1).
3 I.R.C. § 163(j)(1), (3); I.R.C. § 448(c); Rev. Proc. 2025-32, § 4.30.
4 Instructions for Schedule E (Form 1040) (2025), lines 12–13.
5 I.R.C. § 212.
6 Temp. Treas. Reg. § 1.163-8T(c)(1).
7 Temp. Treas. Reg. § 1.163-8T(e)(1).
8 Temp. Treas. Reg. § 1.163-8T(d)(1).

Example 6. Cash-out refinance on a rental

```
Facts: Landlord refinances a rental with a new $200,000 loan. The
old mortgage was allocated entirely to acquiring or improving the
rental, with no earlier personal cash-out and no other allocation.
$150,000 pays off the old rental mortgage; $50,000 buys a boat.
Interest paid in 2026 on the new loan: $12,000. The proceeds were
disbursed directly to pay off the old loan and buy the boat on the
closing date, and no principal was repaid during 2026.
Step 1. Rental allocation: $150,000 / $200,000 = 75%
Step 2. Personal (boat) allocation: $50,000 / $200,000 = 25%
Step 3. Schedule E interest: $12,000 x 75% ..... $9,000
Step 4. Boat interest: $12,000 x 25% ..... $3,000
Conclusion: $9,000 on Schedule E. $3,000 is personal interest and
nondeductible, even though the rental secures the whole loan.
Later years: principal repayments are applied first to the personal
(boat) portion, so the rental share rises as the loan is paid down.
```

The rule works in the client's favor just as often. Interest on a home-equity line secured by the main home, or on a credit card, is rental interest to the extent the proceeds were used for rental repairs, improvements, or acquisition, and it generally belongs on Schedule E even though the main home secures it. Tracing coordinates with the qualified-residence-interest rules: where interest would otherwise qualify as residence interest, the taxpayer may elect to treat the debt as not secured by the residence so that it is allocated under the tracing rules, and that election continues unless revoked with the Commissioner's consent.1 The election is not needed for every rental home-equity line, because home-equity debt not used to buy or improve the residence generally is not qualified residence interest under current law. Keep the draw records; tracing depends on being able to show where the money went.

The rule also determines what happens when the use of a property changes. Debt allocated to an asset is reallocated when the asset is converted to a different use,2 which is why the Delgados' old Maple Street mortgage moves from qualified residence interest to rental interest on the day the house became a rental. Debt is also reallocated when an asset bought with the proceeds is sold, but the trigger is the use of the sale proceeds, not the sale itself: the debt follows the proceeds "on the date on which proceeds from a disposition of such asset are used for another expenditure."3

Caution: Interest after the rental is sold
One instructor text teaches that a second mortgage on a main home used to buy a rental remains traced to the rental activity after the rental is sold, if the loan is not repaid. The regulation points the other way: once the sale proceeds are spent, the debt follows them. If the proceeds buy another rental, the interest stays on Schedule E; if they pay for a car or a vacation, it becomes personal interest. Until the proceeds are spent, apply the regulation's rules for undisbursed proceeds. The amount of debt reallocated on a disposition cannot exceed the disposition proceeds; if the rental sold for less than the debt traced to it, trace the excess debt separately.4 Trace the proceeds before carrying the interest forward on Schedule E.

A buyout loan incident to divorce presents a related point. When one spouse borrows to buy out the other's half of a rental, the loan proceeds are used to acquire the half interest, so the interest is traced to the rental. The buyout does not increase the property's basis, however: for a transfer qualifying under § 1041(a), the transfer is treated as a gift and the acquiring spouse takes the transferor's adjusted basis in that half, regardless of any payment. Section 1041 does not apply if the transferee spouse or former spouse is a nonresident alien **(tax residence, not citizenship, controls)**, and on a transfer in trust gain is recognized to the extent the liabilities assumed and the liabilities to which the property is subject exceed adjusted basis.5 A transfer is incident to divorce if it occurs within one year after the marriage ends or is related to the end of the marriage.6

Points and loan costs. Points that are charged solely for the use of money are prepaid interest and are deducted over the term of the loan, not in the year paid, under the original issue discount rules: constant yield,

1 Temp. Treas. Reg. §§ 1.163-8T(m)(3), 1.163-10T(o)(5).
2 Temp. Treas. Reg. § 1.163-8T(j)(1)(i)(B).
3 Temp. Treas. Reg. § 1.163-8T(j)(1)(i)(A), (j)(1)(ii).
4 Temp. Treas. Reg. § 1.163-8T(j)(1)(ii).
5 I.R.C. § 1041(a)–(b), (d)–(e).
6 I.R.C. § 1041(c).

unless the discount is de minimis, in which case straight-line is a permitted choice.1 Other loan costs, such as appraisal and title fees charged for the loan, are debt issuance costs, amortized under the constant-yield rules of the regulations by treating them as reducing the loan's issue price.2 If the loan ends early through a refinancing or prepayment, the remaining balance generally may be deducted in that year; if the refinancing is with the same lender, the remaining points generally are not deductible in the year of the refinancing and are instead deducted over the term of the new loan.3

Example 7. Unamortized points on refinancing

```
Facts: $3,000 of points paid on a 30-year rental loan. Assume the
loan's total OID, including the points, is de minimis and the landlord
chose straight-line on the original return: $100 per year for five
full years. In year 6 the landlord refinances with a different lender
and pays off the old loan.
Step 1. Points deducted to date: 5 x $100 ..............  $  500
Step 2. Unamortized balance: $3,000 - $500 ..............  $2,500
Conclusion: In year 6 the landlord deducts the year-6 amortization
through the payoff date and the remaining balance, which together total
$2,500 (not $2,500 plus amortization), on Line 19. Had the refinance
been with the same lender, the remaining points generally would be
deducted over the term of the new loan.
```

IV. PERSONAL USE: SECTION 280A, VACATION HOMES, DUPLEXES, ROOMS, AND CONVERSIONS

A. Counting Days on Line 2

Line 2 of Schedule E looks like a data-entry field, but the two numbers on it decide how expenses are divided and whether a statutory limit caps the deductions. **Section** 280A treats a taxpayer as using a dwelling unit as a residence if personal-use days exceed the greater of 14 days or 10 percent of the days the unit is rented at a fair rental.4 A dwelling unit includes a house, apartment, condominium, mobile home, boat, or similar property.5

Fair-rental days are days the unit is actually rented at a fair rental. Days the unit sits vacant, even if advertised, are neither rental days nor personal days; they simply drop out of the fraction. A day is a personal-use day if, for any part of the day, the unit is used for personal purposes by the taxpayer, by any other person who has an interest in the unit, or by a member of the family of either; by anyone under a reciprocal arrangement that lets the taxpayer use another dwelling unit; or by anyone at all, unless the unit is rented that day at a fair rental.6 Family for this purpose means brothers and sisters, spouse, ancestors, and lineal descendants.7 A family member paying full rent is still a personal-use day, with one important exception: a rental at a fair rental to any person, including a relative, for use as that person's principal residence is not personal use.8 A co-owner's use under a shared equity financing agreement at fair rent receives similar treatment.9

Caution: Discounted rent to relatives
Some instructor materials state that a related tenant may be charged roughly 15 percent below market rent. The case usually cited for that idea is Bindseil, in which the court made a fact-specific 20 percent adjustment to stranger-market rent for avoided management fees and trustworthy tenants. Expert testimony elicited on cross-examination indicated that unusually careful tenants could justify a reduction of 10 percent to, at most, 20 percent.10 The taxpayer nevertheless failed to prove receipt of fair rental: the rent he charged his parents fell below even the adjusted figure. Neither the testimony nor the holding establishes a percentage safe harbor. Fair rental remains a facts-and-circumstances question.

1 I.R.C. § 461(g)(1); IRS Pub. 527, ch. 1 (Points) (2025).
2 Treas. Reg. § 1.446-5(a)–(b).
3 IRS Pub. 527, ch. 1 (Points) (2025).
4 I.R.C. § 280A(d)(1).
5 I.R.C. § 280A(f)(1)(A).
6 I.R.C. § 280A(d)(2)(A)–(C).
7 I.R.C. §§ 280A(d)(2)(A), 267(c)(4).
8 I.R.C. § 280A(d)(3)(A).
9 I.R.C. § 280A(d)(3)(B)–(C).
10 Bindseil v. Commissioner, T.C. Memo. 1983-411.

Document comparable market rents and the specific reasons for any reduction; a percentage is not a safe harbor.

Two kinds of days are not personal use even though the owner is present. A day on which the taxpayer is engaged in repair and annual maintenance on a substantially full-time basis is not a personal-use day merely because family members on the premises are not working.1 And days the unit is the taxpayer's principal residence before or after a qualified rental period are not counted as personal use in applying the vacation-home limit to that rental period.2 A qualified rental period is a consecutive period of 12 or more months that begins or ends in the year, during which the unit is rented or held for rental at a fair rental, or a consecutive period of less than 12 months that begins in the taxable year and at the end of which the unit is sold or exchanged; listing the unit for sale is not a sale.3

Example 8. Delgado condo: is it a "residence"?

```
Step 1. Fair-rental days ..................................... 168
Step 2. 10% of fair-rental days: 168 x 10% ..................... 16.8
Step 3. Threshold = greater of 14 or 16.8 ...................... 16.8
Step 4. Personal-use days (family, July 4th week) ................ 9
Step 5. Is 9 greater than 16.8? ............................... No
Conclusion: The condo is NOT used as a residence under § 280A(d)(1).
The § 280A(c)(5) limit does not apply; a Schedule E loss is possible.
Expenses are still divided between rental and personal use (Part IV.B).
Assumption: the platform calendar has been reconciled to calendar
days: 168 days rented at fair rental, 9 personal-use days, and no
personal-use day overlapped a rental day. The § 469 average period of
customer use (Example 1) is computed separately from the customers'
contractual rights and need not equal the Line 2 day counts.
```

Example 9. Delgado Maple Street: the qualified rental period

```
Facts: Main home January 1 - March 31, 2026; held for rent April 1;
12-month lease beginning May 1, 2026.
Step 1. Is there a qualified rental period? Yes: a consecutive period
        of 12+ months (April 2026 forward), rented or held for rent at
        fair rental, beginning in 2026.
Step 2. Residence days before that period (Jan. 1 - Mar. 31) are not
        personal-use days in applying § 280A(c)(5) to the rental period.
Conclusion: No vacation-home limit. Expenses are split by period:
January-March to the residence (Schedule A, if itemizing); April-
December to Schedule E. This assumes the house remains rented or held
for rent at fair rental through at least March 31, 2027. If that does
not happen and the period does not end in a sale, revisit 2026.
```

B. Vacation-Home Allocation and the Section 280A(c)(5) Limit

When a dwelling unit has both rental and personal use during the year, expenses must be divided between them. The basic fraction is fair-rental days divided by total days of use **(rental days plus personal days)**. Days the unit is vacant, and days spent substantially full time on repairs and maintenance when the unit is not rented, are neither rental days nor personal days; a day the unit is rented at fair rental counts as a rental day.4 Keep two counts. For the residence test, any day with personal use for any part of the day is a personal day even if the unit was rented that day; for the expense fraction, a day rented at fair rental is a rental day. Reconcile both counts and do not double-count.5 Costs that relate only to the rental, such as platform fees and turnover cleaning, are not divided between rental and personal use; they are rental expenses in full. A cost is direct only if it relates exclusively to rental use; supplies consumed during personal stays must be allocated.

If the unit is used as a residence under the 14-day/10-percent test, a second rule applies on top of the allocation. Deductions attributable to the rental use may not exceed the gross rental income, reduced by the deductions allocable to the rental that would be allowable anyway, principally mortgage interest and real estate

1 I.R.C. § 280A(d)(2) (flush language).
2 I.R.C. § 280A(d)(4)(A).
3 I.R.C. § 280A(d)(4)(B).
4 I.R.C. § 280A(d)(2) (flush language), (e)(1).
5 IRS Pub. 527, ch. 5 (2025).

taxes; disallowed amounts carry forward to the next year as deductions allocable to that use.1 The order of absorption follows the structure of the statute and the long-pending proposed regulations: first the rental share of interest and taxes, then operating expenses, then depreciation and other basis adjustments.2 Allocation and the income ceiling are separate steps. Under § 280A(c)(5)(B), deductions allowable regardless of rental use **(such as qualifying interest and taxes)** and expenses of the rental activity not attributable to use of the unit **(such as rental agency fees and advertising)** are deducted first and are not limited; they can produce a loss. Classify platform charges by the services purchased. A charge solely for advertising the listing or arranging bookings is analyzed as a rental-activity expense analogous to advertising or rental agency fees. Separately analyze charges attributable to use or operation of the dwelling. The label "platform service fee" does not determine treatment under § 280A(c)(5). Expenses attributable to use of the unit, including operating costs such as turnover cleaning even when 100 percent allocable to rental days, and depreciation, are limited to the remaining gross rental income and cannot create or increase a loss.3 Examples 10, 11, and 14 assume interest and taxes are fully allowable in Tier 1. For a client who takes the standard deduction, or where Schedule A limits such as the SALT limitation or acquisition-debt limits apply, rerun Worksheet 5-1: the amount not otherwise allowable moves to the operating tier, which changes the deductions allowed and the carryover.4 Because depreciation comes last, it is the item most often deferred. Track depreciation allowed and amounts carried forward under § 280A(c)(5) separately; determine basis under § 1016 and the applicable limitation rules.

Example 10. Outcome A: vacation home (limit applies)

```
Facts: Unit is used as a residence. Rental share of each item:
gross rent $5,000; interest and taxes $2,700 (assume fully allowable
on Schedule A); operating expenses $4,000, all attributable to use of
the unit (no agency fees or advertising); depreciation $1,800.
Tier 1. Interest and taxes ........................... ($2,700)
        Remaining room: $5,000 - $2,700 ............... $2,300
Tier 2. Operating expenses: $4,000 available; allowed  ($2,300)
        Carryforward: $4,000 - $2,300 ................. $1,700
        Remaining room ..................................... $0
Tier 3. Depreciation: $1,800 available; allowed ........... $0
        Carryforward ..................................... $1,800
Net Schedule E income ..................................... $0
Conclusion: $3,500 of deductions carry forward under § 280A(c)(5).
The personal share of mortgage interest may be deductible on Schedule
A as qualified residence interest on a second home, because the unit
was used as a residence.
```

The IRS method and the *Bolton* method. For interest and taxes, the IRS allocates by rental days over total days used. The Tax Court, affirmed by the Ninth Circuit, allowed a taxpayer to allocate interest and taxes by rental days over all days in the year, on the reasoning that those items accrue every day of the year whether the unit is used or not.5 The *Bolton* method puts less interest and tax on Schedule E, leaving more room under the limit for operating expenses and depreciation, and leaves more interest and tax on Schedule A. That trade was attractive when most vacation-home owners itemized. For a client who takes the standard deduction, or whose Schedule A taxes are already capped, the interest and tax pushed to Schedule A may produce no benefit at all, and the IRS method can produce the lower total tax. *Bolton* is judicial authority; the IRS continues to publish the days-used method. A return position using *Bolton* is supported by the Tax Court and Ninth Circuit decisions, should be applied consistently from year to year, and should be documented in the workpapers.

1 I.R.C. § 280A(c)(5)(A)–(B) (flush language on carryforward).
2 Prop. Treas. Reg. § 1.280A-3(d)(3), 45 Fed. Reg. 52,399 (Aug. 7, 1980) (proposed; not binding).
3 I.R.C. § 280A(c)(5)(B)(i)–(ii); IRS Pub. 527, Worksheet 5-1, lines 2a–2d (2025).
4 IRS Pub. 527, Worksheet 5-1, lines 2a–2b, 4b–4c (2025).
5 *Bolton v. Commissioner*, 77 T.C. 104 (1981), aff'd, 694 F.2d 556 (9th Cir. 1982).

Example 11. IRS method vs. Bolton method

```
Facts: Unit used 60 rental days and 30 personal days (a residence).
Gross rent $15,000. Annual interest $6,000 + taxes $3,000 = $9,000.
Operating expenses $4,500 and depreciation $6,000 (whole-unit amounts),
allocated by 60/90 under either method: $3,000 and $4,000.
                                    IRS method    Bolton method
Interest/taxes fraction            60/90          60/365
Tier 1 to Schedule E               $6,000         $1,479
Tier 2 operating expenses          $3,000         $3,000
Tier 3 depreciation                $4,000         $4,000
Net Schedule E income              $2,000         $6,521
Interest/taxes left for Schedule A $3,000         $7,521
Derivation: $9,000 x 60/90 = $6,000; $9,000 x 60/365 = $1,479.45,
rounded $1,479. IRS: $15,000 - $6,000 - $3,000 - $4,000 = $2,000.
Bolton: $15,000 - $1,479 - $3,000 - $4,000 = $6,521.
Both methods use the same $16,000 of total deductions on the assumed
full allowability. For a client who takes the standard deduction, the
IRS method reports $4,521 less taxable rental income. Equal combined
deductions do not establish equal total tax: the allocation can change
AGI, QBI, NIIT, and AGI-based limitations, so compare the complete
federal return and relevant state consequences.
```

Outcome B: rental with minor personal use. If personal use does not exceed the 14-day/10-percent threshold, the unit is not used as a residence, § 280A(c)(5) does not cap the current year's deductions **(any amount carried forward from a prior year under § 280A(c)**(5) remains subject to that limitation even in a year the unit is not used as a residence, so track carryovers separately; they are not passive losses and are not released under § 469(g)),1 and Schedule E can show a loss, subject to the passive activity rules. The allocation still applies, and it creates a trap that clients rarely expect. The personal share of mortgage interest is deductible on Schedule A only if it is qualified residence interest, and a second home is a qualified residence only if it is "used by the taxpayer as a residence **(within the meaning of section 280A(d)**(1))."2 A unit with too little personal use to be a residence fails that test, so the personal share of interest is nondeductible personal interest. **(The exception for a unit not rented at any time during the year does not help a unit that is rented.3)** The personal share of real estate taxes remains deductible on Schedule A, subject to the state-and-local-tax limitation.

⊗ **Warning: The section 163(h) citation moved**
The 2025 legislation inserted a new § 163(h)(4) for qualified passenger vehicle loan interest and redesignated the qualified-residence definitions as § 163(h)(5). Materials that cite § 163(h)(4)(A) for the second-residence rule are citing the pre-2025 numbering. The rule itself did not change.

C. Three Everyday Partial-Use Scenarios

The mid-year conversion. When a client converts a main home to a rental during the year, as the Delgados did with Maple Street, the year is divided by period rather than by a vacation-home fraction. Interest and taxes for the residence period go to Schedule A if the client itemizes; those for the rental period, which begins when the property is held out for rent, go to Schedule E. Because the qualified-rental-period rule removes the residence days from the personal-use count, the vacation-home limit does not apply, and the rental period can show a loss. The converted-basis rule in Part V governs depreciation.

1 I.R.C. § 280A(c)(5) (final sentence).
2 I.R.C. § 163(h)(5)(A)(i)(II), as redesignated by Pub. L. 119-21.
3 I.R.C. § 163(h)(5)(A)(iii).

Example 12. Delgado Maple Street, 2026 expense split

```
Rental period: April 1 - December 31 = 275 days; residence period 90 days.
Assume the $6,600 interest relates uniformly to 2026 and the $7,300 tax
was paid in and allocable to 2026; 275/365 is a reasonable period
allocation. In an actual file, account for payment timing, escrow
disbursements, refinancing, coverage periods, and direct expenses.
Step 1. Mortgage interest (Form 1098): $6,600 x 275/365 ..... $4,973
        ($4,972.60, rounded; residence share $1,627 to Schedule A
        only if the Delgados itemize)
Step 2. Real estate taxes: $7,300 x 275/365 ................. $5,500
Step 3. Landlord insurance policy (from April 1) ............. $1,350
Step 4. Plumbing repair (rental period) ...................... $ 900
Step 5. Advertising for tenant ............................... $ 150
Step 6. Depreciation (Example 16, Part V) ..................... $4,547
Total Maple Street expenses ................................. $17,420
Line 3 rents (Example 3) .................................... $21,600
Net Schedule E income, Maple Street ......................... $4,180
```

The owner-occupied duplex. When an owner lives in one unit of a duplex or triplex and rents the others, each rented unit is a separate dwelling unit with no personal use. Whole-building costs **(interest, taxes, insurance, roof work)** are divided by a reasonable method, usually square footage or, for equal units, unit count. Costs that relate only to the rented unit are deducted in full, and costs that relate only to the owner's unit are personal. Because the rented unit is not used as a residence, a rented duplex unit can produce a deductible Schedule E loss.

Example 13. Owner-occupied duplex (two equal units)

```
Whole-building costs: interest $10,000; taxes $6,000; insurance $1,800;
roof repair $2,000. Total $19,800.
Step 1. Rental share: $19,800 x 50% ......................... $9,900
Step 2. Repairs inside the rental unit only (100%) ........... $  700
Step 3. Depreciation: building basis $300,000 x 50% = $150,000;
        $150,000 / 27.5 years (full year) ..................... $5,455
Step 4. Rent: $1,200 x 12 ................................... $14,400
Net Schedule E result: $14,400 - $9,900 - $700 - $5,455 ..... ($1,655)
Conclusion: A $1,655 loss, deductible subject to the passive rules.
The other $9,900 of building costs relate to the owner's unit.
```

Renting a room in the home. A client who rents a bedroom to a lodger divides shared household costs by a reasonable method, typically the room's share of the home's square footage, and deducts costs that relate only to the room in full. The difference from the duplex is that the room is part of a single dwelling unit the client uses as a residence, so § 280A(c)(5) applies to the rental of that portion.1 Before applying that limit, test whether the room is used exclusively as a hotel-type establishment: the dwelling unit does not include a portion used exclusively as a hotel, motel, inn, or similar establishment, so a room regularly available only to paying short-term guests and never used personally may be outside the dwelling unit, even without a separate kitchen, bath, or entrance.2 If the limit applies, deductions attributable to use of the room cannot exceed the room rent remaining after the deductions described in § 280A(c)(5)(B), and the excess carries forward; expenses of the rental activity not attributable to use of the room, such as advertising, are not capped. A space with its own kitchen, bath, and entrance may be a separate dwelling unit, which moves the analysis to the duplex model; look at the physical facts.

1 I.R.C. § 280A(c)(3), (c)(5).

2 I.R.C. § 280A(f)(1)(B); IRS Pub. 527, ch. 5 (2025).

Example 14. Renting a room

```
Facts: 2,000 sq. ft. home; rented room 300 sq. ft. (15%); rented all
year to an unrelated lodger at a fair rental of $300 per month; the
room is not a separate dwelling unit and is not a hotel-type space
under § 280A(f)(1)(B). Household interest $9,000 and taxes $4,000
(assume fully allowable); utilities $3,600 and insurance $1,400;
direct room costs $400 (linens and a lock, attributable to use of
the room; no advertising or agency fees);
depreciation on the home $9,091 per year.
Gross rent: $300 x 12 ..................................... $3,600
Tier 1. Interest and taxes: $13,000 x 15% ................. ($1,950)
        Remaining room: $3,600 - $1,950 ..................... $1,650
Tier 2. Operating: ($5,000 x 15%) + $400 = $1,150 ........... ($1,150)
        Remaining room ....................................... $ 500
Tier 3. Depreciation available: $9,091 x 15% = $1,364;
        allowed $500; carryforward $864 ..................... ($ 500)
Net Schedule E income ..................................... $0
```

V. BASIS, DEPRECIATION, AND REPAIRS VERSUS IMPROVEMENTS

A. Figuring Depreciable Basis

Depreciation errors at storefront offices usually begin before the first year's deduction is computed. They begin with the wrong starting number. Depreciable basis depends on how the client acquired the property, and then on how much of it is land.

Table 4. Starting basis by type of acquisition

How acquired	Starting basis	Authority
Purchase	Cost, plus settlement costs properly added to basis (abstract and title fees, recording fees, surveys, transfer taxes, owner's title insurance, amounts the seller owed that the buyer paid)	I.R.C. §§ 1012(a), 1016(a)(1); IRS Pub. 527, ch. 2
Personal residence converted to rental	Lesser of fair market value or adjusted basis on the date of conversion (building only)	Treas. Reg. § 1.168(i)-4(b)(1)
Inheritance	Fair market value at date of death (or alternate-valuation or special-use value if elected), limited by estate-tax basis consistency where applicable; the surviving spouse's half of community property also takes a new basis if at least half of the community interest was includible in the decedent's gross estate	I.R.C. § 1014(a)(1)–(3), (b)(6), (f)
Gift	Donor's adjusted basis, increased for gift tax paid under § 1015(d); for determining a loss, the lower of that basis or fair market value at the gift date (a sale price between the two produces no gain or loss)	I.R.C. § 1015(a), (d)
Transfer between spouses or incident to divorce	For a transfer qualifying under § 1041(a), transferor's adjusted basis, regardless of any payment. Not available if the transferee is a nonresident alien; a transfer in trust recognizes gain to the extent liabilities exceed basis	I.R.C. § 1041(a)–(b), (d)–(e)

Loan costs are not part of the property's basis; they are amortized over the loan, as discussed in Part III. A purchase basis that includes the lender's fees is a common error on new-client depreciation schedules.

The converted residence. When a personal residence becomes a rental, depreciation is computed as though the property were placed in service on the conversion date, and the depreciable basis is the lesser of its fair market value or its adjusted depreciable basis at that time.1 The regulation's own example uses a house with a fair market value of $130,000 **(excluding land)** and an adjusted basis of $150,000 at conversion, and depreciates it from $130,000.2 The rule exists so that a decline in value while the home was personal cannot be converted into depreciation or a deductible loss later; a parallel rule fixes the basis for loss on a later sale.3 When values have risen, as they have for most clients converting homes they bought years ago, the adjusted basis will be the lower number, and that is the depreciable basis.

An inherited rental generally gets a fresh start. The heir's basis is generally the fair market value at death, a new recovery period begins when the heir places the property in service, and the decedent's accumulated depreciation does not carry over to the heir.4 The general rule is subject to alternate-valuation and special-use values, basis consistency, and statutory exceptions, including the rule denying a new basis for appreciated property given to the decedent within one year of death and passing back to the donor or the donor's spouse; items of income in respect of a decedent do not receive a § 1014 basis.5 Verify ownership and estate inclusion; only the interest that actually receives a new basis gets a new depreciation starting point. A gifted rental, by contrast, carries the donor's adjusted basis, and with it the donor's history of depreciation.

The land allocation. Land is never depreciable, so the cost of every property must be split between land and building. A reasonable, documented method is required. The most common method at a storefront office is the county assessor's ratio, and the key word is ratio. The assessor's dollar values are often far from market, so the assessor's improvement-to-total percentage is applied to the client's actual cost basis; the assessor's dollar amount for the improvements is not itself the building's basis. A 2017 Tax Court summary opinion, which is not precedent, illustrates the IRS's approach: for a property bought for $360,000, the assessor valued the improvements at 44.4 percent of total value, and the court accepted the assessor's allocations as more reliable than the taxpayers' own.6 An appraisal that allocates value between land and building is better support where the stakes justify it.

Example 15. Land allocation: two flawed schedules and the fix

```
Facts: Purchase price $280,000 + capitalized closing costs $6,000
= cost basis $286,000. Assessor: land $60,000; improvements $180,000;
total $240,000.
Step 1. Improvement ratio: $180,000 / $240,000 ..............  75.00%
Correct building basis: $286,000 x 75% ..................... $214,500
Correct annual depreciation: $214,500 / 27.5 ................ $ 7,800

Flawed schedule A ("$0 land"): building $286,000
Annual depreciation: $286,000 / 27.5 ....................... $10,400
Overstatement: $10,400 - $7,800 = $2,600 per year

Flawed schedule B (assessor's dollar figure as basis): $180,000
Annual depreciation: $180,000 / 27.5 ....................... $ 6,545
Understatement: $7,800 - $6,545 = $1,255 per year
(Annual figures are full-year amounts, ignoring the mid-month
convention, to show the size of the error.)
```

1 Treas. Reg. § 1.168(i)-4(b)(1).
2 Treas. Reg. § 1.168(i)-4(b)(2), Example.
3 Treas. Reg. § 1.165-9(b)(2).
4 I.R.C. § 1014(a)(1).
5 I.R.C. § 1014(a)(2)–(3), (c), (e), (f).
6 *Nielsen v. Commissioner*, T.C. Summ. Op. 2017-31 (non-precedential, I.R.C. § 7463(b)).

Example 16. Delgado Maple Street: converted-residence basis

```
Facts: Bought 2014 for $210,000 plus $4,000 capitalized closing costs
= $214,000. Assessor ratio at purchase: 75% building / 25% land.
Kitchen remodel 2019: $16,000. FMV at conversion (April 1, 2026):
$340,000 total; assessor ratio at conversion 75% building.
Step 1. Building share of original cost: $214,000 x 75% ..... $160,500
Step 2. Plus kitchen remodel (building improvement) ......... $ 16,000
Step 3. Adjusted basis of building at conversion ............ $176,500
Step 4. FMV of building at conversion: $340,000 x 75% ....... $255,000
Step 5. Depreciable basis = lesser of Step 3 or Step 4 ...... $176,500
Step 6. 2026 depreciation, 27.5-year SL, mid-month, placed in
        service April: 8.5 months / 12 / 27.5 = 2.576% (table rate)
        $176,500 x 2.576% ................................... $  4,547
        ($4,546.64, rounded)
```

B. MACRS Mechanics: Line 18 and Form 4562

Residential rental property is a building or structure in which 80 percent or more of the gross rental income is from dwelling units, and it is depreciated straight-line over 27.5 years using the mid-month convention.1 If the owner occupies any portion of the building, its rental value is included in gross rental income for the 80-percent test, which matters for the owner-occupied duplex and the rented room.2 Apply the dwelling-unit and transient exclusions separately. Nonresidential real property is depreciated over 39 years, also straight-line and mid-month.3 Under the alternative depreciation system, which applies to property used predominantly outside the United States and in certain other cases, residential rental property is recovered over 30 years and nonresidential real property over 40 years.4 The 30-year ADS period applies to residential rental property placed in service after December 31, 2017; property placed in service earlier generally continues on its original 40-year ADS period, with relief for pre-2018 residential rental property held by an electing real property trade or business that was not previously subject to ADS, which uses a 30-year ADS period for taxable years beginning after 2017.5 Instructor materials that state a 40-year period for foreign residential rental property are describing pre-2018 property.

The short-term rental building. The definition of a dwelling unit excludes "a unit in a hotel, motel, or other establishment more than one-half of the units in which are used on a transient basis."6 The phrase "transient basis" is not defined in § 168, but a long-standing regulation under the investment credit rules provides that accommodations are used on a transient basis "if the rental period is normally less than 30 days."7 Many practitioners and instructor texts therefore treat a whole house or condo rented by the night as nonresidential real property with a 39-year life. That position is common. It produces the smaller annual deduction, but that is not a safe harbor, because basis is reduced by the depreciation allowable under the correct life. It is also not settled. The statute is framed around an establishment with multiple units, its application to a single-family house or a single condominium unit has not been addressed in a regulation or published ruling located for this text, and the regulation's 30-day test would reach stays of eight to 29 days that some texts treat as 27.5-year property.

Caution: Choosing a life for a short-term rental

Determine the recovery period under § 168(e)(2) on the facts. It is not an elective choice, and a shorter annual deduction is not a safe harbor: basis is reduced by the depreciation allowable whether or not it is claimed.8 Application of the transient-basis exclusion to a single house or condominium unit is unresolved; document the position taken and obtain review. This text stipulates 39 years for the Delgados' condo solely to illustrate the computations; that is not a determination that all nightly rentals or single condominium units

1 I.R.C. § 168(b)(3)(B), (c), (d)(2), (e)(2)(A)(i).
2 I.R.C. § 168(e)(2)(A)(ii)(II).
3 I.R.C. § 168(c) (table), (e)(2)(B).
4 I.R.C. § 168(g)(1)(A), (g)(2)(C)(iii)–(iv).
5 Pub. L. 115-97, § 13204(b)(3), as added by Pub. L. 116-260, div. EE, § 202; Rev. Proc. 2021-28, §§ 2.01(4), 6.
6 I.R.C. § 168(e)(2)(A)(ii)(I).
7 Treas. Reg. § 1.48-1(h)(2)(ii).
8 I.R.C. § 1016(a)(2).

are 39-year property. Before an actual Form 3115 is filed, determine the establishment and unit facts under § 168(e)(2)(A)(ii)(I), document the analysis, and recompute every affected amount (current depreciation, the catch-up, basis, and QBI) if the classification differs. If the property's use actually changes, for example from nightly to long-term rental, depreciation is recomputed under the change-in-use rules, and that is not a change in method of accounting.1 Correcting a recovery period that was wrong from the start, after it has been used on two or more returns, is a change in method requiring Form 3115 (Part VII). If the building is nonresidential real property, separately test interior improvements as qualified improvement property and test roofs, HVAC, fire-protection and alarm, and security improvements as § 179(e) qualified real property, subject to the § 179 limits; residential rental property is excluded from both, and a roof is never qualified improvement property because it is not an interior improvement.2

Five-year and 15-year property, bonus depreciation, and section 179. Appliances, carpeting, and furniture used in a residential rental activity are five-year property, and land improvements such as fences, driveways, and landscaping are 15-year property.3 If not fully expensed, five-year property ordinarily uses the 200-percent declining balance method and 15-year land improvements the 150-percent declining balance method, each switching to straight line when that yields a larger deduction. Both ordinarily use the half-year convention unless the mid-quarter convention applies. For that test, compare the aggregate depreciable bases of included MACRS property placed in service during the last three months of the tax year with the aggregate depreciable bases of included MACRS property placed in service during the entire year. More than 40 percent triggers the mid-quarter convention. Exclude nonresidential real property, residential rental property, railroad grading or tunnel bores, and property placed in service and disposed of in the same year, applying the regulations' additional rules. Depreciable land improvements are not excluded merely because they are real property.4 Property with a recovery period of 20 years or less is eligible for the additional first-year **(bonus)** depreciation deduction; 27.5-year and 39-year buildings are not.5 The 2025 legislation restored a permanent 100-percent bonus deduction for qualified property acquired after January 19, 2025, with an election to claim a reduced percentage for property placed in service in the first taxable year ending after that date.6 Property acquired under a binding contract entered into before January 20, 2025, is not treated as acquired after that date; check the contract date for anything purchased around the turn of 2025. Bonus depreciation is computed on the business-use portion of the property; for a unit with personal use, that is the rental share.

Section 179 expensing is a separate tool, with limits of $2,500,000 for 2025 and $2,560,000 for 2026.7 For individual landlords it is usually the wrong tool. It requires property used in the active conduct of a trade or business, and the deduction cannot exceed taxable income from the taxpayer's trades or businesses. For that limit, taxable income from the active conduct of trades or businesses includes wages earned as an employee, and spouses filing jointly aggregate their amounts; the active-conduct concept is not **§** 469 material participation.8 A noncorporate lessor must also satisfy **§** 179(d)(5): either the lessor manufactured or produced the property, or the lease term, including renewal options, is less than 50 percent of the property's class life and, for the first 12 months, the lessor's **§** 162 deductions for the property **(excluding rents and reimbursed amounts)** exceed 15 percent of its rental income.9 With 100-percent bonus available, which needs none of those conditions, most residential landlords will use bonus depreciation for qualifying personal property.

1 Treas. Reg. §§ 1.168(i)-4(d), 1.446-1(e)(2)(ii)(d)(3)(ii).
2 I.R.C. §§ 168(e)(6), 179(e).
3 IRS Pub. 527, ch. 2, Table 2-1 (2025).
4 I.R.C. § 168(b)(1)–(2), (d)(1), (d)(3)(A)–(B); Treas. Reg. § 1.168(d)-1(a)–(b); IRS Pub. 946, ch. 4 (Which Convention Applies?) (2025).
5 I.R.C. § 168(k)(2)(A)(i)(I).
6 Pub. L. 119-21, § 70301; Notice 2026-11, §§ 2.02(1), 2.06(2).
7 I.R.C. § 179(b)(1); Rev. Proc. 2025-32, §§ 3.02(1), 4.24.
8 Treas. Reg. § 1.179-2(c)(6)(iv), (c)(7).
9 I.R.C. § 179(b)(3)(A), (d)(1), (d)(5).

Example 17. Delgado condo: new furniture, March 2026

```
Facts: $9,000 of furniture on one invoice, placed in service March
2026; acquired after Jan. 19, 2025. Assume the furniture's actual
rental and personal use after its March placed-in-service date yields
the same 168/177 allocation (94.915%); establish asset-specific use for
an actual return. Reconcile the replaced furniture's cost, allowable
depreciation, and disposition separately; no remaining basis for it is
assumed in this illustration.
Step 1. Business-use basis: $9,000 x 94.915% ..............  $8,542
        ($8,542.37, rounded)
Step 2. Five-year property; eligible for 100% bonus .........  $8,542
Step 3. Remaining depreciable basis ............................  $0
Line 18 (furniture): $8,542.
Alternative: if the invoice itemized each item at $2,500 or less, the
Delgados had accounting procedures at the start of 2026 to expense such
items, they expensed them on their books, and they attach the annual
election, the de minimis safe harbor (Part V.C) could produce the same
rental-share deduction. Invoices may not be split to fit the limit,
and receipts must still be retained.
```

When depreciation begins. Depreciation begins when property is placed in service, meaning placed "in a condition or state of readiness and availability for a specifically assigned function."1 For a rental, that is ordinarily when the property is ready and held out for rent, which is neither the closing date **(if renovation is still underway)** nor the date the first tenant moves in.

Example 18. Placed-in-service date

```
Facts: Closing February 10; renovation February-May; listed for rent
June 15; first tenant moves in July 1.
Conclusion: Placed in service in June. Under the mid-month convention,
the building is treated as placed in service on June 15 (6.5 months of
depreciation in year 1 for a calendar-year taxpayer: half of June plus
July through December). The renovation
costs are added to basis. Carrying costs incurred before the property
was held out for rent need their own analysis; do not simply deduct
them on Schedule E.
```

Cost segregation and leasehold improvements. A cost segregation study reclassifies parts of a building into 5-, 7-, and 15-year property so they can be depreciated faster and, now, often expensed through bonus depreciation. The IRS's audit technique guide on the subject describes what a quality study looks like; it is examiner guidance, not precedent.2 The acceleration comes with a cost at sale, and disposition character must be determined separately for each cost-segregated asset. For a taxable sale of a § 1245 component, ordinary recapture generally equals the lesser of recognized gain or the depreciation and amortization adjustments included in recomputed basis. Those adjustments generally include amounts allowed or allowable, although the taxpayer may substitute a lower amount actually allowed if established by adequate records or other sufficient evidence.3 Other components, such as land improvements, may be § 1250 property; § 1250 property depreciated faster than straight line may have ordinary recapture for the excess over straight line, and the remaining depreciation-related gain is unrecaptured § 1250 gain subject to the 25-percent maximum rate after netting.4 Cost segregation does not give every reclassified asset the same recapture character. Improvements a landlord makes for a tenant are depreciated under the ordinary MACRS rules for the property improved, not over the lease term, and if the improvement is abandoned at the end of the lease, its remaining basis is taken into account at that time. An abandonment loss requires intent to discard the asset irrevocably so that it will neither be used again nor retrieved for sale or other disposition; lease termination or vacancy alone is not enough, and an abandoned asset subject to nonrecourse debt is treated under the sale or exchange rules.5

1 Treas. Reg. §§ 1.167(a)-10(b), 1.46-3(d)(1)(ii).
2 IRS Pub. 5653, Cost Segregation Audit Techniques Guide (non-precedential).
3 I.R.C. § 1245(a)(1), (a)(2)(A)–(B).
4 I.R.C. §§ 1245(a)(1), 1250(a)(1), (b)(1), 1(h)(6).
5 I.R.C. § 168(i)(8)(A)–(B); Treas. Reg. § 1.168(i)-8(e)(2).

C. Repairs (Line 14) Versus Improvements (Line 18)

The tangible property regulations require capitalization of amounts paid to improve a unit of property, and they define an improvement as a betterment, a restoration, or an adaptation to a new or different use.1 Practitioners use the acronym BAR. For a building, the improvement tests are applied separately to the building structure and to each building system: heating, ventilation, and air conditioning; plumbing; electrical; escalators; elevators; fire protection and alarm; security; and gas distribution.2 For a condominium owner, the unit of property is the individual unit and the structural components that are part of the unit, and the improvement rules apply to the building structure that is part of the condominium and to the portion of each building system that is part of the condominium; the association applies the rules to the building structure and systems it owns. For assessments, obtain the association's project scope to determine what the owner is paying for.3 Applying the test system by system is what makes replacing a whole HVAC system a capital expenditure even though, measured against the entire house, it might look like a repair.

A betterment fixes a material condition or defect that existed before the client acquired the property, materially adds to the property **(an addition, or a material increase in capacity or productivity)**, or materially increases its efficiency, strength, or quality.4 A restoration includes replacing a major component or a substantial structural part of the unit of property, rebuilding to like-new condition after the end of its class life, and returning the unit of property to its ordinarily efficient operating condition after it has deteriorated to a state of disrepair and is no longer functional for its intended use.5 Ordinary wear, or disrepair without loss of function, does not alone satisfy that last test; apply the other BAR provisions and the safe harbors. An adaptation changes the property to a use not consistent with the owner's ordinary use when it was placed in service, such as converting a garage into a rental studio.6

Table 5. Repairs and improvements: storefront examples

Expenditure	Usual treatment	Reason
Replace a broken window pane	Repair (Line 14)	Restores to ordinary operating condition
Patch a roof leak; replace a few damaged shingles	Repair (Line 14)	Not a major component or substantial structural part
Replace the entire roof	Improvement (Line 18), recovered over the period that applies to the building's classification (ordinarily 27.5 years for GDS residential rental; 39 years for nonresidential)	**Restoration:** major component of building structure; test the safe harbors first
Replace the whole HVAC system	Improvement (Line 18)	**Restoration:** the HVAC system is a building system to which the improvement tests are applied separately
Convert gravel driveway to concrete	Improvement (Line 18; 15-year land improvement)	**Betterment:** material increase in quality
Repaint the interior between tenants	Repair; often routine maintenance	Keeps property in ordinarily efficient operating condition
Convert a detached garage into a studio apartment	Improvement (Line 18)	Adaptation to a new use
Replace a water heater for $1,400	Often expensed under the de minimis election	Invoice at or below $2,500; otherwise a facts-dependent restoration analysis

1 Trea s. Reg. § 1.263(a)-3(d), (j)–(l).
2 Treas. Reg. § 1.263(a)-3(e)(2)(ii)(B).
3 Treas. Reg. § 1.263(a)-3(e)(2)(iii).
4 Treas. Reg. § 1.263(a)-3(j)(1).
5 Treas. Reg. § 1.263(a)-3(k)(1).
6 Treas. Reg. § 1.263(a)-3(l)(1).

Three capitalization reliefs: two annual elections and the routine maintenance rule. The regulations offer three ways to deduct costs that might otherwise be capitalized. Two are annual elections; the third, routine maintenance, is a rule applied whenever its conditions are met, with no election.

The de minimis safe harbor lets a taxpayer deduct amounts paid for property costing up to a set amount per invoice, or per item as substantiated by the invoice. For a taxpayer with an applicable financial statement **(AFS)**, the regulation sets the limit at $5,000. AFS status is determined from a descending-priority list: a financial statement required to be filed with the SEC; a certified audited financial statement accompanied by an independent accountant's report and used for credit purposes, reporting to owners, or another substantial nontax purpose; or a financial statement, other than a tax return, required to be provided to a federal or state government or agency other than the SEC or the IRS.1 For everyone else, including virtually every individual landlord, the regulation's printed figure of $500 was raised to $2,500 by notice, effective for costs incurred in taxable years beginning on or after January 1, 2016.2 An AFS taxpayer must have written accounting procedures at the beginning of the year and must expense the amount on its AFS; a taxpayer without an AFS must have accounting procedures at the beginning of the year and must actually expense the amount in its books and records under those procedures.3 In either case the taxpayer must make the election annually by attaching a statement, titled "**Section** 1.263(a)-1(f) de minimis safe harbor election," with the taxpayer's name, address, and identifying number and a statement that the taxpayer is making the election, to a timely filed original return including extensions.4 The election applies to all qualifying amounts for that year.

The safe harbor for small taxpayers **(SHST)** lets a qualifying taxpayer, one with average annual gross receipts of $10,000,000 or less for the three preceding taxable years, determined under **§** 1.263(a)-3(h)(3), including its new-taxpayer and short-year rules, deduct all amounts paid during the year for repairs, maintenance, improvements, and similar activities on an eligible building, one with an unadjusted basis of $1,000,000 or less, if the total for that building does not exceed the lesser of $10,000 or 2 percent of the building's unadjusted basis.5 Two features catch preparers. The limit is a ceiling, not an allowance: if the total exceeds it by a dollar, the safe harbor is unavailable for that building for that year. And amounts deducted under the de minimis election and the routine maintenance safe harbor count toward the total.6 The election is made annually, building by building, by a statement titled "**Section** 1.263(a)-3(h) Safe Harbor Election for Small Taxpayers," with the taxpayer's name, address, identifying number, and a description of each eligible building, attached to a timely filed original return.7

Example 19. Safe harbor for small taxpayers

```
Facts: Building unadjusted basis $300,000; landlord's gross receipts
well under $10,000,000.
Step 1. 2% of unadjusted basis: $300,000 x 2% ..... $6,000
Step 2. Limit = lesser of $6,000 or $10,000 ..... $6,000
Case 1: Total repairs, maintenance, and improvements for the year
        $5,800 (including a $1,900 new roof section). $5,800 does not
        exceed $6,000: elect SHST; deduct all $5,800.
Case 2: Same facts, total $6,200. $6,200 exceeds $6,000: SHST is
        unavailable for this building this year. Apply the BAR
        analysis item by item. Items that qualify under the de minimis
        election or the routine maintenance rule may still be deducted,
        and a replaced roof section may support a partial disposition
        election made on the timely filed return (Treas. Reg.
        § 1.168(i)-8(d)(2)).
```

The routine maintenance safe harbor requires no election. It treats as not improving the property the recurring activities a taxpayer expects to perform to keep a building structure or building system in its ordinarily efficient operating condition, including inspection, cleaning, testing, and replacing damaged or worn parts with comparable parts, if at the time the system was placed in service the taxpayer reasonably expected to perform

1 Treas. Reg. § 1.263(a)-1(f)(4).
2 Treas. Reg. § 1.263(a)-1(f)(1)(i)(D), (f)(1)(ii)(D); Notice 2015-82, 2015-50 I.R.B. 859.
3 Treas. Reg. § 1.263(a)-1(f)(1)(i)(A)–(C), (f)(1)(ii)(A)–(C).
4 Treas. Reg. § 1.263(a)-1(f)(5).
5 Treas. Reg. § 1.263(a)-3(h)(1), (h)(3)(i), (h)(4).
6 Treas. Reg. § 1.263(a)-3(h)(2).
7 Treas. Reg. § 1.263(a)-3(h)(6).

the activity more than once during the 10-year period that begins then.1 The safe harbor covers recurring activities that result from the taxpayer's own use; costs incurred primarily because of a prior owner's use fall outside it and must be tested under the betterment, restoration, and adaptation rules, though they are not capital merely because the safe harbor does not apply. It does not cover betterments; adaptations; certain replacements of components for which a loss was deducted or whose basis was taken into account in a disposition; restorations of casualty damage subject to the paragraph **(k)**(4) limitation; or returns of property to operation after it has deteriorated to a state of disrepair and is no longer functional.2 Review those exclusions before treating recurrence as conclusive.

Finally, a taxpayer may elect to capitalize repair and maintenance costs that it treats as capital expenditures on its books, an option occasionally useful for a client who wants a higher basis. The election is made annually by attaching a statement titled "**Section** 1.263(a)-3(n) Election," with the taxpayer's name, address, and identifying number and a statement that the taxpayer is making the election, to a timely filed original return including extensions. It applies to all repair and maintenance amounts capitalized on the books for that year, so items cannot be selected one by one; partnerships and S corporations make it at the entity level.3

Practice Pointer: Keep the election statements in the permanent file
The de minimis and SHST elections are annual and are made on a timely filed original return, including extensions. If one is missed, relief may be available: an automatic six-month extension where the return was timely filed and corrective action, such as an amended return headed "FILED PURSUANT TO § 301.9100-2," is taken within six months of the unextended due date, or discretionary relief by private letter ruling.4 Neither is assured in every case. Build the elections into the rental workflow so that they are generated automatically each year a client may need them, and keep copies in the permanent file with the depreciation schedule.

VI. LOSS LIMITS, PASSIVE ACTIVITIES, AND REAL ESTATE PROFESSIONALS

A. The Loss-Limitation Sequence

When a property shows a loss on Line 21, the loss passes through a fixed sequence of limitations before it reaches the client's taxable income. For a dwelling unit used as a residence, apply the § 280A(c)(5) limit first **(Part IV)**. For losses from a passthrough entity, apply the owner-level basis rules next; directly owned rental property has no separate entity-basis ceiling on operating losses, although basis still controls depreciation and gain. Then apply the at-risk, passive activity, and excess business loss rules, in that order. The Form 461 instructions state the order directly: "First, apply the at-risk rules; next, apply the passive activity loss rules; and then apply the excess business loss rules."5 A loss suspended at an earlier hurdle never reaches the later ones in that year, and each hurdle has its own carryforward.

Basis. For directly owned property, basis limits depreciation and determines gain rather than operating as a separate hurdle on operating losses. It matters more for interests held through entities, where losses are limited to the owner's basis in the partnership interest or S corporation stock and debt.6

At-risk. A taxpayer may deduct losses from an activity only to the extent the taxpayer is at risk in it.7 For real estate, the key rule is that qualified nonrecourse financing counts as an amount at risk: generally, money borrowed from a bank, other qualified lender, or government, secured by the real property, for which no one is personally liable.8 A recourse bank mortgage, or financing that meets all of the qualified nonrecourse conditions **(security by the real property, a qualified lender or government source, no personal liability other than as permitted, and no convertibility)**, rarely creates an at-risk problem; commercially reasonable financing from a

1 Treas. Reg. § 1.263(a)-3(i)(1)(i).
2 Treas. Reg. § 1.263(a)-3(i)(3).
3 Treas. Reg. § 1.263(a)-3(n)(1)–(2).
4 Treas. Reg. §§ 1.263(a)-1(f)(5), 1.263(a)-3(h)(6), 301.9100-2(b)–(d), 301.9100-3(a).
5 Instructions for Form 461 (2025), General Instructions.
6 I.R.C. §§ 704(d), 1366(d)(1).
7 I.R.C. § 465(a)(1).
8 I.R.C. § 465(b)(6)(A)–(B).

qualified related lender can also qualify.1 Side arrangements that protect an investor against loss do create one. The at-risk box on Line 21 and Form 6198 come into play when some investment is not at risk.

Example 20. "Uncle and Nephew": basis without risk

```
Facts: Uncle contributes $50,000 cash for a 50% interest in a rental
he owns with his nephew. The nephew promises in writing to reimburse
Uncle for any loss on the investment.
Step 1. Uncle's basis in his interest ..................... $50,000
Step 2. Amount protected against loss by the guarantee ... $50,000
Step 3. Amount at risk: $50,000 - $50,000 ................ $     0
Conclusion: Uncle has basis but is not at risk. Losses allocable to
him are suspended under § 465 (Form 6198) and carried forward, and
never reach the passive loss computation while the guarantee stands.
```

The at-risk rule that produces this result provides that a taxpayer is not at risk with respect to amounts protected against loss through guarantees, stop-loss agreements, or similar arrangements.2

Passive activity loss. Discussed in Parts VI.B through VI.E.

Excess business loss. For noncorporate taxpayers, net business losses that clear the passive rules are further limited each year to a threshold amount; the excess becomes a net operating loss carryforward.3 Wages are not business income for this computation; items attributable to the trade or business of performing services as an employee are disregarded.4 The thresholds are $313,000 **($626,000 joint)** for 2025 and $256,000 **($512,000 joint)** for 2026; the 2026 figures are lower because the 2025 legislation reset the inflation base, and that legislation also made the limitation permanent for taxable years beginning after 2026.5 Few storefront rental clients will reach these numbers, but a client with a large nonpassive short-term rental loss, a cost segregation study, and a Form 3115 catch-up in the same year can.

B. The Passive Activity Rules and the $25,000 Allowance

A passive activity is a trade or business in which the taxpayer does not materially participate, and every rental activity is passive by definition unless the real estate professional rule applies.6 Passive losses offset passive income; the net passive loss is disallowed for the year and carried forward to the next year, indefinitely, on Form 8582.7

The most important relief for ordinary landlords is the special allowance for rental real estate activities in which the taxpayer actively participated. Up to $25,000 of passive loss from those activities may be deducted against nonpassive income each year.8 Active participation is a much lower standard than material participation. It requires bona fide involvement in management decisions, such as approving tenants, setting rents, and approving capital or repair expenditures, and it may be satisfied even when a property manager handles day-to-day operations. It is unavailable if the taxpayer's interest, together with the spouse's, is less than 10 percent by value at any time during the year, and a limited partner is not treated as actively participating.9

Three short examples from a widely used instructor text mark the boundaries. John, who owns a rental outright and manages it himself, actively participates. Joe and Jim, who own a rental 50/50 and use a property manager but personally approve new tenants, lease terms, and major repairs, both actively participate, including Joe, who lives in another state. Jeff, who owns 20 percent of a rental and makes no decisions at all, does not, even though he meets the 10-percent ownership requirement.

The allowance phases out by 50 percent of the amount by which the taxpayer's modified adjusted gross income exceeds $100,000, so it is gone at $150,000.10 Modified AGI for this purpose is computed without regard to

1 I.R.C. § 465(b)(6)(B), (D)(ii).
2 I.R.C. § 465(b)(4).
3 I.R.C. § 461(l)(1)(B), (l)(2).
4 I.R.C. § 461(l)(3)(A) (flush language).
5 Rev. Proc. 2024-40, § 2.32; Rev. Proc. 2025-32, § 4.31; Pub. L. 119-21, § 70601.
6 I.R.C. § 469(c)(1)–(2), (c)(7).
7 I.R.C. § 469(a)(1), (b).
8 I.R.C. § 469(i)(1)–(2).
9 I.R.C. § 469(i)(6)(A), (C).
10 I.R.C. § 469(i)(3)(A).

taxable social security benefits, IRA deductions, and any passive activity loss, among other adjustments.1 The $100,000 threshold is the same for single and joint filers and is not indexed for inflation, so it bites harder every year.

Example 21. The $25,000 allowance phase-out

```
Case 1: MAGI $130,000; actively participating; rental loss $14,000.
  Step 1. Excess over $100,000: $130,000 - $100,000 ..... $30,000
  Step 2. Reduction: $30,000 x 50% ....................... $15,000
  Step 3. Allowance: $25,000 - $15,000 ..................... $10,000
  Result: $10,000 deducted; $4,000 suspended (Form 8582).
Case 2: MAGI $150,000 or more. Reduction $25,000; allowance $0;
  entire loss suspended unless offset by passive income.
Case 3: Married filing separately, spouses lived together at any time
  during the year. Allowance $0, regardless of MAGI.
Case 4: Married filing separately, lived apart all year. Allowance
  $12,500, phased out between $50,000 and $75,000 of MAGI.
```

The married-filing-separately rules come straight from the statute: the allowance does not apply to a married individual filing separately who does not live apart from the spouse at all times during the year, and for spouses who lived apart all year, $12,500 and $50,000 replace $25,000 and $100,000.2 One more rule catches preparers working through a client's carryforwards. The allowance covers a suspended loss from a prior year only if the taxpayer actively participated both in the current year and in the year the loss arose.3

⚠ Caution: The Line 2 test also comes first

A dwelling unit the taxpayer used as a residence is subject to the § 280A(c)(5) limit, not the passive loss rules; the Schedule E instructions note that the rental of a dwelling unit used as a home is not subject to the passive loss limitation rules.4 Run the § 280A analysis in Part IV before turning to Form 8582.

C. Real Estate Professionals and Material Participation

A taxpayer who qualifies as a real estate professional is released from the rule that rental activities are automatically passive.5 Qualification is a two-part annual test. More than half of the personal services the taxpayer performed in all trades or businesses during the year must have been performed in real property trades or businesses in which the taxpayer materially participated, and the taxpayer must have performed more than 750 hours of services in those real property trades or businesses.6 A real property trade or business means "any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business."7 Mortgage lending is not on the list. Hours worked as an employee do not count unless the employee owns more than 5 percent of the employer.8 On a joint return, one spouse alone must meet both parts of the test; the spouses' hours may not be combined.9

Qualifying is only the first step. A real estate professional's rental activities are no longer automatically passive, but each one is still passive unless the taxpayer materially participates in it, and each interest in rental real estate is treated as a separate activity unless the taxpayer elects otherwise.10 A taxpayer materially participates in an activity for a year if any one of seven tests is met: **(1)** more than 500 hours of participation; **(2)** participation that is substantially all of the participation of all individuals, including non-owners; **(3)** more than 100 hours, and not less than the participation of any other individual, including non-owners such as a manager or cleaner; **(4)** participation in significant participation activities **(generally, trade or business activities in which the individual participates more than 100 hours)** that together exceed 500 hours; **(5)** material participation in the activity for any five of the preceding ten taxable years; **(6)** for a personal service activity, material participation in

1 I.R.C. § 469(i)(3)(E).
2 I.R.C. § 469(i)(5)(A)–(B).
3 I.R.C. § 469(i)(1) (parenthetical).
4 I.R.C. § 469(j)(10); Instructions for Schedule E (Form 1040) (2025), Part I.
5 I.R.C. § 469(c)(7)(A).
6 I.R.C. § 469(c)(7)(B)(i)–(ii).
7 I.R.C. § 469(c)(7)(C).
8 I.R.C. § 469(c)(7)(D)(ii).
9 I.R.C. § 469(c)(7)(B) (flush language).
10 I.R.C. § 469(c)(7)(A) (flush language).

any three preceding taxable years, a test not ordinarily relevant to renting property; and **(7)** regular, continuous, and substantial participation on all the facts and circumstances, which requires more than 100 hours and does not count the individual's management services if any other person is compensated for management services or any individual performs more management hours.1 For rentals the first three and the fifth are usually the ones in play. First determine whether any interest is a limited partnership interest: an individual who is also a general partner at all times during the partnership year is not treated as holding one, and LLC membership is not automatically one. For a limited partnership interest, material participation may be established only under tests **(1)**, **(5)**, or **(6)**.2 If a § 1.469-9(g) election includes any limited partnership interest, the combined activity is tested under those three tests unless the taxpayer's share of gross rental income from limited partnership interests is less than 10 percent of gross rental income from all rental real estate interests.3 Unlike the real estate professional test, material participation counts both spouses' participation together.4

Example 22. Two real estate professional tests

```
Case 1: Lena, a hospital nurse (W-2), works 1,900 hours at the
  hospital and 800 hours on her four rentals.
  Step 1. Total personal services: 1,900 + 800 ..... 2,700
  Step 2. Real property share: 800 / 2,700 ..... 29.6%
  Result: Fails the more-than-half test. Not a real estate
  professional, even though she exceeds 750 hours. Her husband's
  hours cannot be added to hers for this test.
Case 2: Marco, a licensed real estate agent (self-employed, no other
  job), works 1,200 hours in brokerage and 400 hours on four rentals.
  Assume Marco materially participates in his brokerage business.
  Step 1. Brokerage alone: 1,200 / 1,600 total hours ..... 75%
  Step 2. Brokerage alone more than 750 hours? ..... Yes
  He qualifies without counting the 400 rental hours. Rental hours
  join the qualifying numerator only where he materially participates
  in the rentals; then test each rental or the elected aggregate.
  Result: Qualifies as a real estate professional. But each rental is
  a separate activity: about 100 hours per property does not meet the
  500-hour test for any one of them. With a § 1.469-9(g) election to
  treat all rentals as one activity, his 400 hours are tested against
  the single combined activity, where test (3), more than 100 hours and
  not less than anyone else, may be met depending on how many hours his
  property manager and contractors put in. Under the facts-and-
  circumstances test (7), his management services do not count if a
  property manager is compensated for management services.
```

The election to aggregate all rental real estate into a single activity is made by attaching a statement to the original return for the year, declaring that the taxpayer is a qualifying taxpayer and is making the election under § 469(c)(7)(A).5 It is binding for the year made and for all future years in which the taxpayer is a qualifying taxpayer, and it carries two traps. First, losses that were suspended before the election, while the rentals were passive, remain suspended losses of a former passive activity; they first offset income from that activity, and any remainder continues to be treated as passive: it may offset other passive income, may be allowed under § 469(i) if the taxpayer actively participated in both the current year and the year the loss arose, and is released on a qualifying fully taxable disposition of the entire interest. It does not offset wages merely because the taxpayer is now a real estate professional.6 Second, selling one property from the grouped activity is not a disposition of the taxpayer's entire interest in the activity, so it does not release the group's suspended losses the way a stand-alone sale would.7 A real estate professional continues to report each property in Part I and also completes Schedule E, Line 43, to show net income or loss from rental real estate activities in which he or she materially participated. **Section** 1411 is a separate test; § 469 classification does not decide it. Under the safe harbor available only to a real estate professional, rental income is deemed trade-or-business income for net investment income purposes if the taxpayer participates in the rental real estate activity for more than 500

1 Temp. Treas. Reg. § 1.469-5T(a)(1)–(7), (b)(2)(ii)–(iii), (c).
2 Temp. Treas. Reg. § 1.469-5T(e)(1)–(3).
3 Treas. Reg. § 1.469-9(f).
4 I.R.C. § 469(h)(5); Temp. Treas. Reg. § 1.469-5T(f)(3).
5 Treas. Reg. § 1.469-9(g)(1), (g)(3).
6 I.R.C. § 469(f)(1), (f)(3), (g), (i).
7 I.R.C. § 469(g)(1)(A).

hours during the year, or did so for more than 500 hours in each of any five of the ten preceding taxable years; otherwise the taxpayer must show the income is derived in the ordinary course of a § 162 trade or business.1

D. The Short-Term Rental Path: Material Participation Without Professional Status

The real estate professional rule is a way out of the per se passive rule for rental activities. A short-term rental with an average stay of seven days or less is not a rental activity at all, so it never needs that way out. If it is a trade or business activity, a question determined separately under § 162, it is nonpassive in any year in which the owner materially participates under the regular tests.2 This is how a client with a full-time W-2 job can deduct a short-term rental loss against wages without coming close to 750 hours.

The path is real, but it is narrow. The hours that count are work actually done in the operation of the activity: guest communication, pricing, booking management, restocking, cleaning, maintenance, and coordinating vendors. Work done in the capacity of an investor, such as reviewing statements or reports, generally does not count unless the individual is directly involved in day-to-day management. Work not customarily done by owners, undertaken with a principal purpose of avoiding § 469, also does not count, and travel should be recorded separately from on-site work.3 Participation may be established by any reasonable means, including calendars and appointment books; in practice, a calendar kept during the year carries far more weight than an estimate assembled at filing time.4 And the 100-hour test compares the owner's hours against every other individual's, so a full-service manager or a single cleaner who logs more hours than the owner defeats it.

Example 23. Delgado condo: material participation in 2026

```
Facts from Rosa's calendar and vendor invoices:
  Rosa: guest messages, pricing, listing, restocking, vendor
        coordination ..................................... 140 hrs
  Kevin: two maintenance trips, small repairs ................ 30 hrs
  Cleaning company: 41 turnovers; largest single cleaner about
        50 hrs; company total about 90 hrs
Step 1. Delgados' combined participation (spouses combine for
        material participation): 140 + 30 ................... 170 hrs
Step 2. Test (a)(1), more than 500 hours? ..................... No
Step 3. Test (a)(3), more than 100 hours? ..................... Yes
Step 4. Not less than any other individual? 170 vs. about 50
        (and vs. the company's 90 total) ..................... Yes
On these facts Rosa's 140 documented hours alone exceed every other
individual's participation.
Conclusion: The Delgados materially participate in the condo activity
for 2026. Because the average stay (4.10 days) takes it out of the
rental-activity definition, the condo loss is NONPASSIVE.
Caution: Kevin's hours help only if documented; Rosa's calendar is
the critical record. Hiring a manager in a later year does not by
itself make the activity passive, but it can defeat tests (2) and (3)
and limits test (7). Check all seven tests each year, including
test (5), five of the preceding ten years.
```

Warning: The flip side: no $25,000 allowance

If the Delgados had not materially participated, the condo would be a passive trade or business activity, and its loss would NOT qualify for the $25,000 active-participation allowance, which applies only to rental real estate activities. A short-term rental client who does not materially participate is in a worse position than an ordinary long-term landlord with the same income. Part VIII works the numbers.

E. Two One-Way Recharacterization Traps

Two regulations turn passive rental income into nonpassive income while leaving passive rental losses passive. Under the self-rental rule, net rental income from property rented for use in a trade or business in which the taxpayer materially participates is treated as not from a passive activity.5 A dentist who owns her office building and rents it to her practice cannot use the building's net rent to absorb passive losses from other rentals; if

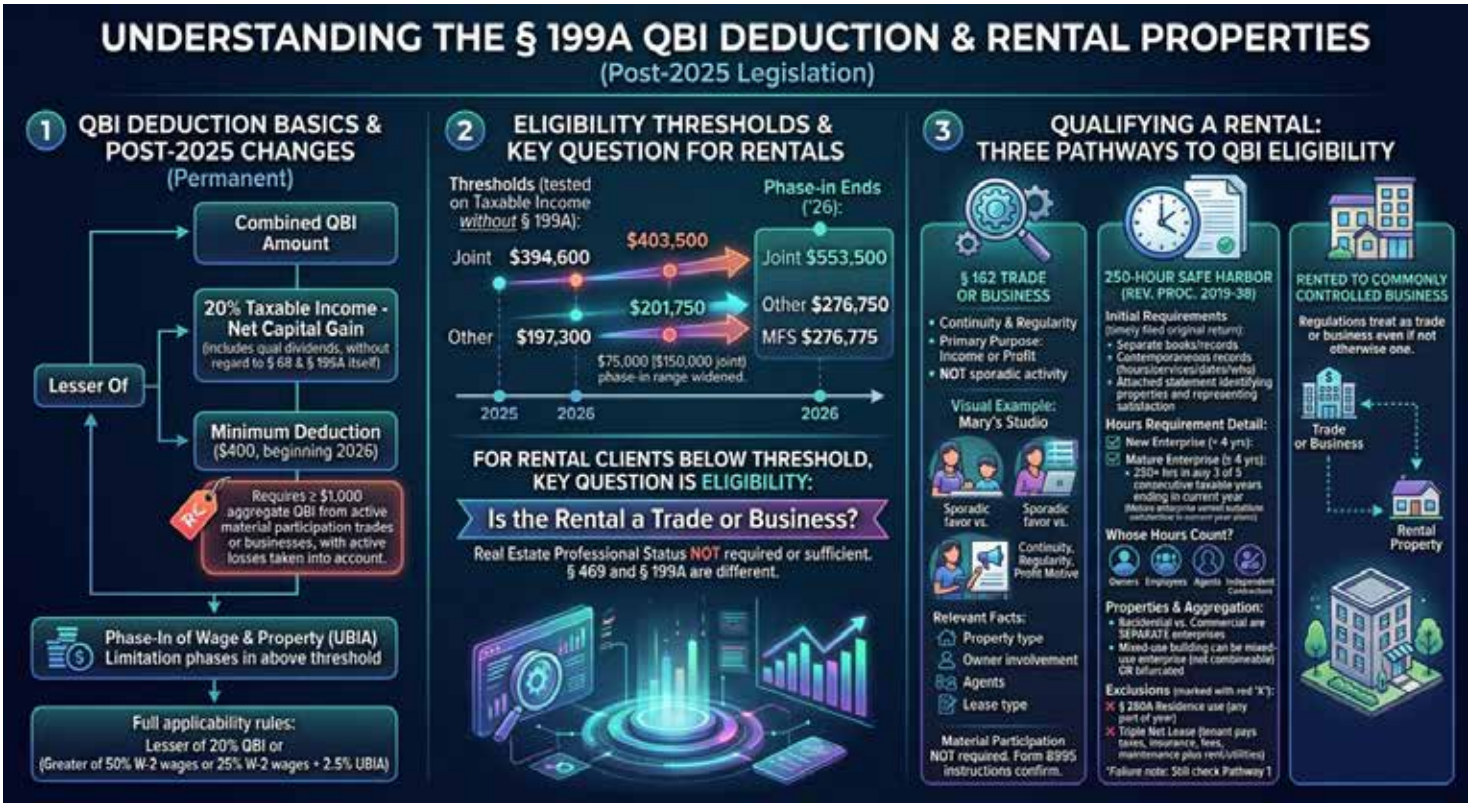
1 I.R.C. § 1411(c)(1)(A), (c)(2); Treas. Reg. § 1.1411-4(g)(7).
2 Temp. Treas. Reg. §§ 1.469-1T(e)(3)(ii)(A), 1.469-5T(a).
3 Temp. Treas. Reg. § 1.469-5T(f)(2)(i)–(ii).
4 Temp. Treas. Reg. § 1.469-5T(f)(4).
5 Treas. Reg. § 1.469-2(f)(6).

the building produces a loss, the self-rental rule does not make the loss nonpassive. That is not the end of the analysis: appropriate grouping of the rental with the operating business, or real estate professional status with material participation, can change the underlying activity's classification, and both should be tested before treating the loss as passive.1 Grouping is fact-specific and not automatically available. Self-rental property is Line 1b code 7. Similarly, if less than 30 percent of the unadjusted basis of rental property is depreciable, as with a rental of mostly raw land, the net rental income is treated as not from a passive activity.2

The practical consequence is that the software must be told. Most programs need a self-rental or "other passive exception" flag on the property; without it, the program will happily net the recharacterized income against passive losses on Form 8582. For net investment income tax purposes, gross rental income that is recharacterized as nonpassive under the self-rental rule is treated as derived in the ordinary course of a trade or business.3

VII. SECTION 199A, MISSED DEPRECIATION, SALES, AND DOCUMENTATION

A. Rental Real Estate and the Qualified Business Income Deduction



The § 199A deduction is now permanent. Except for the minimum deduction, it is limited to the lesser of the combined qualified business income amount or 20 percent of taxable income in excess of net capital gain **(for this purpose, § 1222(11)** net capital gain plus qualified dividend income), with taxable income computed without regard to § 68 and the § 199A deduction itself.4 Above the threshold the W-2 wage and qualified-property **(UBIA)** limitation phases in, and once fully applicable each business's amount is the lesser of 20 percent of its qualified business income or the greater of 50 percent of its W-2 wages or 25 percent of W-2 wages plus 2.5 percent of UBIA.5 The 2025 legislation struck the provision's sunset, widened the phase-in range above the threshold to $75,000 **($150,000 for joint returns)**, and added a minimum deduction of $400 for taxpayers with at least $1,000 of qualified business income from active trades or businesses in which they

1 Treas. Reg. §§ 1.469-4(d)(1), 1.469-9(e).
2 Temp. Treas. Reg. § 1.469-2T(f)(3).
3 Treas. Reg. § 1.1411-4(g)(6).
4 I.R.C. § 199A(a), (e)(1); Treas. Reg. § 1.199A-1(b)(3).
5 I.R.C. § 199A(b)(2)–(3).

materially participate, beginning in 2026.1 The threshold below which the wage and property limitations and the specified-service rules do not apply is $197,300 **($394,600 joint)** for 2025 and $201,750 **($403,500 joint; $201,775 married filing separately)** for 2026.2 The threshold is tested against taxable income computed without the § 199A deduction; for 2026 the phase-in range ends at $553,500 **(joint)**, $276,775 **(married filing separately)**, and $276,750 **(others)**.3 The $400 minimum requires at least $1,000 of aggregate qualified business income from all active qualified trades or businesses in which the taxpayer materially participates, with active-business losses taken into account. Most storefront rental clients are well below the threshold, which means the question for them is not the computation but eligibility: whether the rental is a trade or business at all.

A rental qualifies through one of three pathways under the regulations and rental real estate safe harbor.4 The rental may rise to the level of a § 162 trade or business. It may meet the rental real estate safe harbor of Revenue Procedure 2019-38. Or it may be rented to a commonly controlled trade or business, which the regulations treat as a trade or business for § 199A purposes even if it would not otherwise be one.5 Real estate professional status is neither required nor sufficient; the § 469 tests and the § 199A tests are different.6

Pathway 1: a § 162 trade or business. The regulations adopt the § 162 standard,7 and § 162 asks whether the taxpayer is involved in the activity with continuity and regularity and with the primary purpose of income or profit; a sporadic activity does not qualify.8 Neither material participation nor real estate professional status is required, and the Form 8995 instructions confirm that rental real estate that does not meet the safe harbor may still be a trade or business for this purpose.9 Relevant facts include the number and type of properties, the owner's day-to-day involvement, the use of agents, and the type of lease. A net-leased single property on which the owner does little is a weak case; several actively managed residential units are a much stronger one.

An instructor example frames the question well. Mary lets her divorcing sister live rent-cheap in the studio above her garage for a few months as a favor; that is sporadic and not a trade or business. Later, Mary advertises the studio, screens tenants, signs leases, and rents it continuously to fund her retirement; that pattern of continuity and regularity with a profit motive is much more likely to be a § 162 trade or business.

Pathway 2: the 250-hour safe harbor. Under Revenue Procedure 2019-38, a rental real estate enterprise is treated as a trade or business if the taxpayer maintains separate books and records for the enterprise; meets the rental-services hours requirement described below; keeps contemporaneous records of the hours, services, dates, and who performed them; and attaches a statement to a timely filed original return. The statement must identify each enterprise's properties by address and rental category, identify properties acquired or disposed of during the year, and represent that the revenue procedure's requirements are satisfied; supporting records must be available on request. The amended-return alternative in the revenue procedure applied only to 2018.10 The rental-services hours requirement depends on the enterprise's age. An enterprise in existence for less than four years must have at least 250 hours of qualifying rental services per year. An enterprise in existence for at least four years must have at least 250 hours per year in any three of the five consecutive taxable years ending with the current taxable year. The mature enterprise cannot substitute satisfaction in the current year alone.11 Hours performed by owners, employees, agents, and independent contractors all count. Residential and commercial property may not be combined in one enterprise, but a single building containing residential and commercial units may be treated as a separate mixed-use rental real estate enterprise or bifurcated into residential and commercial interests; if treated as one mixed-use enterprise, it cannot be combined with other residential, commercial, or mixed-use property.12 The safe harbor excludes real estate used by the taxpayer as a residence under § 280A for any part of the year and property rented under a triple net lease, defined as a lease

1 Pub. L. 119-21, § 70105; I.R.C. § 199A(b)(3)(B), (d)(3), (i).
2 Rev. Proc. 2024-40, § 2.27; Rev. Proc. 2025-32, § 4.26.
3 I.R.C. § 199A(e)(1); Rev. Proc. 2025-32, § 4.26.
4 Treas. Reg. § 1.199A-1(b)(14); Rev. Proc. 2019-38, 2019-42 I.R.B. 942.
5 Treas. Reg. § 1.199A-1(b)(14).
6 Treas. Reg. § 1.199A-1(b)(14).
7 Treas. Reg. § 1.199A-1(b)(14).
8 *Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987).
9 Instructions for Form 8995 (2025), Trade or business of rental real estate.
10 Rev. Proc. 2019-38, § 3.03(A)–(D), 2019-42 I.R.B. 942.
11 Rev. Proc. 2019-38, § 3.03(B).
12 Rev. Proc. 2019-38, § 3.02.

that requires the tenant to pay taxes, fees, insurance, and maintenance in addition to rent and utilities.1 Failing the safe harbor does not prevent the taxpayer from showing that the rental is a trade or business under Pathway 1.2

Caution: Personal use, countable hours, and the safe harbor

The safe harbor excludes real estate used by the taxpayer as a residence under § 280A(d), which is the 14-day/10-percent test; the Delgados' nine personal days, against a 16.8-day threshold, do not trigger the exclusion. Rental services exclude financial or investment management activities, including arranging financing, procuring property, and studying or reviewing financial statements or operating reports; improving property under § 1.263(a)-3(d); and travel to and from the real estate. Those hours do not count toward the 250. Self-rented property is also excluded, and the safe harbor excludes the entire rental real estate interest if any portion of that interest is treated as a specified service trade or business under § 1.199A-5(c)(2).3

Pathway 3: self-rental. A rental that does not itself rise to a § 162 trade or business is nevertheless treated as one for § 199A if the property is rented to a trade or business conducted by the individual or by a relevant passthrough entity that is commonly controlled, generally 50 percent or more common ownership.4 The rule does not cover a C corporation tenant; a rental to a commonly owned C corporation must qualify on its own under § 162. And where the commonly owned tenant is a specified service trade or business, the portion of the rental provided to it is itself treated as a specified service trade or business with respect to the related parties.5

The information-return consistency point. A landlord who claims that a rental is actually conducted as a § 162 trade or business should be prepared to file the information returns a trade or business must file under §§ 6041 and 6041A, subject to their exceptions.6 Qualification solely under Revenue Procedure 2019-38, or under the § 199A-specific self-rental rule, does not itself establish a trade or business for other Code purposes.7 Determine Form 1099 obligations independently, and document payee classification and payment method. Filing Forms 1099 is not proof of § 162 status. The threshold is $600 for payments made in 2025 and $2,000 for payments made in 2026. A landlord who asserts actual trade-or-business status must separately determine and satisfy the applicable information-return obligations. A § 199A deduction combined with no Form 1099 does not, standing alone, establish inconsistent treatment; document the rental's qualification pathway and the reason reporting was or was not required.

1 Rev. Proc. 2019-38, § 3.05(A)–(B).
2 Rev. Proc. 2019-38, § 1.
3 Rev. Proc. 2019-38, §§ 3.04, 3.05(A)–(D).
4 Treas. Reg. §§ 1.199A-1(b)(14), 1.199A-4(b)(1)(i).
5 Treas. Reg. § 1.199A-5(c)(2).
6 I.R.C. § 6041(a); Treas. Reg. § 1.6041-1(a)(1)(iv).
7 Rev. Proc. 2019-38, § 1; Treas. Reg. § 1.199A-1(b)(14); I.R.C. § 6041(a).

Example 24. Delgados and section 199A for 2026

```
Condo: continuous, regular short-term rental with material
  participation. Strong § 162 trade or business (Pathway 1).
  2026 condo result (Part VIII): ($32,842), including the negative
  § 481(a) adjustment, which counts in QBI, to the extent the
  § 199A requirements are otherwise met, because it arises in a
  taxable year ending after December 31, 2017.
Maple Street: one long-term rental, self-managed, continuously leased
  from May 2026. Assume Maple Street does not qualify for Rev. Proc.
  2019-38 for 2026, including because qualifying rental services
  performed by the owners, employees, agents, and independent
  contractors total less than 250 hours. Its separate § 162
  trade-or-business status turns on the actual facts (continuity,
  regularity, and profit motive), not on failure of the safe harbor,
  and is not elective. Both outcomes:
  If a § 162 trade or business:
    Total QBI: ($32,842) + $4,180 ......................... ($28,662)
  If not a trade or business:
    Total QBI: ($32,842) + $0 ............................. ($32,842)
QBI deduction for 2026 (either outcome) ......................... $0
Negative QBI carried forward to 2027: ($28,662) or ($32,842)
Document the facts supporting whichever conclusion is reached.
Information returns: the cleaning company was paid $4,510 in 2026.
Assume it is taxed as a sole proprietorship or partnership and was paid
by check or ordinary bank transfer, not by payment card or through a
third-party network covered by § 6050W. On those assumptions, the
Delgados issue a 2026 Form 1099-NEC ($2,000 threshold), consistent with
treating the condo as a business. In practice, obtain Form W-9 and
verify the payment method before deciding the filing obligation.
```

The § 481(a) treatment in the example rests on the regulation providing that § 481 adjustments, positive or negative, are taken into account in computing qualified business income if the adjustment arises in a taxable year ending after December 31, 2017.1 A negative total is carried forward and reduces future qualified business income.2 Suspended passive losses are different. When they are allowed, they reduce qualified business income only to the extent they otherwise qualify under § 199A, with their attributes determined in the year each loss arose, and they are taken into account oldest first; losses from taxable years ending before January 1, 2018 are excluded. A § 481(a) adjustment arising in 2026 is tested separately.3

B. Missed Depreciation and Form 3115

The basis consequence. A landlord's basis is reduced each year for depreciation "allowed as deductions in computing taxable income," but "not less than the amount allowable."4 Practitioners call this the "allowed or allowable" rule, and it means that a client who never claimed depreciation still has basis reduced as if the client had. Gain characterization is a separate determination. Unrecaptured § 1250 gain, taxed at up to 25 percent, and the § 121(d)(6) exclusion limitation both depend on "depreciation adjustments" as defined in § 1250(b)(3), and that definition permits the taxpayer to establish by adequate records or other sufficient evidence that the depreciation actually allowed was less than the amount allowable.5 Apply that evidentiary rule when determining the depreciation adjustments for those purposes, and do not infer the gain's character or applicable rate solely from the reduction in basis.

1 Treas. Reg. § 1.199A-3(b)(1)(iii).
2 I.R.C. § 199A(c)(2); Treas. Reg. § 1.199A-1(c)(2)(i).
3 Treas. Reg. § 1.199A-3(b)(1)(iii)–(iv).
4 I.R.C. § 1016(a)(2).
5 I.R.C. §§ 1(h)(1)(E), (h)(6), 121(d)(6), 1250(b)(3); Treas. Reg. § 1.1250-2(d)(4).

Example 25. The cost of the prior preparer's omission

```
Delgado condo: building basis $240,000 (purchase $300,000 x 80%
assessor building ratio); placed in service July 2021; 39-year SL,
mid-month (see Part V.B). No depreciation claimed 2021-2025.
Assume the condo was rented or held for rent at fair rental with no
personal use from July 2021 through 2025, that 39 years is the
applicable recovery period, and that the purchase price included no
separately valued furnishings.
Step 1. 2021 (July; 5.5 months): $240,000 x 1.177% ..... $ 2,824.80
Step 2. 2022-2025 (4 full years): $240,000 x 2.564% x 4 .... $24,614.40
Step 3. Allowable depreciation 2021-2025 ................... $27,439.20
        rounded ..................................... $27,439
In practice, build a year-by-year schedule of allowable depreciation
using each year's actual rental-use percentage and any § 280A(c)(5)
limit; the 2026 fraction cannot be applied backward. Determine whether
earlier furniture was owned, depreciated, still held, sold, or
discarded; do not assume its basis or depreciation history.
Step 4. If sold without correction, basis is still reduced by the
        allowable $27,439, so recognized gain is $27,439 larger. The
        gain's character and applicable rate require a separate
        sale-year computation, including consideration of
        § 1250(b)(3).
If 27.5 years were the correct life, the allowable amount would be:
  2021: $240,000 x 1.667% = $4,000.80; 2022-2025: $240,000 x 3.636% x 4
  = $34,905.60; total $38,906.40.
```

Why a method change, not an amended return. Claiming no depreciation, or the wrong recovery period, on two or more consecutively filed returns is generally the adoption of an impermissible method of accounting.[1] A change from not depreciating a depreciable asset to depreciating it, and a change in recovery period, are changes in method of accounting.[2] Once a method has been adopted, the correction is generally made prospectively through Form 3115, not by amending the closed and open years one by one. The change is made under the automatic-change procedures of Revenue Procedure 2015-13 and the list of automatic changes now in Revenue Procedure 2025-23, section 6.01, designated change number 7.[3] Automatic does not mean unconditional. DCN 7 applies only if the § 6.01 and Revenue Procedure 2015-13 eligibility requirements are met; check for a change for the same item during the five taxable years ending with the year of change, applicable waivers, the exclusions in § 6.01, and the current list when filed. For a taxpayer under examination, separately evaluate audit protection and any shortened positive-adjustment period.[4] The section 6.01 change covers depreciable property owned by the taxpayer at the beginning of the year of change; eligible disposed property is handled under a separate change in section 6.07 **(DCN 107)**, whose mechanics differ: the year of change is the year of disposition. The change may be made on the disposition year's timely filed original return, including extensions, or through the permitted amended-return or applicable administrative adjustment request **(AAR)** procedure. The amended-return route requires filing before the § 6501(a) assessment period for the disposition year expires; the AAR route for a partnership under the centralized audit regime requires filing before the applicable § 6235 adjustment period for the reviewed year expires. Either way, include the required income and collateral adjustments and comply with the Form 3115 filing requirements of § 6.07(6). A prior-year disposition does not become a catch-up in an arbitrarily chosen later year.[5] For a partnership under the centralized audit regime, the AAR must also satisfy § 6227(c): it cannot be filed more than three years after the later of the partnership return's filing date or its unextended due date, and it cannot be filed after a notice of administrative proceeding for that year has been mailed. The § 6235 condition in the revenue procedure does not replace these independent restrictions.[6] These are method-change filing conditions; they do not extend the independent time limits or payment lookback for a refund under § 6511. Generally, a refund claim must be filed within three years after the return was filed or two years after tax was paid, whichever expires later; the

1 Rev. Proc. 2025-23, § 6.01(1)(a)(i); IRS Pub. 946, ch. 1 (Adoption of accounting method defined).
2 Treas. Reg. § 1.446-1(e)(2)(ii)(d)(2), (d)(2)(i).
3 Rev. Proc. 2015-13, 2015-5 I.R.B. 419; Rev. Proc. 2025-23, § 6.01, 2025-24 I.R.B. 1476.
4 Rev. Proc. 2015-13, §§ 5.01(1), 7.03(3)(b), 8.02.
5 Rev. Proc. 2025-23, §§ 6.01(1)(a)(iv), 6.07(3)(a), (3)(b)(i)(A)–(B), (4), (6), (9); I.R.C. §§ 6227, 6235; see Rev. Proc. 2007-16, § 3.02(1)–(2) (source of the procedure).
6 I.R.C. § 6227(c).

amount refundable is separately limited by § 6511(b), subject to applicable special rules.1 An impermissible depreciation method generally is adopted after it has been used on two or more consecutively filed returns; a permissible method generally is adopted on the first return. A one-year impermissible error may generally be corrected by amendment, subject to the immediately-preceding-year option below.2 Mathematical and posting errors, placed-in-service corrections, changes in use, and late elections require separate analysis. For qualifying property placed in service in the immediately preceding taxable year, § 6.01(1)(b) permits correction through Form 3115, provided its § 481(a) adjustment includes all required adjustments attributable to property covered by that form. Alternatively, the taxpayer may file an amended return for the placed-in-service year, or an AAR under § 6227, as applicable, before filing the return for the succeeding taxable year.3 A positive § 481(a) adjustment, from over-depreciation, is generally taken into account over four years, or entirely in the year of change if it is less than $50,000 and the taxpayer so elects by completing the appropriate Form 3115 line and including the entire positive adjustment in the year of change.4

The change is made with a § 481(a) adjustment, which captures the cumulative difference between the depreciation claimed and the depreciation allowable for all prior years, open or closed.5 When the client under-depreciated, the adjustment is negative, a deduction, and a negative adjustment is taken into account entirely in the year of change.6 In practice it is reported on Schedule E, Line 19, labeled "**Section** 481(a) adjustment, depreciation," with the depreciation schedule updated to show the corrected accumulated amount. A qualified small taxpayer may complete a reduced set of Form 3115 lines for this change. For this reduced filing provision, a qualified small taxpayer has average annual gross receipts, determined under § 1.263(a)-3(h)(3), of $10,000,000 or less for the three preceding taxable years. This is not the § 448(c) gross-receipts threshold.7 The original Form 3115 is attached to the timely filed original return for the year of change, including extensions, and a signed copy is filed with the IRS in Ogden, Utah, no earlier than the first day of the year of change and no later than the date the original is filed with the return.8 Confirm the current address or fax number in the Form 3115 instructions on the filing date.

Practice Pointer: Where the section 481(a) deduction lands under section 469

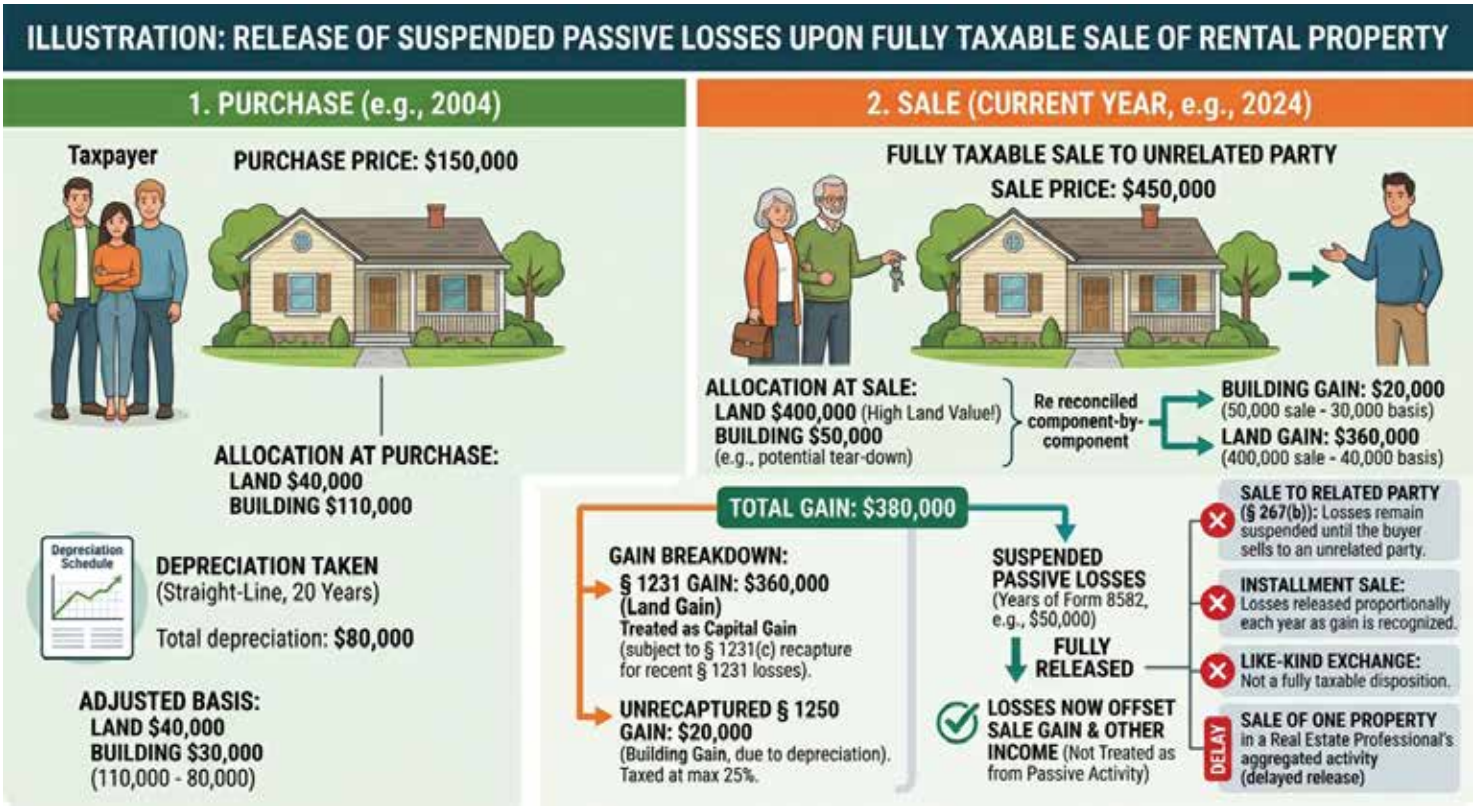
A negative § 481(a) adjustment is treated as a deduction from the activity for which it arose, and it is a passive activity deduction if and only if that activity is a passive activity for the year of change, regardless of the activity's status in the years the depreciation was missed.9 For the Delgados, whose condo is nonpassive in 2026, the catch-up offsets wages. For a client whose rental is passive in the year of change, the same deduction joins the passive computation on Form 8582.

Practice Pointer: Storefront diagnostic and hand-off protocol

At intake for any new rental client: (1) compare the prior depreciation schedule to the closing disclosure and the assessor ratio; (2) look for no depreciation, land included in the building, the wrong life, and improvements never added; (3) explain the allowed-or-allowable consequence to the client in writing; and (4) unless the office has the training, software, and review process to prepare Form 3115 and its duplicate filing, refer the change to, or prepare it with review by, a practitioner who does. The diagnosis is the storefront preparer's job; the method change can be someone else's.

1 I.R.C. § 6511(a)–(b).
2 IRS Pub. 946, ch. 1 (What If You Deduct the Wrong Amount?); Treas. Reg. § 1.446-1(e)(2)(ii)(b), (d)(3).
3 Rev. Proc. 2025-23, § 6.01(1)(b); I.R.C. § 6227.
4 Rev. Proc. 2015-13, § 7.03(1), (3)(c).
5 I.R.C. § 481(a); Rev. Proc. 2025-23, § 6.01(5).
6 Rev. Proc. 2015-13, § 7.03(1).
7 Rev. Proc. 2025-23, § 6.01(4); Treas. Reg. § 1.263(a)-3(h)(3).
8 Rev. Proc. 2015-13, § 6.03(1)(a).
9 Temp. Treas. Reg. § 1.469-2T(d)(7)(i); see id. § 1.469-2T(c)(5) (positive adjustments).

C. A Brief Bridge to Sales



Releasing suspended passive losses. When a taxpayer disposes of the entire interest in a passive activity in a fully taxable transaction to an unrelated party, the activity's suspended losses, to the extent they exceed net income from other passive activities, are treated as not from a passive activity.1 Years of suspended Form 8582 losses can then offset the sale gain and the client's other income. Four patterns delay or deny the release: a sale to a related party **(the losses remain suspended until the interest is acquired, in a fully taxable transaction, by a person who is not related to the original seller under § 267(b)** or § 707(b)(1));2 an installment sale **(losses are released in proportion to the gain recognized each year)**;3 a like-kind exchange, which is not a fully taxable disposition; and the sale of one property out of a real estate professional's aggregated activity, discussed in Part VI.C.

Form 4797 and the land-building split. Rental property used in a trade or business and held more than one year is § 1231 property.4 Gain attributable to straight-line depreciation on the building is unrecaptured § 1250 gain, taxed at up to 25 percent; the rest is § 1231 gain, and a net § 1231 loss is ordinary.5 A net § 1231 gain is treated as ordinary income to the extent of non-recaptured net § 1231 losses: the aggregate net § 1231 losses for the five most recent preceding taxable years, reduced by the portion already taken into account under § 1231(c)(1) in those preceding years. Only the remaining gain receives the otherwise applicable § 1231 treatment.6 At sale, the price should be allocated between land and building by their relative values on the sale date, which may be very different from the purchase allocation; a house bought decades ago in a market where it is now a tear-down may have almost all of its value in the land. A sale-date allocation that differs from the purchase allocation is a fact about the sale, not a change in accounting method. Reconcile each component on the depreciation schedule with the actual transaction. Treat as sold only the assets actually transferred, and allocate supported consideration to them; recognize an abandonment only when its requirements are met.

1 I.R.C. § 469(g)(1)(A).
2 I.R.C. § 469(g)(1)(B).
3 I.R.C. § 469(g)(3).
4 I.R.C. § 1231(b)(1).
5 I.R.C. §§ 1(h)(6), 1231(a).
6 I.R.C. § 1231(c)(1)–(3).

Retained or personally converted assets are not deemed sold because the building was sold, and no remaining-basis deduction arises merely because the property sale occurred.

Example 26. "Tear-down" sale: the allocation changes the character

```
Facts: Rental sold for $900,000. Sale-date values: land $880,000;
building $20,000. Adjusted basis: land $200,000; building $90,000
(after depreciation of $110,000). Assume a qualified appraisal
supports the sale-date allocation and the sale is at arm's length; the
buyer's intent to demolish does not by itself set the allocation.
Step 1. Total gain: $900,000 - ($200,000 + $90,000) ........ $610,000
Step 2. Building: $20,000 - $90,000 ..................... ($ 70,000)
        No gain on the building, so no unrecaptured § 1250 gain.
Step 3. Land: $880,000 - $200,000 ........................ $680,000
Step 4. Net: $680,000 - $70,000 .......................... $610,000
Contrast: allocating by the purchase-date ratio (50/50, building cost
$200,000) would put $450,000 of price on the building, a $360,000
building gain, and up to $110,000 of unrecaptured § 1250 gain.
Total gain is the same; its character and rate are not.
(Simplified: ignores selling costs, § 1231 netting with other
transactions, and state treatment.)
```

The section 121 connection. A former main home converted to a rental may still qualify for the home-sale exclusion if it is sold within the window that preserves two years of ownership and use in the five years before the sale, which as a practical matter means within about three years after moving out.1 The exclusion does not apply to gain up to the depreciation adjustments attributable to periods after May 6, 1997, as defined in § 1250(b)(3), which generally includes depreciation allowed or allowable but permits the taxpayer to establish by adequate records or other sufficient evidence that the amount actually allowed was less.2 Rental use during the portion of the five-year period after the last date the home was used as the principal residence of the taxpayer or spouse is not "nonqualified use"; the exception is limited to that portion of the five-year period and is not unlimited post-move-out time. Rental use before a later conversion to a principal residence generally is nonqualified use and reduces the exclusion proportionally, although periods before January 1, 2009 are disregarded and other statutory exceptions can apply.3 The depreciation-adjustment bar is separate. These rules are developed fully in the companion Southern Regional Tax Conference program on § 121.

D. The Landlord File: A Documentation Checklist

Every taxpayer must keep records sufficient to establish the amount of income, deductions, and other items on the return.4 For a landlord, the permanent file is what protects both the client and the preparer when an examiner asks about basis, days, or hours years after the fact.

Table 6. The eight-item storefront landlord file

Record	What it supports
1. Closing disclosures for every purchase and refinance	Cost basis, capitalized settlement costs, points and loan costs
2. Assessor statement or appraisal at acquisition (and at conversion)	Land-building allocation; lower-of basis at conversion
3. Signed leases and a security-deposit ledger	Line 3 income; advance rent; deposits kept or returned
4. Calendar of fair-rental, personal-use, and repair days	Line 2; § 280A allocation and residence test
5. Invoices, annual election statements (de minimis, SHST), and Forms 1099 issued	Expense deductions; repair vs. improvement; § 199A consistency
6. Mileage logs and time logs	Line 6; material participation; 250-hour safe harbor; real estate professional status

1 I.R.C. § 121(a).
2 I.R.C. §§ 121(d)(6), 1250(b)(3).
3 I.R.C. § 121(b)(5)(A), (C)(i)–(ii).
4 I.R.C. § 6001; Treas. Reg. § 1.6001-1(a).

Record	What it supports
7. Prior-year depreciation schedules and Form 8582 carryover worksheets	Allowable depreciation; suspended losses
8. Copies of continuing elections and statements (§ 1.469-9(g) aggregation, § 1.199A-4 aggregation, QJV), with a note of the conditions under which each remains in effect or may be revoked	Consistency in every later year

VIII. THE DELGADOS' CASE, RESOLVED

Rosa asked two questions: whether the condo loss can offset the couple's wages, and whether the prior preparer was doing it right. Both answers turn on facts gathered at intake, not on anything the prior returns show, and the resolution below walks through them in the order a preparer would.

Step one: classify the condo. The condo's average period of customer use for 2026 was 168 nights over 41 stays, or 4.10 days **(Example 1)**. That takes it out of the definition of a rental activity under § 469; it is analyzed as a trade or business activity, and on the facts below **(continuous listing, regular operation, profit motive, Rosa's ongoing management)** it is treated as a § 162 trade or business, a conclusion reached separately from the seven-day exception. The Delgados provide turnover cleaning, supplies, and the internet connection, all of which maintain the unit for occupancy; they provide no daily maid service, meals, or concierge services. The income is therefore not self-employment income, and the condo stays on Schedule E, Part I, with property type code 3.

Step two: count the days. Nine personal days against 168 fair-rental days is under the greater of 14 days or 16.8 days, so the condo is not used as a residence **(Example 8)**. The vacation-home limit of § 280A(c)(5) does not apply, and a loss is possible. Shared expenses are allocated 168/177, or 94.915 percent, to the rental. The other side of that coin is that the personal share of the condo's mortgage interest, $427, is not qualified residence interest and is not deductible anywhere. The personal share of the real estate taxes, $183, is deductible on Schedule A only if the Delgados itemize.

Step three: fix the depreciation, prospectively. The prior preparer claimed no depreciation on the condo for 2021 through 2025. That is an impermissible method adopted over five returns, and the correction, assuming the § 6.01 and Revenue Procedure 2015-13 eligibility requirements are met, is an automatic change under designated change number 7 on Form 3115 for 2026, with a negative § 481(a) adjustment of $27,439 **(Example 25)**. For this illustration, the correct recovery period is stipulated to be 39 years, as explained in Part V.B. Nightly rental alone does not establish that classification. Before filing an actual return or Form 3115, the office resolves and documents the property's classification and recomputes all affected amounts if the correct recovery period differs. The catch-up figure rests on the assumed rental-use history stated in Example 25, which the office confirms year by year before filing. The building's 2026 depreciation is $6,154 for the full year, of which the rental share is $5,841. The March furniture purchase is five-year property acquired after January 19, 2025; its rental share, $8,542, is deducted in full as bonus depreciation **(Example 17)**. Because the office does not regularly prepare method changes, the Form 3115 is prepared with review by an enrolled practitioner who does, and the Delgados receive a short written explanation of the allowed-or-allowable rule and why the change matters at sale.

Table 7. Delgado condo, Schedule E column B, 2026

Line	Item	Computation	Amount
3	Rents received	Platform gross bookings, including guest cleaning fees	$36,900
7	Cleaning and maintenance	41 turnovers x $110 (direct; 100% rental)	$4,510
8	Commissions	Platform host service fee (direct)	$1,107
9	Insurance	$1,500 x 94.915%	$1,424
12	Mortgage interest (Form 1098)	$8,400 x 94.915%	$7,973
14	Repairs	$1,250 x 94.915%	$1,186
15	Supplies	Guest supplies (direct; assume all consumed by guests)	$900

Line	Item	Computation	Amount
16	Taxes	$3,600 x 94.915%	$3,417
17	Utilities	$3,000 x 94.915%	$2,847
18	Depreciation	Building $5,841 + furniture bonus $8,542	$14,383
19	**Other:** HOA dues	$4,800 x 94.915%	$4,556
19	**Other:** § 481(a) adjustment, depreciation	Form 3115, DCN 7	$27,439
20	Total expenses	Sum of Lines 5 through 19	$69,742
21	Income or (loss)	$36,900 - $69,742	($32,842)

Step four: material participation. Rosa's calendar and Kevin's two documented trips total 170 hours, more than 100 and more than any other individual, including the busiest cleaner **(Example 23)**. The Delgados materially participate. The 170 hours establish only that the condo loss is nonpassive. Assume the Delgados' amount at risk under § 465 at year-end is sufficient to absorb the condo loss, the activity is a § 162 trade or business, and no other limitation applies; the loss is well below the 2026 excess business loss threshold. On those assumptions the $32,842 loss offsets their wages. Real estate professional status is not needed and is not claimed. The $25,000 allowance plays no part in the answer.

Step five: Maple Street. The converted house's depreciable basis is the lower adjusted basis of $176,500, not its $255,000 building value **(Example 16)**, and its first-year depreciation is $4,547. Rents of $21,600 include the last month's rent received at signing; the security deposit is excluded. After expenses of $17,420, Maple Street shows net income of $4,180 **(Example 12)**. It is a rental activity, passive by definition, and with no passive losses to absorb its income is simply included. The old mortgage's interest became rental interest on April 1 under the tracing rules' change-in-use provision.

Step six: section 199A and information returns. The condo is a strong § 162 trade or business, and its loss, including the § 481(a) adjustment, is negative qualified business income. Whether Maple Street is also a § 162 trade or business is a facts question, not an hours count; either way the Delgados have no deduction for 2026, with a negative carryforward into 2027 of $28,662 if Maple Street qualifies or $32,842 if it does not **(Example 24)**. The office documents the facts behind its conclusion. Consistent with treating the condo as a business, and on the Example 24 assumptions that the cleaning company is a sole proprietorship or partnership paid by check or ordinary bank transfer, they issue a Form 1099-NEC for the $4,510 paid in 2026. Payment-card and qualifying third-party-network payments generally fall under § 6050W rather than duplicate Form 1099-NEC reporting by the Delgados. A TPSO may nevertheless issue no Form 1099-K when the payee does not exceed both federal thresholds **(Part II.C)**. The office obtains a Form W-9 and confirms the payment method before filing.

Table 8. Delgado 2026: the answer and three alternative fact patterns (simplified directional deltas, not final Form 1040 results; omitted adjustments listed below)

Scenario	Condo treatment	Schedule E or Form 8582 result	2026 AGI
As resolved: average stay 4.10 days; material participation; Form 3115 filed	Nonpassive trade or business	Condo ($32,842) + Maple $4,180 = ($28,662) deducted	$109,338
Same, but no material participation	Passive trade or business; no $25,000 allowance	Net passive loss ($28,662) suspended	$138,000
Average stay 9 days; active participation; no real estate professional status	Rental activity; $25,000 allowance with MAGI $138,000	Allowance $25,000 - 50% x ($138,000 - $100,000) = $6,000 allowed; ($22,662) suspended	$132,000
As resolved, but no Form 3115 (catch-up not claimed)	Nonpassive trade or business	Condo ($5,403) + Maple $4,180 = ($1,223) deducted	$136,777

The table assumes wages of $138,000 and no other income or adjustments. The nine-day row is a controlled classification illustration only: it assumes a different booking pattern with a nine-day average **(168 nights over 41 stays cannot average nine days)** and holds condo income, deductions, and Maple Street income constant solely to isolate the loss limitation. In an actual nine-day case, retest services, personal use, participation,

recovery period, use allocation, and expenses. Its AGI figures are simplified directional deltas illustrating the classification rules, not final Form 1040 results; they omit the Schedule A interplay for the residence-period interest and the personal share of condo taxes, state treatment, any credits, and the § 199A carryforward. In the passive scenarios the § 481(a) adjustment is included in the condo's passive loss, because it follows the activity's status in the year of change **(Temp. Treas. Reg. § 1.469-2T(d)**(7)(i)).

Workpaper. Lines 23a through 26, Delgado 2026

```
Maple Street (column A), Line 21 income ..................... $ 4,180
Condo (column B), Line 21 loss ............................. ($32,842)
Line 23a total rents: $21,600 + $36,900 ..................... $58,500
Line 24 income (positive amounts) ........................... $ 4,180
Line 22, condo (nonpassive; loss allowed in full) ........... ($32,842)
Line 25 losses (from Line 22) ............................... ($32,842)
Line 26 total rental real estate income (loss) .............. ($28,662)
AGI: wages $138,000 + ($28,662) ............................. $109,338
```

So the answer to Rosa is yes, with conditions. The condo loss offsets the couple's wages this year because guests stayed an average of about four days and because Rosa did, and documented, the work. It does not offset wages because of anything the online advice usually says about the $25,000 allowance, which does not apply to this property, or about real estate professional status, which the Delgados do not have. On the stated assumptions, the condo activity is nonpassive because combined qualifying participation is 170 hours and exceeds each other individual's participation. The final allowable deduction cannot be confirmed until entity classification, the applicable recovery period, and the historical rental use and depreciation are verified; because a negative § 481(a) adjustment follows the activity's status in the year of change, the $27,439 catch-up is provisional until that year-by-year calculation is complete. If next year they hire a full-service manager, re-test material participation under all seven tests: the manager's hours can affect tests **(2)** and **(3)**, and test **(5)** should be checked. Records kept during the year are the best proof, although participation may be established by any reasonable means.

Two items go in the planning letter. First, the Maple Street house may still qualify for the § 121 exclusion if sold within the window that preserves two years of ownership and use in the five years ending on the closing date. The illustration stipulates a March 31, 2026 move-out. Before advising an actual last eligible closing date, verify both spouses' complete ownership and principal-residence use histories and any prior excluded sale, and do not substitute the approximate three-year planning guideline for that calculation; for the joint $500,000 ceiling, either spouse may meet ownership but both must meet use, and neither may have excluded gain on another sale within the preceding two years.1 Depreciation adjustments after conversion, as defined in § 1250(b)(3), are not excludable. Second, the condo's recovery-period classification **(stipulated at 39 years here)**, the documentation of hours, and the Form 1099 practice should be reviewed together each January, because each of them is a position that must be supported again every year the condo is reported on Schedule E.

1 I.R.C. § 121(a), (b)(2)–(3).

HOME SWEET TAX HOME: PRINCIPAL RESIDENCE TAX ISSUES



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(03) Program # A5BAX-T-00128-25-I

Course Details	
Name of the CE Provider	AmData
Program name	**Home Sweet Tax Home:** Principal Residence Tax Issues
IRS program number	A5BAX-T-**00142-26**-I
CE	2
Prerequisite	Basic understanding of individual income tax principles and joint tax filing. Taxes
Advanced Preparation	None
Program Level	Intermediate
Delivery Method:	Live in-person
Program Category:	Federal Tax Law Topics/Federal Tax Related Matters - A program designed to enhance professional knowledge in Federal Tax related matters.



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ABSTRACT

Section 121 of the Internal Revenue Code lets a homeowner exclude up to $250,000 of gain on the sale of a principal residence, or $500,000 for many married couples. Some home sales are straightforward. The intake

interview decides whether this one is. The sales that cause trouble at the storefront involve a home that was once a rental, a death or divorce, a home office, a like-kind exchange, or a foreclosure.

The First Call: Dolores Pruitt and the Form 1099-S

Dolores Pruitt calls the office on a Tuesday in late January 2027. She is 71 and recently widowed. Her closing attorney mailed her a Form 1099-S showing gross proceeds of $1,175,000 from the September 30, 2026 sale of her house in Atlanta's Virginia-Highland neighborhood. She and her husband, Walter, lived there for fourteen years. Walter died on August 15, 2025. Her question is short: "We lived there forever. That's tax-free, isn't it? Do I even need to bring this in?"

Most of the gain is excludable, but not all of it, and the reasons are the outline of this course. Dolores and Walter did not buy the house to live in. They closed on it June 1, 2004 for $242,000 and rented it to tenants, claiming depreciation on Schedule E. The last tenant left June 30, 2012, and they moved in July 1, 2012. Dolores ran a small bookkeeping practice from the spare bedroom from 2018 until the sale and claimed a home-office deduction. The deed named Dolores and Walter as joint tenants with right of survivorship. They remodeled the kitchen, replaced the roof, and installed a heat pump for which they claimed a residential energy credit. Dolores has not remarried. The sale closed thirteen and a half months after Walter's death.

Each of those facts changes the computation. The rental years before 2009 are not nonqualified use, but the rental years after 2008 are. All of the 2004 through 2012 rental depreciation falls after the statutory May 6, 1997 cutoff, so it cannot be excluded, but only Dolores's share of it survived Walter's death. Walter's half of the house took a new basis equal to its value on the date he died. The home office may or may not matter, depending on the method she used. And because the sale closed within two years of Walter's death, Dolores may be entitled to a $500,000 ceiling even though she will file as a single taxpayer for 2026. The text returns to Dolores in the closing section, "Dolores's Case, Resolved."

Practice Pointer: The first call

The answer to "Do I even need to bring this in?" is yes. A Form 1099-S was issued, so the sale goes on Form 8949 and Schedule D even if every dollar of gain is excludable. Before computing anything, run the intake checklist in Table 11.

I. INTRODUCTION

A. Scope and How This Text Is Organized

This program covers federal income tax treatment of the sale or other disposition of a principal residence and the related basis rules. It does not cover mortgage-interest, points, or property-tax deductions on Schedule A, or estate-freeze techniques. State income tax conformity is outside scope. State property law appears only where it changes a federal answer, such as community property.

Section II covers gain, basis, and the three core tests. **Section** III covers the reduced exclusion under section 121(c). **Section** IV covers married couples, divorce, and surviving spouses. **Section** V covers home offices, detached structures, room rentals, and depreciation recapture. **Section** VI covers conversions between residential and rental use, nonqualified use, and section 1031. **Section** VII covers gifts, inheritances, and foreclosures. **Section** VIII covers the preparer's obligations and an intake checklist. Worked examples show every step of the arithmetic. Two examples deliberately show an incorrect computation first, because those are the computations preparers see in practice.

B. Assumptions Used in the Examples

Unless an example states otherwise, assume the taxpayer meets the applicable ownership, use, and look-back tests; did not acquire the property in a section 1031 exchange; had no nonqualified use other than what is described; had no depreciation allowed or allowable other than the amount stated; and had no selling expenses or basis adjustments other than those shown. For character, assume no ordinary depreciation recapture, no other section 1231 or capital gains or losses, and no nonrecaptured net section 1231 losses from the preceding five years. These assumptions never override a fact the example states. Dollar amounts are rounded to whole dollars. Day counts include both the first and last day.

IRS product status as of October 23, 2026: Final 2026 versions of Forms 8949, 4797, and 8824, Schedule D **(Form 1040)**, and Publications 523 and 4681 were not available. Draft 2026 Forms 8949, 4797, and 8824, draft Form 8824 instructions, and draft Publication 4681 were available, but are not filing authority. Unless

otherwise identified, reporting illustrations use the 2025 final forms and instructions. References marked "final 2026 version unavailable at publication" require confirmation before preparing a 2026 return. The Form 1099-S instructions **(Rev. December 2026)** and continuous-use Form 982 **(Rev. March 2018)**, with instructions revised December 2021, were current.

C. Vocabulary

Acronyms are defined on first use and collected in Table 1. Terms that recur are defined in Table 1A.

Table 1. Acronyms used in this text

Term	Meaning
AFR	**Applicable federal rate:** a rate the IRS publishes monthly, used under specified rules such as below-market-loan and deferred-payment rules
BEA	Basic exclusion amount for federal estate and gift tax
CCA / PLR / SCA	Chief Counsel Advice / Private Letter Ruling / Service Center Advice (written determinations; not precedent)
CE	Continuing education
COD	Cancellation-of-debt income
FMV	Fair market value
HOA	Homeowners' association
HOH / MFJ / MFS / QSS	Head of household / Married filing jointly / Married filing separately / Qualifying surviving spouse
HVAC	Heating, ventilation, and air conditioning
LLC	Limited liability company
LTCG	Long-term capital gain
MACRS; SL; MM	Modified Accelerated Cost Recovery System; straight-line; mid-month convention
MAGI; NIIT	Modified adjusted gross income; 3.8% Net Investment Income Tax
NQ use	Nonqualified use under section 121(b)(5)
PAL	Passive activity loss
QPRI	Qualified principal residence indebtedness (section 108(a)(1)(E))

Table 1A. Terms used in this text

Term	Meaning
Amount realized	Cash plus FMV of property received plus debt relief, less selling expenses
Adjusted basis	Cost, plus improvements, less depreciation, credits, and other required reductions
Realized, recognized, excluded gain	**Realized gain is the profit:** amount realized minus adjusted basis. In this text, recognized gain is the amount reported as taxable after any exclusion; excluded gain is the part section 121 removes from gross income. Technically, section 1001(c) treats the whole sale as a recognition event and section 121 then excludes qualifying gain; the suspended-loss discussion in Section VI.A relies on that distinction. In the home-sale workpapers, "recognized gain" labels the amount remaining taxable after the section 121 exclusion, following the wording of the regulation's examples. Recognition and exclusion remain distinct legal concepts.
Unrecaptured section 1250 gain	Gain attributable to straight-line depreciation on real property, taxed at a maximum 25% rate
Section 1231 property	Depreciable or real property used in a trade or business and held more than one year; reported on Form 4797
Boot	Cash or other property received in a like-kind exchange that is not like-kind property

Term	Meaning
Recourse / nonrecourse debt	Debt the borrower is personally liable for / debt the lender can collect only from the property
Part-sale, part-gift	A transfer for consideration below FMV that includes a gift component
Grantor trust; disregarded entity	A trust whose owner is taxed as owning its assets; a single-owner entity ignored for federal income tax
Section 481(a) adjustment	The catch-up adjustment taken when a taxpayer changes an accounting method, such as correcting missed depreciation
Tax attributes	Items such as loss carryovers, credits, and basis that must be reduced when canceled debt is excluded

D. A Word on Authority

The Code and the Treasury regulations control. Revenue rulings and revenue procedures are published guidance on which taxpayers may rely. IRS publications such as Publication 523 **(Selling Your Home)** explain the law but are not authority. When a publication and a regulation disagree, follow the regulation.1 Private letter rulings, Chief Counsel Advice, and Service Center Advice are written determinations. Under section 6110(k)(3) they may not be used or cited as precedent.2 This text uses several of them to show how the IRS analyzes facts, and labels them each time.

II. GAIN, BASIS, AND THE THREE CORE TESTS

A. Realized Gain, Recognized Gain, and the Nondeductible Loss

Every home-sale analysis starts with the same subtraction. The amount realized is the money received, plus the FMV of any other property received, plus any debt the buyer assumes or takes subject to.3 It is reduced by selling expenses such as commissions, seller-paid transfer taxes, legal fees, and seller-paid points that are normally the buyer's cost.4 Realized gain or loss is the amount realized minus adjusted basis.5 **Section** 1001 supplies the general gain-recognition rule.6 **Section** 121 excludes qualifying principal-residence gain from gross income; it is not an exchange-deferral provision.

Personal losses follow a different rule. A loss on the sale of a home used as a personal residence up to the time of sale is not deductible.7 It is a personal loss, not a loss from a business or a transaction entered into for profit. Clients who sold at a loss often believe they have a capital loss to deduct. They do not. When a Form 1099-S was issued, the preparer still reports the sale and zeroes out the loss, as shown in subsection F.

B. Reconstructing Basis

Basis starts with cost, which includes the purchase price and most settlement charges paid to acquire title.8 It increases for capital improvements. It decreases for depreciation allowed or allowable, casualty losses deducted, and certain credits and subsidies.9 The source documents are the buyer's closing statement, improvement records, prior depreciation schedules, and, for longtime owners, any old Form 2119. Table 2 summarizes the categories Publication 523 uses.

1 *Zimmerman v. Commissioner*, 71 T.C. 367, 371 (1978), *aff'd*, 614 F.2d 1294 (2d Cir. 1979) (IRS publications not authoritative).
2 I.R.C. § 6110(k)(3).
3 I.R.C. § 1001(b); Treas. Reg. § 1.1001-2(a)(1).
4 IRS Pub. 523 (2025), Worksheet 2, line 2.
5 I.R.C. § 1001(a).
6 I.R.C. § 1001(c).
7 I.R.C. § 165(c); Treas. Reg. § 1.165-9(a).
8 I.R.C. § 1012(a); IRS Pub. 523 (2025) ("Fees and Closing Costs").
9 I.R.C. § 1016(a)(1)–(2), (33)–(34); IRS Pub. 523 (2025), Worksheet 2, line 5.

Table 2. What goes into (and comes out of) basis

Category	Included in basis	Not included or subtracted
Purchase and closing	Price; abstract and title-search fees; legal fees for contract and deed; recording and survey fees; transfer or stamp taxes; owner's title insurance; utility hook-ups; seller's back taxes paid by buyer	Fire and casualty insurance; pre-closing rent; buyer's share of taxes and interest; HOA dues; loan costs (points, mortgage insurance, credit reports, lender appraisal); refinancing fees
Construction	Land; paid labor and materials; architect fees; permits; meter and connection charges	Owner's own labor ("sweat equity")
Improvements	Additions, decks, garages; landscaping, driveways, fences, pools; roof, siding, windows, insulation; HVAC, water heater, septic, wiring; built-ins, kitchen remodels, flooring; repairs done as part of an extensive remodel	Routine repairs and maintenance; improvements no longer part of the home at sale (replaced carpet); items with a life of less than one year
Required reductions	Not applicable	Depreciation allowed or allowable; residential energy credits and utility subsidies; deducted casualty losses and insurance recoveries; easement payments; gain postponed under former § 1034 before May 7, 1997; certain excluded canceled debt (see Section VII.D)

Source: IRS Pub. 523 **(2025) ("Basis"; Worksheet 2)**. Publication 523 lists "fees for refinancing a mortgage" among costs that may not be included in basis.

Two reductions are commonly missed. First, residential energy credits reduce basis. A client who installed a qualifying heat pump and claimed a credit on Form 5695 subtracts the credit from the cost of the improvement.1 These are historical-credit adjustments. **Section** 25C does not apply to property placed in service after December 31, 2025. **Section** 25D does not apply to expenditures made after that date. A credit allowed in an earlier year still reduces basis in a home sold in 2026.2

Second, gain postponed under former section 1034 on a sale before May 7, 1997 reduced the basis of the replacement home and still does.3 Before the Taxpayer Relief Act of 1997, a seller who bought a replacement home of equal or greater cost within two years deferred the gain on Form 2119. Separately, sellers age 55 or older could take a one-time $125,000 exclusion. A client who has traded homes since the 1980s may carry a deferred gain in the current home's basis. The modern exclusion still applies, but the gain is larger than the client expects.

Workpaper II-1. Basis reconstruction, illustrative

```
Purchase price (closing statement)                $310,000
+ Title insurance, recording, transfer tax           4,200
+ Kitchen remodel (2019)                            42,000
+ Heat pump (2023)                                  12,000
- Energy credit claimed on 2023 Form 5695           (2,000)
- Postponed § 1034 gain from 1995 sale             (38,000)
                                                   --------
Adjusted basis                                    $328,200

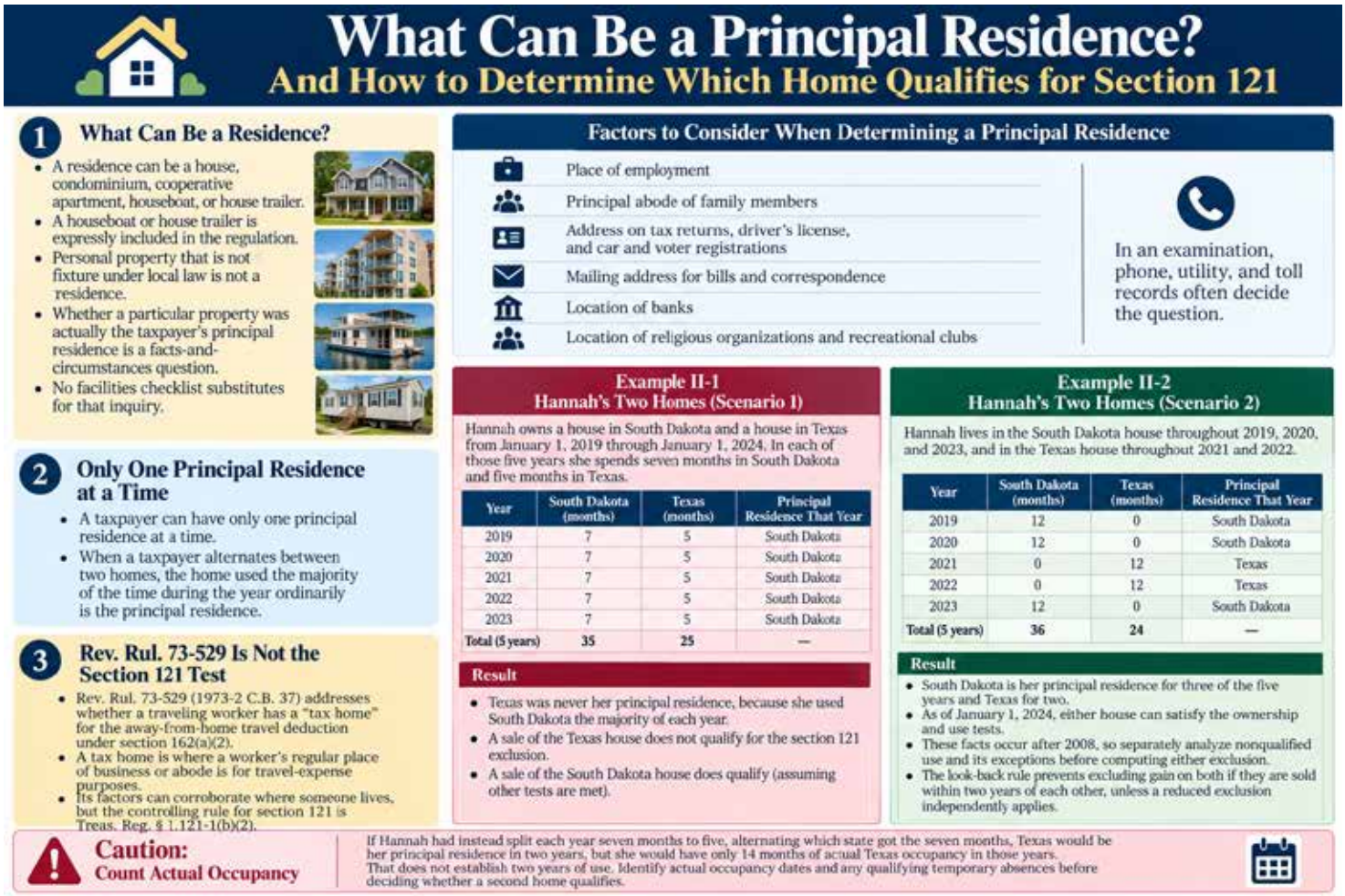
Conclusion: the purchase price alone misses $58,200 of capitalized
costs and $40,000 of basis reductions. Adjusted basis is $328,200,
which is $18,200 above the original purchase price.
```

1 I.R.C. §§ 25C(g), 25D(f); IRS Pub. 523 (2025), Worksheet 2, line 5e.

2 I.R.C. §§ 25C(i), 25D(h) (as amended by Pub. L. No. 119-21 (2025)).

3 Pub. L. No. 105-34, § 312, 111 Stat. 788 (1997); IRS Pub. 523 (2025), Worksheet 2, line 5l.

C. What Is a Principal Residence, and Which One Counts



A residence can be a house, a condominium, a cooperative apartment, a houseboat, or a house trailer, but not personal property that is not a fixture under local law.1 The regulation expressly includes a houseboat or house trailer as possible residential property. Whether a particular property was actually the taxpayer's principal residence remains a facts-and-circumstances question; no facilities checklist substitutes for that inquiry.

A taxpayer has only one principal residence at a time. When a taxpayer alternates between two homes, the home used the majority of the time during the year ordinarily is the principal residence.2 The regulation lists additional factors:

(i) place of employment; **(ii)** principal abode of family members; **(iii)** the address on tax returns, driver's license, and car and voter registrations; **(iv)** mailing address for bills and correspondence; **(v)** location of banks; and **(vi)** location of religious organizations and recreational clubs. In an examination, phone, utility, and toll records often decide the question.

Caution: Rev. Rul. 73-529 is not the section 121 test

Rev. Rul. 73-529, 1973-2 C.B. 37, addresses whether a traveling worker has a "tax home" for the away-from-home travel deduction under section 162(a)(2). A tax home is where a worker's regular place of business or abode is for travel-expense purposes. The ruling's factors can corroborate where someone lives, but the controlling rule for section 121 is Treas. Reg. § 1.121-1(b)(2).

Example II-1 (Hannah's two homes, Scenario 1). Hannah owns a house in South Dakota and a house in Texas from January 1, 2019 through January 1, 2024. In each of those five years she spends seven months in South Dakota and five months in Texas. She spent 25 months in Texas over five years, more than 24. But, assuming no other facts overcome the ordinary majority-use conclusion, Texas was never her principal residence, because

1 Treas. Reg. § 1.121-1(b)(1).

2 Treas. Reg. § 1.121-1(b)(2).

she used South Dakota the majority of each year. A sale of the Texas house does not qualify. A sale of the South Dakota house does.1

Example II-2 (Hannah's two homes, Scenario 2). Now Hannah lives in the South Dakota house throughout 2019, 2020, and 2023, and in the Texas house throughout 2021 and 2022. South Dakota is her principal residence for three of the five years and Texas for two, and each house meets the use test during the five-year period. On January 1, 2024 either house can satisfy the ownership and use tests. That does not establish that all gain is excludable. Because these facts occur after 2008, separately analyze nonqualified use and its exceptions before computing either exclusion.2 The regulation's example predates the nonqualified-use rule. The look-back rule prevents excluding gain on both if they are sold within two years of each other, unless a reduced exclusion independently applies.3

⚠ Caution: count actual occupancy

Suppose Hannah had instead split each year seven months to five, alternating which state got the seven months. Texas would be her principal residence in two years, but she would have only 14 months of actual Texas occupancy in those years. That does not establish two years of use. Identify actual occupancy dates and any qualifying temporary absences before deciding whether a second home qualifies.

D. The Three Statutory Tests

Section 121(a) excludes gain if, during the five years ending on the date of sale, the taxpayer owned the property and used it as a principal residence for periods totaling two years or more.4 The ceiling is $250,000. It is $500,000 on a joint return when either spouse meets the ownership test, both meet the use test, and neither is barred by the look-back rule **(see Section IV.A)**.5 The look-back rule denies the exclusion if the taxpayer excluded gain on another sale during the two years ending on the date of this sale.6 The ceilings are not indexed for inflation.

Table 3. The three core tests at a glance

Test	Requirement	Common pitfall
Ownership	24 full months or 730 days of ownership in the 5 years ending on the sale date	Title held in a partnership; title in a child's name
Use	24 full months or 730 days of use as principal residence in the same 5 years	Furniture moved in but no occupancy; long absences counted as use
Look-back	No other excluded sale in the 2 years ending on the sale date	Two homes sold in consecutive tax years

Two years means 24 full months or 730 days. The ownership and use periods need not overlap if each is met within the five-year window.7 A tenant who lives in a house, then buys it and moves out, can meet both tests on a later sale.8 Use means occupancy. Moving belongings in without living there is not use. Short temporary absences, such as vacations, count as use even if the home is rented during the absence. A one-year sabbatical does not.9

Ownership through a grantor trust or a single-owner disregarded entity counts as ownership by the individual.10 Ownership through a partnership generally does not. The IRS issued a private letter ruling treating partnership

1 Treas. Reg. § 1.121-1(b)(4), Ex. 1.
2 I.R.C. § 121(b)(5)(A)–(C).
3 Treas. Reg. § 1.121-1(b)(4), Ex. 2; I.R.C. § 121(b)(3), (c).
4 I.R.C. § 121(a).
5 I.R.C. § 121(b)(1)–(2)(A).
6 I.R.C. § 121(b)(3); Treas. Reg. § 1.121-2(b)(1).
7 Treas. Reg. § 1.121-1(c)(1).
8 Treas. Reg. § 1.121-1(c)(4), Ex. 3.
9 Treas. Reg. § 1.121-1(c)(2)(i); id. § 1.121-1(c)(4), Exs. 4–5.
10 Treas. Reg. § 1.121-1(c)(3)(i)–(ii).

ownership as individual ownership, then revoked it as not in accord with its current views.1 A client who moved the house into a family LLC taxed as a partnership may have broken the ownership test.

Three special rules adjust the tests.

Care facilities. This rule applies to a taxpayer who becomes physically or mentally incapable of self-care and who used the home as a principal residence for at least one year during the five-year window. While still owning the home, that taxpayer is treated as using it during time spent in a facility, including a nursing home, licensed by a state or political subdivision to care for a person in the taxpayer's condition.2

Service suspension. The taxpayer may elect to suspend the five-year period for up to ten years while the taxpayer or spouse is on qualified official extended duty.3 **Section** 121(d)(9) covers the uniformed services, the Foreign Service, and the intelligence community. Qualified official extended duty means extended duty **(a call or order to active duty for more than 90 days or for an indefinite period)** at a duty station at least 50 miles from the residence, or while residing under government orders in government quarters.4 **Section** 121(d)(12) separately covers service outside the United States as a Peace Corps employee, enrolled volunteer, or volunteer leader.5 The election applies to one property at a time and may be revoked.6

Election out. A taxpayer may elect not to apply section 121 to a sale, which preserves the exclusion for a larger sale expected within two years. The election is made by including the gain in income. It may be made or revoked within three years after the original due date of the return.7

Example II-3 (Alice in the Navy). Alice bought her home May 1, 2006 and lived in it until August 27, 2009, when she began qualified official extended duty overseas. She remained on qualifying duty and sold the house August 1, 2022 without moving back. Without the election, the five-year window runs August 2, 2017 through August 1, 2022, and she has no use in it. If she elects the full ten-year suspension, the window moves back to August 2, 2007 through August 1, 2012. She occupied the house from August 2, 2007 through August 27, 2009, more than 730 days, and owned it throughout the window. She qualifies for the full exclusion.8

Workpaper II-2. Alice's shifted window

Sale date	08/01/2022
Ordinary 5-year window	08/02/2017 – 08/01/2022
Maximum suspension (§ 121(d)(9)(B))	10 years
Suspended period	08/02/2012 – 08/01/2022
Shifted 5-year window	08/02/2007 – 08/01/2012
Occupancy inside shifted window	08/02/2007 – 08/27/2009
Days of occupancy	757 (> 730)

Conclusion: use and ownership tests met; full $250,000 ceiling, assuming qualifying duty for the entire suspended period (confirm orders).

E. Selling Adjacent Vacant Land Separately

Clients who own a house on a large lot sometimes sell the extra land separately. Vacant land is treated as part of the principal residence only if all four conditions are met:9

(A) the land is adjacent to the land containing the dwelling; **(B)** the taxpayer owned and used it as part of the residence; **(C)** the taxpayer sells the dwelling in a qualifying sale within two years before or after the land sale; and **(D)** the section 121 requirements are otherwise met for the land.

The land sale and the dwelling sale are treated as one sale with one maximum exclusion, applied first to gain on the dwelling.10 If the dwelling sale occurs in a later tax year and after the prescribed filing deadline, including

1 PLR 200119014 (revoking PLR 200004022). Written determinations; not precedent. I.R.C. § 6110(k)(3).
2 I.R.C. § 121(d)(7); Treas. Reg. § 1.121-1(c)(2)(ii).
3 I.R.C. § 121(d)(9)(A)–(B).
4 I.R.C. § 121(d)(9)(C)(i), (v).
5 I.R.C. § 121(d)(12)(A).
6 I.R.C. § 121(d)(9)(D)(i)–(ii).
7 I.R.C. § 121(f); Treas. Reg. § 1.121-4(g).
8 IRS Pub. 523 (2025) (military suspension example, same mechanics with different dates).
9 Treas. Reg. § 1.121-1(b)(3)(i)(A)–(D).
10 Treas. Reg. § 1.121-1(b)(3)(ii)(A).

extensions, for the land-sale year, report the land gain as taxable.1 After the requirements are satisfied, claim the exclusion by amended return while the refund period remains open. Moving the dwelling off the land, as with a manufactured home, disqualifies the land.

Example II-4 (the regulation's own facts). C sells eight of his ten acres in May 2005 for a $110,000 gain and reports it as taxable because he has not yet sold the house. In March 2007 he sells the house and the remaining two acres for a $180,000 gain. The 2005 land sale is within two years of the house sale, so both are one principal-residence sale. The $250,000 ceiling applies first to the $180,000 house gain, leaving $70,000 for the land. C amends his 2005 return to exclude $70,000 of the $110,000 land gain and remains taxable on $40,000.2

Practice Pointer: calendar the amendment

Calendar both the claim deadline and the payment look-back limit. Section 6511(a) generally allows the later of three years from filing or two years from payment. Section 6511(b)(2) separately limits the amount recoverable to tax paid within the applicable look-back period. Early-filed returns, extensions, and any relief provisions need additional checks. A client who sells the land in Year 1 and the house late in Year 3 may be close to the deadline, so calendar it the day the land sale is reported.

F. Reporting the Sale: Form 1099-S, Form 8949, and Schedule D

The closing agent must file Form 1099-S for a real estate sale unless an exception applies.1 For a principal residence, the agent may skip the form when three things are true:

(1) gross proceeds are $250,000 or less, or $500,000 or less if the seller's certification includes an assurance that the seller is married; **(2)** the agent obtains a written certification from each seller, signed under penalties of perjury, that the home was the seller's principal residence, there was no nonqualified use after 2008, and the full gain is excludable; and **(3)** the certification is obtained by January 31 of the year after the sale.4

For 2026 transactions, the Form 1099-S total gross proceeds appear in box 2a. A buyer's payment in digital assets is reported in additional boxes for digital-asset proceeds and token detail.5

Report a home sale on Form 8949 and Schedule D if any of the following is true:6

(1) any gain is taxable; **(2)** the taxpayer received a Form 1099-S, even if all gain is excluded or the sale was at a loss; or **(3)** the taxpayer elects out of section 121. A Form 1099-S sale omitted from the return is a common Automated Underreporter mismatch.

A long-term home sale goes in Part II of Form 8949 with box F checked. The asset sold determines the category. Because the seller disposes of a house, not a digital asset, the sale belongs in box F even when the buyer pays in digital assets; the instructions do not address this fact pattern directly, so this is the author's analysis.7 Enter the Form 1099-S gross proceeds in column **(d)**, basis in column **(e)**, and the excluded gain as a negative number in column **(g)** with code H in column **(f)**. If the proceeds were not reduced by selling expenses, add code E and combine both adjustments in column **(g)**. Codes are entered alphabetically, so column **(f)** reads "EH."8 Part II, box F totals flow to Schedule D, line 10. Schedule D and Form 8949 instructions: final 2026 version unavailable at publication; confirm before use.

Example II-5 (Joseph's simple sale). Joseph, single, bought his home August 1, 2012 for $420,000 and sold it September 15, 2024 for $575,000. He had no selling expenses that were not reflected on the Form 1099-S, made no improvements, and never rented or used the home for business. His realized gain is $155,000, all excludable.

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1 Treas. Reg. § 1.121-1(b)(3)(ii)(C).
2 Treas. Reg. § 1.121-1(b)(4), Ex. 3.
1 I.R.C. § 6045(e); Instructions for Form 1099-S (Rev. Dec. 2026).
4 I.R.C. § 6045(e)(5); Rev. Proc. 2007-12, 2007-4 I.R.B. 354; Instructions for Form 1099-S (Rev. Dec. 2026).
5 Instructions for Form 1099-S (Rev. Dec. 2026), What's New; boxes 2a–2c, 8a–8d.
6 IRS Pub. 523 (2025) ("Reporting Your Home Sale").
7 *See* Instructions for Form 8949 (2025) (reporting categories; main-home example) (final 2026 version unavailable at publication); 2026 Form 8949 (draft Apr. 1, 2026), Part II, box F ("Long-term transactions, other than digital asset transactions") and Schedule D, line 10.
8 Instructions for Form 8949 (2025) (column (f) codes E, H; main-home example) (final 2026 version unavailable at publication).

Table 4. Joseph's Form 8949, Part II (box F)

(a) Description	(b) Acquired	(c) Sold	(d) Proceeds	(e) Basis	(f) Code	(g) Adj.	(h) Gain
Principal residence	08/01/2012	09/15/2024	575,000	420,000	H	(155,000)	0

When a client with a Form 1099-S sold the home at a personal loss, enter code L in column **(f)**.1 Enter the nondeductible loss as a positive number in column **(g)**, so column **(h)** is zero. Without the adjustment, software will carry a capital loss the client cannot deduct.

III. SELLING EARLY: THE REDUCED EXCLUSION UNDER SECTION 121(c)

A. How the Reduced Exclusion Works

A taxpayer who fails the two-year ownership test, use test, or look-back test may still qualify for a reduced exclusion. The sale must be by reason of a change in place of employment, health, or, to the extent the regulations provide, unforeseen circumstances.2 When it is, the ownership, use, and look-back requirements do not apply, but the dollar ceiling is reduced. A satisfied regulatory safe harbor deems the sale to be by reason of the qualifying circumstance. Outside a safe harbor, establish that employment, qualifying health needs, or unforeseen circumstances were the primary reason for the sale.3

The reduced ceiling equals the full ceiling **($250,000, or $500,000 for a qualifying joint return)** multiplied by a fraction.4 The denominator is 730 days or 24 months. The numerator is the shortest of three periods:

(1) the time the taxpayer owned the property during the five years ending on the sale date; **(2)** the time the taxpayer used it as a principal residence during those five years; and **(3)** the time since the taxpayer's last excluded sale. Use days or months, but use the same unit in the numerator and denominator. Depreciation recapture and nonqualified-use limits still apply to a reduced exclusion.

Formula III-1. Reduced maximum exclusion

Reduced ceiling = Full ceiling x (Shortest of ownership, use, or time since last excluded sale) / 730 days

Then: Excluded gain = the LESSER of eligible gain or the reduced ceiling.

The fraction reduces the CEILING. It never multiplies the gain.

The most common error is applying the fraction to the gain instead of the ceiling. The difference is large whenever the gain is smaller than the full ceiling, which for a short holding period is almost always.

Example III-1 (Joseph's job move, as it is often prepared). Joseph, single, bought his home August 14, 2023 for $420,000. He lived in it 365 days, took a new job more than 50 miles farther from the house than his old job, and sold August 15, 2024 for $575,000. His realized gain is $155,000. A preparer who multiplies the gain by the fraction excludes $77,500 and reports $77,500 of taxable gain.

Workpaper III-1A. Joseph's job move: INCORRECT (fraction applied to gain)

```
Realized gain ($575,000 - $420,000)          $155,000
Fraction (365 / 730)                            50%
"Excluded" ($155,000 x 50%)                 ($77,500)
Taxable gain reported                        $77,500   <-- wrong
```

1 Instructions for Form 8949 (2025) (code L, nondeductible loss other than a wash sale) (final 2026 version unavailable at publication).

2 I.R.C. § 121(c)(1)–(2).

3 Treas. Reg. § 1.121-3(a), (b).

4 I.R.C. § 121(c)(1)(B); Treas. Reg. § 1.121-3(g)(1).

Workpaper III-1B. Joseph's job move: CORRECTED (fraction applied to ceiling)

```
Shortest period: ownership 368 days; use 365 days; no prior sale
Reduced ceiling ($250,000 x 365 / 730)          $125,000
Realized gain                                   $155,000
Excluded (lesser of gain or ceiling)           ($125,000)
Taxable long-term capital gain                   $30,000

Conclusion: the incorrect method overstated taxable gain by $47,500.
Had the gain been $120,000, the entire gain would be excluded.
```

Joseph held the house more than one year, so the sale goes in Part II of Form 8949 with box F checked.1

Table 4A. Joseph's job move on Form 8949, Part II (box F)

(a) Description	(b) Acquired	(c) Sold	(d) Proceeds	(e) Basis	(f) Code	(g) Adj.	(h) Gain
Principal residence	08/14/2023	08/15/2024	575,000	420,000	H	(125,000)	30,000

B. The Regulatory Safe Harbors

The regulations deem certain sales to be by reason of employment, health, or unforeseen circumstances. The employment and unforeseen-circumstances safe harbors require the triggering event to occur during the period the taxpayer owned and used the home as a principal residence.2 The health rule contains no requirement that the condition first arise after purchase.3

Each rule turns on a "qualified individual": the taxpayer, the taxpayer's spouse, a co-owner, or a person whose principal place of abode is in the taxpayer's household.4 For the health rule only, additional relatives qualify. These are relatives of any of those people described in section 152(a)(1) through **(8)** as in effect when the regulation was written **(now section 152(d)**(2)(A) through **(H)**), without regard to dependency, and descendants of the taxpayer's grandparents. Table 5 summarizes the rules.

Table 5. Section 121(c) safe harbors and the general health rule

Reason	Rule	Regulation
Employment (safe harbor)	A qualified individual's new place of employment is at least 50 miles farther from the home sold than the former place of employment. If there was no former job, the new job is at least 50 miles from the home. Employment includes a new employer, a transfer, and starting or continuing self-employment.	§ 1.121-3(c)(2)–(3)
Health (safe harbor)	A physician recommends a change of residence for a qualifying health reason described in § 1.121-3(d)(1). A recommendation merely beneficial to general well-being is insufficient.	§ 1.121-3(d)(2)
Health (general rule)	Outside the safe harbor, show the primary reason was to obtain, provide, or facilitate diagnosis, cure, mitigation, or treatment of disease, illness, or injury, including caring for a sick relative. A move merely beneficial to general well-being does not qualify.	§ 1.121-3(d)(1)
Unforeseen circumstances (safe harbor)	**Any of:** involuntary conversion; casualty from a natural or man-made disaster, war, or terrorism; or, for a qualified individual, death, job loss with eligibility for unemployment compensation, a change in employment leaving the household unable to pay housing costs and reasonable basic living expenses, divorce or legal separation under a decree, or multiple births from one pregnancy.	§ 1.121-3(e)(2)(i)–(iii)

1 Instructions for Form 8949 (2025) (code H) (final 2026 version unavailable at publication); Treas. Reg. § 1.121-3(g)(2), Ex. 1 (12/24 x $250,000 = $125,000).
2 Treas. Reg. § 1.121-3(c)(2), (e)(2).
3 Treas. Reg. § 1.121-3(d)(1)–(3).
4 Treas. Reg. § 1.121-3(f).

The regulation still cross-references the pre-2005 numbering of I.R.C. § 152(a)(1)–(8); confirm an unusual relationship against the regulation text.

Improved finances are not unforeseen circumstances. A promotion and raise, a lottery win, or a wish for a larger home after rates fall do not qualify.1 Neither does a problem the buyer should have seen coming. In the regulation's example, a taxpayer buys a house on a heavily traveled road and sells after a few months because of the traffic. The sale is not by reason of unforeseen circumstances, because the traffic was foreseeable.2

C. When No Safe Harbor Applies: Facts and Circumstances

Outside the safe harbors, the question is whether the primary reason for the sale was employment, health, or an event the taxpayer could not reasonably have anticipated before buying and occupying the home.3 The regulation lists these factors:

(1) the sale and the triggering event are close in time; **(2)** the suitability of the property as a principal residence materially changed; **(3)** the taxpayer's financial ability to maintain the property was materially impaired; **(4)** the taxpayer used the property as a residence during ownership; **(5)** the circumstances were not reasonably foreseeable when the taxpayer began using the property; and **(6)** the circumstances arose during ownership and use. The IRS may also designate additional events by published guidance or private ruling.4

The private letter rulings in Table 6 show how the IRS has applied those factors. They may not be used or cited as precedent.5 Their value is the reasoning, which a preparer can use to organize a client's facts and records.6

Table 6. Private letter rulings on unforeseen circumstances (illustrative only)

Ruling	Facts	Result
PLR 200702032	Buyer moved from an apartment to a house the same distance from an airport. Runway patterns produced about five times the sound energy at the house. Sellers and agents had not made a state-required noise disclosure. Sold after about 20 months at a loss; later received a settlement from sellers and agents.	Settlement treated as additional sale proceeds; resulting gain eligible for the reduced exclusion as unforeseen. Contrast the foreseeable busy-road example, § 1.121-3(e)(4), Ex. 5.
PLR 200504012	Police officer signed a contract on an HOA townhouse, then took a competitive test for the K-9 unit (about 3% of the force) before closing. After moving in, he was selected; K-9 officers must keep a dog and kennel, which the HOA prohibited.	Reduced exclusion allowed. The regulations now contain a similar K-9 example. Treas. Reg. § 1.121-3(e)(4), Ex. 9.
PLR 200615011	Narcotics investigator's home address was discovered by associates of a publicized arrestee who planned to kill him at home; police posted security and reassigned him.	Reduced exclusion allowed.
PLR 200820016	Taxpayer's daughter was assaulted on the school bus soon after the move; efforts with the school district failed; taxpayer sold to move out of the district.	Reduced exclusion allowed.
PLR 200601023	Retirees bought in an age-restricted community. Their daughter then lost her job and began a divorce and needed to move in with a grandchild, which community rules barred.	Reduced exclusion allowed for a sale that failed the use test and came within two years of a prior excluded sale.

Written determinations under I.R.C. § 6110; not precedent. I.R.C. § 6110(k)(3).

1 Treas. Reg. § 1.121-3(e)(1); id. § 1.121-3(e)(4), Exs. 7, 8, 10.
2 Treas. Reg. § 1.121-3(e)(4), Ex. 5.
3 Treas. Reg. § 1.121-3(b), (e)(1).
4 Treas. Reg. § 1.121-3(e)(3).
5 I.R.C. § 6110(k)(3).
6 But cf. Mellencamp, J.C., *Authority Song*, on *Uh-Huh* (1983) ("I fight authority, authority always wins"), https://youtu.be/wsEwK69LXjQ.

Practice Pointer: assemble the records before filing
For a facts-and-circumstances reduced exclusion, assemble the records when the return is prepared: dated documents for the triggering event, the timeline from event to listing to sale, and why the home became unsuitable. The return position must be supportable under section 6694.

IV. SPOUSES, DIVORCE, AND SURVIVING SPOUSES

A. The $500,000 Joint-Return Rule and Its Fallback

Married taxpayers filing jointly may exclude up to $500,000 if either spouse meets the ownership test, both spouses meet the use test, and neither spouse is barred by the two-year look-back rule.1 If a joint-filing couple fails any of those, the ceiling is the sum of the ceilings each spouse would have if unmarried.2 For that computation, each spouse is treated as owning the property during any period either spouse owned it. That attribution of ownership periods does not supply missing use. One spouse cannot use the other's unused ceiling to cover gain on a home only the first spouse qualified for.3

Example IV-1 (the newlywed). Harold has owned and lived in his home for ten years. He marries Wanda, who moves in and lives there one year before they sell. They file jointly. Wanda fails the use test, so the $500,000 ceiling is unavailable. Harold's separate ceiling is $250,000. Wanda's is zero unless the sale is by reason of employment, health, or unforeseen circumstances. If it is, her reduced ceiling is $250,000 x 365/730 = $125,000, for a combined $375,000.4

Example IV-2 (spouses living in two states). A married couple jointly owns a home in Vermont and a home in Ohio. For three years one spouse lives and works in Vermont and the other in Ohio. Because they did not both use the same home, neither sale qualifies for $500,000. On a joint return, the Vermont spouse's ceiling on the Vermont home is $250,000, computed as if that spouse were unmarried; for this purpose each spouse is treated as owning the property during any period either spouse owned it.5 The Ohio spouse has a $250,000 ceiling on the Ohio home. Each spouse's look-back test is applied to that spouse's own prior excluded sales.

Caution: joint versus separate returns
The ownership attribution in section 121(b)(2)(B) is written for joint returns. On separate returns, joint owners each exclude up to $250,000 of the gain attributable to their own interest (Treas. Reg. § 1.121-2(a)(2)). The Ohio spouse's half of the Vermont gain would not be covered. Run the separate-return computation rather than assume the joint-return answer.

B. Divorce: Section 1041 and the Two Section 121(d)(3) Rules

A transfer of property between spouses, or to a former spouse incident to divorce, is not a taxable event. The transferee takes the transferor's adjusted basis, as though the property had been received by gift.6 A transfer is incident to divorce if it occurs within one year after the marriage ends or is related to the end of the marriage.7 Section 1041 does not apply if the transferee spouse is a nonresident alien.8

Section 121 adds two rules for divorcing clients. First, a spouse who receives the home in a section 1041 transfer includes the transferor's ownership period in his or her own.9 That adds ownership only; the transferee must still meet the use test. Second, a spouse who continues to own all or part of the home is treated as using it as a principal residence while the other spouse or former spouse is granted use under a divorce or separation instrument, provided that spouse or former spouse actually uses it as a principal residence. A continuing right under the decree does not supply deemed use after the occupant stops living there.10 A divorce or separation

1 I.R.C. § 121(b)(2)(A); Treas. Reg. § 1.121-2(a)(3)(i).
2 I.R.C. § 121(b)(2)(B); Treas. Reg. § 1.121-2(a)(3)(ii).
3 Treas. Reg. § 1.121-2(a)(4), Ex. 3.
4 Treas. Reg. § 1.121-3(g)(2), Ex. 2; *see also* id. § 1.121-2(a)(4), Ex. 4.
5 I.R.C. § 121(b)(2)(B); Treas. Reg. § 1.121-2(a)(3)(ii); *see* id. § 1.121-2(a)(4), Ex. 3.
6 I.R.C. § 1041(a)–(b).
7 I.R.C. § 1041(c).
8 I.R.C. § 1041(d).
9 I.R.C. § 121(d)(3)(A); Treas. Reg. § 1.121-4(b)(1).
10 Treas. Reg. § 1.121-4(b)(2); *see* I.R.C. § 121(d)(3)(B).

instrument includes a decree of divorce or separate maintenance, a written instrument incident to one, a written separation agreement, and certain support decrees.1

The three cases in Table 7 use the same couple, Rob and Rhonda, and show how the divorce instrument moves the exclusion.

Table 7. Rob, Rhonda, and Roy: three divorce outcomes

Case	Facts	Result
1. Title transfer	Basis $200,000; FMV $575,000 at divorce. Rob deeds 100% to Rhonda under § 1041. Years later, unmarried Rhonda sells for $600,000.	Rhonda's basis is $200,000; gain $400,000. Her ceiling is $250,000. She reports $150,000 of taxable LTCG.
2. Co-ownership with occupancy decree	Same basis and sale price. They remain 50/50 owners; the decree grants Rhonda use until sale.	**Rob is treated as using the home through Rhonda's occupancy. Each reports half:** $300,000 proceeds, $100,000 basis, $200,000 gain, all excluded. Taxable gain $0.
3. Remarriage before sale	Basis $200,000; FMV $1,000,000 at divorce; 50/50 co-owners; decree grants Rhonda use until the youngest child turns 18. Rhonda marries Roy, who moves in. Four years later the home sells for $1,200,000 (gain $1,000,000).	**Rob (single):** $600,000 proceeds, $100,000 basis, $500,000 gain, excludes $250,000, taxable $250,000. Rhonda and Roy (MFJ): $500,000 gain on Rhonda's half, excluded in full because Rhonda owns, both use, and neither is barred. Combined exclusion $750,000.

Assumes each person meets the tests stated and none excluded gain on another sale within two years.

Workpaper IV-1. Case 3 reconciliation

```
Sale price                                  $1,200,000
Basis                                         (200,000)
Total gain                                  $1,000,000

Rob's half:     $600,000 - $100,000 = $500,000; excluded (250,000); taxable $250,000
Rhonda's half:  $600,000 - $100,000 = $500,000; excluded (500,000); taxable $0
Total excluded $750,000 + total taxable $250,000 = $1,000,000  (foots)
```

Caution: the $750,000 result

Rhonda and Roy's $500,000 rests on applying the joint-return rule to Rhonda's ownership interest, with Roy (who owns nothing) meeting the use test. Rob separately excludes gain on his own interest under Treas. Reg. § 1.121-2(a)(2). The regulation's one-maximum-exclusion-per-residence statement (§ 1.121-2(a)(1)) is read as applying per taxpayer. No regulation example addresses this pattern. Document the decree terms and each person's occupancy.

Practice Pointer: talk to the divorce lawyer early

The title transfer in Case 1 left Rhonda taxable on $150,000 of gain that Case 2 avoided. That decision is usually made in a settlement agreement drafted before anyone calls the tax preparer. When a client mentions a pending divorce and a jointly owned home, point out section 121(d)(3)(B) and suggest the client's attorney consider an occupancy provision. Drafting the instrument is the attorney's job.

C. Surviving Spouses

Three rules work together when a spouse dies.

Tacking. An unmarried surviving spouse includes the deceased spouse's periods of ownership and use in his or her own.2

The two-year $500,000 window. An unmarried surviving spouse who sells not later than two years after the date of death keeps the $500,000 ceiling, if the joint-return requirements of section 121(b)(2)(A) were met immediately

1 I.R.C. § 121(d)(3)(C).

2 I.R.C. § 121(d)(2); Treas. Reg. § 1.121-4(a)(1).

before the death.1 Publication 523 lists the conditions:2 **(1)** the sale is within two years of death; **(2)** the survivor has not remarried at the time of sale; **(3)** neither spouse excluded gain on another home sold within two years before the sale; and **(4)** the ownership and use tests were met immediately before death.

If the survivor sells in the year of death and files a joint return with the decedent, the ordinary joint-return rule applies.3 Without the two-year rule, a later-year sale on a single return would be limited to $250,000.

The basis adjustment at death. Property acquired from a decedent generally takes a basis equal to its FMV at the date of death.4 A qualified joint interest is a home held by spouses as joint tenants with right of survivorship or tenants by the entirety, with only the spouses as joint owners. Half its value is included in the first decedent's estate.5 Only that half receives a new basis.6 In community property states, both halves of community property receive a new basis if at least half the community interest was includible in the decedent's estate.7 The nine traditional community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Among the conference states, only Louisiana is on that list.

Workpaper IV-2. Common-law versus community-property basis

```
Joint basis $50,000; FMV at first spouse's death $100,000

Common-law state (qualified joint interest):
  Survivor's half: $50,000 / 2 =                $25,000
  Decedent's half: $100,000 / 2 =               $50,000
  Survivor's new basis                          $75,000

Community property state:
  Both halves to FMV                           $100,000

Source: IRS Pub. 523 (2025) (jointly owned and community property examples).
```

Caution: elective community property trusts

Tennessee and Florida allow married couples to transfer property into a statutory community property trust (Tenn. Code Ann. § 35-17-101 et seq.; Fla. Stat. §§ 736.1501–736.1512). The stated goal is a full section 1014(b)(6) basis adjustment at the first death. No regulation or published ruling has resolved whether elective community property created by residents of a common-law state qualifies. If a client's home is titled in such a trust, get the trust and the estate planner's basis position. Do not assume a full basis adjustment.

Depreciation affects the survivor's basis. With a qualified joint interest, the survivor's own half does not receive a new basis. It keeps its adjusted historical basis, including the survivor's share of depreciation deducted while both spouses were alive.8 The decedent's half receives the date-of-death basis adjustment, which eliminates that half's depreciation history.9 The section 1250 regulations illustrate surviving depreciation history, but their example uses a tenancy by the entirety with a different estate-inclusion pattern.10 Older joint interests, unequal ownership, and other inclusion patterns need separate analysis.

Practice Pointer: the surviving-spouse calendar

When a married client dies and the survivor may sell the home, put three items in the file: (1) the date of death; (2) the date two years later, the last day a sale can close under the $500,000 ceiling; and (3) a note that remarriage before the sale ends the two-year rule. Order a date-of-death appraisal at the same time. It is the basis document for the decedent's half.

1 I.R.C. § 121(b)(4).
2 IRS Pub. 523 (2025) (surviving spouse).
3 Treas. Reg. § 1.121-2(a)(4), Exs. 5–6 (pre-2008 examples; § 121(b)(4) now extends the window to two years).
4 I.R.C. § 1014(a)(1).
5 I.R.C. § 2040(b)(1)–(2).
6 I.R.C. § 1014(b)(9).
7 I.R.C. § 1014(b)(6).
8 I.R.C. §§ 1016(a)(2), 2040(b).
9 I.R.C. §§ 1014(a)(1), 1250(d)(2).
10 Treas. Reg. § 1.1250-3(b)(2)–(3), Ex. 2.

V. HOME OFFICES, DETACHED STRUCTURES, ROOM RENTALS, AND DEPRECIATION

A. Depreciation Recapture Under Section 121(d)(6)

Section 121 does not exclude gain to the extent of depreciation adjustments attributable to periods after May 6, 1997.1 Depreciation taken on or before May 6, 1997 reduced basis, but the resulting gain is excludable. If total gain is less than the post-May 6, 1997 depreciation, all of the gain is recognized. For the long-term, straight-line real-property examples in this text, that amount generally is unrecaptured section 1250 gain, taxed at a maximum federal rate of 25 percent and computed on the worksheet for Schedule D, line 19.2 On a real return, consider ordinary recapture **(for example, property held one year or less)**, section 1231 netting, and the five-year section 1231 loss look-back before assigning final character.3

The regulation's example states the rule. A taxpayer rented a house, moved in July 1, 1999, claimed $14,000 of post-May 6, 1997 depreciation, lived there two full years, and sold in August 2001 at a $40,000 gain. Only $26,000 is excludable; $14,000 is recognized as unrecaptured section 1250 gain.4

Two separate questions arise when depreciation was never claimed. Basis generally must be reduced for depreciation allowed or allowable.5 The section 121(d)(6) restriction uses "depreciation adjustments" as defined in section 1250(b)(3). That definition generally includes depreciation allowed or allowable, but if adequate records or other sufficient evidence establish that the amount allowed was less than the amount allowable, the amount taken into account is the amount allowed.6 Consider a client who used the actual-expense home-office method on Form 8829 **(39-year nonresidential real property, straight-line, mid-month)**, or rented the home on Schedule E **(27.5-year residential rental property)**, and never claimed depreciation. Basis is still reduced. Whether the unclaimed amount is also nonexcludable under section 121(d)(6) depends on the records and on any correction procedure used. Analyze basis, the exclusion restriction, and any depreciation correction separately.

Awareness level: correcting missed depreciation. The usual correction is an automatic accounting-method change on Form 3115, with the missed depreciation taken as a section 481(a) adjustment.7 Rev. Proc. 2025-23 provides one procedure for property still held **(designated change number 7)** and a separate procedure, with its own filing requirements, for property disposed of **(designated change number 107)**.8 Evaluate which procedure applies, and whether another provision such as the section 280A home-office income limit restricts the deduction, before telling a client a catch-up deduction is available.

Warning: unclaimed depreciation still reduces basis
Failing to claim depreciation does not preserve basis. Reconstruct allowable depreciation from the date the space was placed in service, obtain the filed returns, and separately determine the depreciation adjustment under section 1250(b)(3). Evaluate any correction procedure before filing the sale-year return.

B. The Simplified Home-Office Method and Zero Recapture

A taxpayer who qualifies for a home-office deduction under section 280A(c) may elect the simplified method: $5 per square foot of qualifying space, up to 300 square feet.9 The square-footage maximum is $1,500. The deduction is also limited to the business's gross income less business expenses unrelated to the home; a disallowed simplified-method amount does not carry forward.10 The method is elected year by year on a timely filed original return, and the choice for a year is irrevocable.11

1 I.R.C. § 121(d)(6); Treas. Reg. § 1.121-1(d)(1).
2 I.R.C. § 1(h)(1)(E), (h)(6); Instructions for Schedule D (2025), line 19 worksheet (final 2026 version unavailable at publication).
3 I.R.C. §§ 1(h)(6)(A)–(B), 1231(c), 1250(b)(1).
4 Treas. Reg. § 1.121-1(d)(2), Ex.
5 I.R.C. § 1016(a)(2).
6 I.R.C. § 1250(b)(3) (last sentence); Treas. Reg. § 1.1250-2(d)(4)(i).
7 Treas. Reg. § 1.446-1(e)(2)(ii)(d)(2); Rev. Proc. 2025-23, §§ 6.01, 6.07, 2025-24 I.R.B. 1476.
8 Rev. Proc. 2025-23, §§ 6.01(9), 6.07(9).
9 Rev. Proc. 2013-13, § 4.01(2)–(3), 2013-6 I.R.B. 478.
10 Rev. Proc. 2013-13, § 4.08(2).
11 Rev. Proc. 2013-13, § 4.03.

For any year the simplified method is used, the depreciation deduction allowable for that portion of the home is deemed to be zero.1 Basis is not reduced and there is nothing to recapture at sale for those years. A client who switched methods recaptures only the depreciation from actual-expense years.

Practice Pointer: the method choice also affects the sale

When a client's home-office deduction is modest, the simplified method is often close to the actual-expense figure and avoids recapture at sale. Compare the methods with the eventual sale in mind, and record the method in the client's permanent file so a later preparer does not compute recapture that does not exist.

C. Business Use Inside the Dwelling Unit Versus a Separate Structure

Business or rental use within the same dwelling unit does not require a separate spatial allocation of gain.2 The applicable post-May 6, 1997 depreciation adjustment under section 121(d)(6), determined as explained in **Section** V.A, remains nonexcludable. The exclusion ceiling and any applicable nonqualified-use limitation still apply.3 Where the space is separate from the dwelling unit and was not used as a residence for two of the last five years, an allocation is required.4 The taxpayer allocates basis and amount realized between the residential and non-residential portions, using the method used to compute depreciation. Only the residential share is excludable. "Dwelling unit" follows section 280A(f)(1) but excludes appurtenant structures, so a detached garage office, backyard studio, barn, or stable is outside it.5

Example V-1 (Janice and Martin, office inside the home). Janice and Martin paid $325,000 for their home and added $25,000 of improvements, for a basis of $350,000. Janice used a room inside the house as her real estate office and claimed $10,000 of depreciation, reducing adjusted basis to $340,000. They sold in 2021 for $700,000 and paid $30,000 of selling expenses. They file jointly and meet the $500,000 joint-return tests.

Workpaper V-1. Janice and Martin: office within the dwelling unit

Sale price	$700,000	
Selling expenses	(30,000)	
Amount realized	$670,000	
Adjusted basis ($350,000 - $10,000)	(340,000)	
Realized gain	$330,000	
Less § 121(d)(6) depreciation (not excludable)	(10,000)	
Gain eligible for exclusion	$320,000	(under $500,000 MFJ)
Excluded under § 121	$320,000	
Recognized: unrecaptured § 1250 gain	$10,000	

Report the sale on Form 8949, Part II, box F, without allocating a separate business share of the sale. A home held more than one year belongs in Part II; a missing acquisition date in software can drop the sale into Part I.

Table 4B. Janice and Martin on Form 8949, Part II (box F)

(a) Description	(b) Acquired	(c) Sold	(d) Proceeds	(e) Basis	(f) Code	(g) Adj.	(h) Gain
Principal residence	06/01/2005	12/31/2021	700,000	340,000	EH	(350,000)	10,000

Column **(g)** = $30,000 selling expenses + $320,000 exclusion. Column **(h)** flows to Schedule D, line 10; enter $10,000 on the line 19 worksheet.

Caution: Publication 523's Form 4797 wording

Publication 523's discussion of space within the living area says no separate Form 4797 reporting is needed for that space, while its "Logan" example says the depreciation-related gain is reported on Form 4797. Reconcile with the current-year Form 4797 and Schedule D instructions and with the software's output. Whatever route is used, the taxable amount is the same and the gain must not be reported twice.

The regulation's attorney examples confirm the rule for business use within a dwelling unit. An attorney who used part of a single dwelling unit as a law office and claimed $2,000 of depreciation recognizes only the $2,000

1 Rev. Proc. 2013-13, § 4.06.
2 Treas. Reg. § 1.121-1(e)(1).
3 I.R.C. § 121(b)(1), (b)(5).
4 Treas. Reg. § 1.121-1(e)(1), (3).
5 Treas. Reg. § 1.121-1(e)(2).

on a $13,000 gain and excludes $11,000.1 In the next example the attorney was not entitled to depreciation, so she excludes all $13,000.2 That is different from being entitled to depreciation and failing to claim it, which still reduces basis.

Apply that to Joseph from **Section** II. If he had used 168 of his home's 1,645 square feet **(10.21 percent)** as an office, he would not cut his gain by 10.21 percent. On Joseph's stated facts, taxable gain is limited to his post-May 6, 1997 depreciation adjustments under section 1250(b)(3): his remaining gain fits within the available exclusion, and no separate nonqualified-use period is stated. If he used the simplified method every year, that depreciation is zero.

Example V-2 (Janice, office in a detached structure). Same facts, except Janice's office is in a separate detached building that is 10 percent of the property, the allocation she used for depreciation.

Workpaper V-2. Janice: detached office, allocation required

	Residence (90%)	Detached office (10%)
Amount realized ($670,000)	$603,000	$67,000
Unadjusted basis ($350,000)	315,000	35,000
Depreciation (all to office)	0	(10,000)
Adjusted basis	315,000	25,000
Gain	288,000	42,000
Excluded under § 121	(288,000)	0
Recognized	0	42,000

Office gain detail: $10,000 unrecaptured § 1250 + $32,000 § 1231 gain
Check: $288,000 + $42,000 = $330,000 total gain (foots to V-1)

The residential portion goes on Form 8949 with code H. The office portion is section 1231 property reported on Form 4797, with the depreciation portion flowing to the Schedule D, line 19 worksheet.3 Moving the office from a back bedroom to the backyard turned $32,000 of excluded gain into taxable gain.

Table 8. Business and rental use: which rule applies

Situation	Gain allocation?	What is taxable
Home office or rented room inside the dwelling unit	No	Post-May 6, 1997 depreciation ($0 for simplified-method years)
Detached office, studio, barn, or separate apartment not used as a residence 2 of 5 years	Yes, using the depreciation allocation method	All gain on the non-residential portion (§ 1250 + § 1231), on Form 4797
Residence later rented, sold within the 5-year window	No (post-residence rental is not NQ use)	Depreciation; plus any gain from an earlier NQ-use period
Rental or vacation home later used as residence	Yes, by time (§ 121(b)(5))	Depreciation first, then the NQ-use share of remaining gain

Results assume all other **§** 121 requirements are met and eligible gain does not exceed the available ceiling. Gain above the ceiling is also taxable. "Depreciation" in this table means the **§** 121(d)(6) adjustment determined under **§** 1250(b)(3) **(Section V.A)**.

D. Renting a Room, a Basement Apartment, or a Short-Term Rental

Two threshold rules come first. If a dwelling unit the taxpayer uses as a residence is rented for fewer than 15 days during the year, the rental income is excluded.4 Rental-use deductions are denied, so the rental produces no depreciation deduction for the year. **Section** 121 still requires its own principal-residence and nonqualified-use analysis: a vacation home used personally enough to be a residence under section 280A(d)(1) and rented

1 Treas. Reg. § 1.121-1(e)(4), Ex. 5.
2 Treas. Reg. § 1.121-1(e)(4), Ex. 6.
3 I.R.C. § 1231(b)(1); Treas. Reg. § 1.121-1(e)(1), (e)(4), Ex. 1 (separate stable and acreage); IRS Pub. 523 (2025) (separate business or rental space: report the business or rental part on Form 4797); Instructions for Schedule D (2025), Unrecaptured Section 1250 Gain Worksheet (final 2026 version unavailable at publication).
4 I.R.C. § 280A(g).

fewer than 15 days a year may still be accumulating nonqualified use.1 Short-term rental income from a room or unit is generally reported on Schedule E and is not subject to self-employment tax.2 The exception is an owner who provides substantial services for the occupant's convenience, such as daily maid service or meals, beyond what is needed to maintain the space.

Example V-3 (Sally's condo, a computation you may see). Sally bought her condo 13 years ago for $200,000. For the last four years she rented a bedroom, 15 percent of the floor area, on a short-term rental platform and claimed $3,046 of depreciation. Her adjusted basis is $196,954. She sells for $325,000 with $19,700 of selling expenses. A common approach applies a time-and-space fraction to the gain.

Workpaper V-3A. Sally: time-and-space allocation (do not follow)

```
Amount realized ($325,000 - $19,700)                $305,300
Adjusted basis                                      (196,954)
Realized gain                                       $108,346
Step 1: depreciation recaptured                       (3,046)
Step 2: remaining gain                              $105,300
Step 3: $105,300 x 4/13 years rented = $32,400; x 15% space = $4,860 "taxable"
Step 4: excluded ($105,300 - $4,860)                $100,440
Reported taxable: $3,046 + $4,860 =                   $7,906   <-- overstated
```

The method does not fit the law. The room was inside the dwelling unit, and Sally lived in the condo as her principal residence the entire time. Nonqualified use applies to periods during which "the property" is not used as the principal residence, and the condo was her principal residence throughout.3 For space within the dwelling unit, the regulation requires no spatial allocation; depreciation remains nonexcludable, and the ceiling still applies **(Sally's remaining gain is well under $250,000)**. Publication 523 lists "a rented spare bedroom" as space within the living area.4

Workpaper V-3B. Sally: corrected

```
Realized gain                                       $108,346
Recognized: § 121(d)(6) depreciation                   $3,046  (unrecaptured § 1250)
Excluded under § 121                                $105,300  (under $250,000)
Check: $3,046 + $105,300 = $108,346

Conclusion: the time-and-space method overstated taxable gain by $4,860.
```

Caution: when the rented space is its own dwelling unit

A basement converted into an apartment with its own kitchen, bathroom, sleeping area, and separate entrance is a second dwelling unit. Gain allocable to it is not excludable unless the owner used that unit as a residence for two of the five years (Treas. Reg. § 1.121-1(e)(4), Ex. 3). The regulation's next example, where the owner reincorporates the space into the residence, involves rental years before 2009 (id., Ex. 4). Do not assume it resolves a post-2008 rental period, which may raise nonqualified-use questions.

VI. RENTAL CONVERSIONS, NONQUALIFIED USE, AND SECTION 1031

A. Residence Before Rental

When a residence is converted to rental use, its depreciable basis is the lesser of its adjusted basis or its FMV on the date of conversion, reduced by the portion allocable to land.5 The same lesser-of rule sets the basis for computing a loss if the rental is later sold at a loss.6 Land is never depreciable. Acceptable allocation methods include the county assessor's land-to-improvement ratio, an appraisal, or other documented evidence. An unsupported rule of thumb is hard to defend when the tax bill shows a larger land share.

1 I.R.C. §§ 280A(d)(1), (g), 121(b)(5)(C)(i).
2 I.R.C. § 1402(a)(1); Treas. Reg. § 1.1402(a)-4(a), (c)(1)–(2); Instructions for Schedule E (Form 1040) (2025); CCA 202151005 (Nov. 19, 2021; rel. Dec. 23, 2021) (not precedent, I.R.C. § 6110(k)(3)).
3 I.R.C. § 121(b)(5)(C)(i).
4 Treas. Reg. § 1.121-1(e)(1); IRS Pub. 523 (2025) ("Space within the living area").
5 Treas. Reg. § 1.168(i)-4(b)(1).
6 Treas. Reg. § 1.165-9(b)(2).

Workpaper VI-1. Land allocation from the tax bill

Purchase price	$212,500
Assessor: land $115,000; improvements $242,000; total $357,000	
Improvement ratio ($242,000 / $357,000)	67.79%
Depreciable building ($212,500 x 242/357)	$144,048
Non-depreciable land ($212,500 - $144,048)	$68,452

Once the owner moves out, the remaining eligibility period begins to run out. The use test looks back five years from the sale, so a former residence generally must be sold within about three years of moving out to keep 24 months of use in the window. Two owners who lived in their homes since 1990 each sold on April 18, 2022; the window for both is April 19, 2017 through April 18, 2022. Edward moved out January 1, 2020 and has 987 days of use in the window. He qualifies. Charlie moved out January 1, 2019 and has 622 days. He does not.

If the owner sells within that window, the rental period after the last day of residential use is not nonqualified use.1 Depreciation from the rental period remains nonexcludable. Gain above the available ceiling, and gain attributable to any earlier nonqualified-use period, also remains taxable.

Example VI-2 (Beth's home). Beth, single, bought her home for $500,000 and lived in it for several years. She moved out and rented it for two years, claiming $30,000 of depreciation. She sells within three years of moving out for $800,000 with $75,000 of selling expenses.

Workpaper VI-2. Beth: residence before rental

Amount realized ($800,000 - $75,000)	$725,000
Adjusted basis ($500,000 - $30,000)	(470,000)
Realized gain	$255,000
§ 121(d)(6) depreciation (recognized)	(30,000)
Gain eligible for exclusion	$225,000
Nonqualified use (post-residence rental excepted)	0
Excluded under § 121 (under $250,000)	$225,000
Recognized: unrecaptured § 1250 gain	$30,000

Note: appreciation above cost is $225,000; total realized gain is $255,000 because depreciation reduced basis. Report both components.

Because the property was rental property when sold, the Form 4797 instructions direct computing the gain in Part III **(if held more than one year after conversion)** and entering "**Section** 121 exclusion" with the excluded amount in parentheses on Part I, line 2.2 On Beth's facts, only the depreciation-related gain then flows to Schedule D.

Awareness level: suspended passive losses. When a converted rental is sold, passive losses suspended during the rental years may be released. In CCA 201428008, a former principal residence converted to a passive rental was sold to an unrelated party within three years.3 The IRS concluded that section 121-excluded gain is not passive activity gross income and does not absorb the suspended losses, and that the sale was a complete disposition under section 469(g)(1)(A).4 The suspended losses were treated as nonpassive to the extent they exceeded net passive income for the year. Do not extend the result automatically to related-party sales, partial dispositions, or installment sales.

Net investment income. Gain excluded under section 121 is not net investment income.5 Taxable gain from an ordinary passive rental generally is included. The 3.8 percent tax applies to the lesser of net investment income or MAGI above $200,000 **(single or HOH)**, $250,000 **(MFJ or QSS)**, or $125,000 **(MFS)**.6 Property used in a nonpassive trade or business requires a separate analysis.7

1 I.R.C. § 121(b)(5)(C)(ii)(I).
2 Instructions for Form 4797 (2025) ("Exclusion of gain on sale of home used for business") (final 2026 version unavailable at publication; 2026 draft form posted).
3 CCA 201428008 (Apr. 21, 2014; rel. July 11, 2014) (not precedent, I.R.C. § 6110(k)(3)).
4 CCA 201428008 (not precedent); I.R.C. § 469(g)(1)(A).
5 I.R.C. § 1411(c)(1)(A)(iii).
6 I.R.C. § 1411(a)(1), (b).
7 I.R.C. § 1411(c)(1)(A)(iii), (c)(2).

B. Rental Before Residence: Nonqualified Use

For sales after 2008, gain allocated to periods of nonqualified use is not excludable.1 A period of nonqualified use is any period after December 31, 2008 during which the property was not used as the principal residence of the taxpayer, the taxpayer's spouse, or a former spouse.2 Three periods are excepted:3

(I) any part of the five-year window after the last date the property was used as the principal residence of the taxpayer or spouse; **(II)** up to ten years of qualified official extended duty in the uniformed services, Foreign Service, or intelligence community described in section 121(d)(9)(A)(i)–(iii); and **(III)** up to two years of temporary absence due to change of employment, health, or other unforeseen circumstances specified by the IRS. Do not assume that the separate Peace Corps suspension in section 121(d)(12) automatically provides the same nonqualified-use exception as **(II)**.4

The computation has a fixed order. First set aside the gain that section 121(d)(6) makes nonexcludable, using the applicable depreciation adjustment determined under section 1250(b)(3). Then multiply the remaining gain by a fraction: aggregate periods of nonqualified use over the total period the taxpayer owned the property.5 Determine nonqualified-use days after applying each statutory exception. The post-residence exception covers only the portion of the five-year period after the last residential use; it is not an unlimited exclusion of every day after the owner last lived there. The numerator counts only post-2008 days. The denominator counts every day of ownership, including pre-2009 days. What remains is eligible for the exclusion, up to the ceiling. Publication 523, Worksheet 3, performs the computation in days.

Formula VI-1. Nonqualified-use gain

NQ gain = (Total gain - gain nonexcludable under § 121(d)(6))
x (aggregate post-2008 NQ-use days during ownership,
after applying each statutory exception)
/ (total days owned)

Excludable = (Total gain - § 121(d)(6) gain - NQ gain), up to the ceiling
Determine the § 121(d)(6) amount using § 1250(b)(3), including its adequate-records exception. It cannot exceed total gain.

Example VI-3 (vacation home to residence). A single taxpayer buys a vacation home April 1, 2019 for $500,000 and uses it as a vacation home for three years. It becomes her principal residence April 1, 2022, and she sells March 31, 2024 for $800,000. No depreciation was claimed.

Workpaper VI-3. Vacation home converted to residence

```
Realized gain ($800,000 - $500,000)              $300,000
Depreciation                                            0

Using years:  3 / 5 = 60%     NQ gain $180,000   excluded $120,000
Using days:   1,096 / 1,827   NQ gain $179,967   excluded $120,033
  (NQ 4/1/2019-3/31/2022 = 1,096 days; owned 4/1/2019-3/31/2024 = 1,827)
  (Residence 4/1/2022-3/31/2024 = 731 days; use test met)

Form 8949, Part II, box F: (d) 800,000 (e) 500,000 (f) H
  (g) (120,033)  (h) 179,967   [days method]
```

Example VI-4 (Anna, rental to residence). Anna, single, buys a rental house for $500,000, rents it three years, and claims $43,000 of depreciation. She then lives in it two years and sells for $800,000 with $75,000 of selling expenses. Assume exactly three and two years for the illustration.

1 I.R.C. § 121(b)(5)(A); Housing Assistance Tax Act of 2008, Pub. L. No. 110-289, § 3092, 122 Stat. 2654.
2 I.R.C. § 121(b)(5)(C)(i).
3 I.R.C. § 121(b)(5)(C)(ii)(I)–(III).
4 I.R.C. § 121(b)(5)(C)(ii)(II), (d)(9)(A), (d)(12).
5 I.R.C. § 121(b)(5)(B), (D).

Workpaper VI-4. Anna: rental converted to residence

```
Amount realized ($800,000 - $75,000)              $725,000
Adjusted basis ($500,000 - $43,000)               (457,000)
Total realized gain                               $268,000
Step 1: § 121(d)(6) depreciation (recognized)      (43,000)
Remaining gain                                    $225,000
Step 2: NQ use 3/5 x $225,000 (recognized LTCG)   (135,000)
Step 3: Excluded 2/5 x $225,000                    $90,000

Recognized: $43,000 unrecaptured § 1250 + $135,000 LTCG = $178,000
Check: $178,000 + $90,000 = $268,000
Note: the 60/40 split applies to the $225,000, not the $268,000.
```

Two more patterns. Darla rents a property for seven years, all after 2008, then lives in it two years and sells. Her nonqualified-use fraction is 7/9, or 77.78 percent **(not 0.778 percent, a decimal error that understates taxable gain a hundredfold)**.1 In a rental, residence, then rental pattern, a taxpayer rents for seven years, lives in the home two years, then rents it again for two years before selling, eleven years in all. The first seven years are nonqualified use. The last two follow the last date of residential use and fall within the five-year window, so they are excepted. The fraction is 7/11 **(63.64 percent)**, applied after all nine years of rental depreciation are removed.2

A renovation-and-resale project requires a character analysis. Property held primarily for sale to customers in the ordinary course of a trade or business is not a capital asset.3 If the owner later moves in, the change to principal-residence use must be established from the facts. **Section** 121 treatment does not follow merely from an address change or a homestead filing, and the post-2008 period before occupancy is nonqualified use.

C. Section 1031 and Section 121 (Awareness Level)

Exchange property later used as a residence. **Section** 121 does not apply at all to a sale within five years after property acquired in a section 1031 exchange.4 Publication 523 states that the rule also applies to a seller whose basis is determined by reference to the basis of a person who acquired the property in an exchange. A donee of exchanged property is the common example.5 The replacement property also must have been held for investment or business use in the first place.

Rev. Proc. 2008-16 provides a safe harbor for a dwelling unit's investment status. The taxpayer must own the replacement dwelling for at least 24 months immediately after the exchange.6 In each of the two 12-month periods, the taxpayer must rent it at fair rent for at least 14 days. Personal use in each period cannot exceed the greater of 14 days or 10 percent of the fair-rental days. The safe harbor addresses investment holding only, not every section 1031 requirement.

After five years, section 121 can apply, but the gain is large. Basis is the low carryover basis from the exchange. **Section** 121 does not exclude the applicable post-May 6, 1997 depreciation adjustment reflected in the property's basis, including carried-over adjustments from the relinquished property; determine that adjustment under section 1250(b)(3), as explained in **Section** V.A. The post-2008 rental period before moving in is nonqualified use.7

Warning: the five-year bar is absolute
Section 121(d)(10) is not a reduced exclusion. A sale before the fifth anniversary of the exchange acquisition gets no section 121 exclusion, regardless of how long the client lived there or why the client sold. Ask every home seller whether the property was acquired in an exchange, and ask donees whether the donor acquired it that way.

1 I.R.C. § 121(b)(5)(B).
2 I.R.C. § 121(b)(5)(B), (C)(ii)(I), (D), (d)(6).
3 I.R.C. § 1221(a)(1).
4 I.R.C. § 121(d)(10); American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 840, 118 Stat. 1418.
5 IRS Pub. 523 (2025) (like-kind/1031 exchange).
6 Rev. Proc. 2008-16, §§ 4.01, 4.02(2), 2008-10 I.R.B. 547.
7 I.R.C. §§ 1031(d), 121(b)(5), (d)(6).

Residence exchanged for rental property. A client may move out of a high-gain residence, rent it, and exchange it for rental property while still within the five-year window. Rev. Proc. 2005-14 permits both provisions to apply.1 **Section** 121 is applied first. **Section** 1031 may defer the depreciation gain that section 121 cannot exclude. Boot is taken into account only to the extent it exceeds the gain excluded under section 121. The excluded gain is treated as recognized gain in computing the replacement property's basis. The post-residence rental period is not nonqualified use.2

Workpaper VI-5. Rev. Proc. 2005-14, § 5, Example 1

Cost of house (residence 4 years, then rental 2 years)	$210,000	
Depreciation during rental	(20,000)	
Adjusted basis	$190,000	
Received: townhouse (rental) $460,000 + cash $10,000	$470,000	
Realized gain	$280,000	
Excluded under § 121	(250,000)	
Remaining gain (includes $20,000 depreciation)	$30,000	deferred § 1031
Cash boot $10,000 < $250,000 excluded: taxable boot	0	
Replacement basis: $190,000 + $250,000 - $10,000	$430,000	
Check: $460,000 FMV - $30,000 deferred = $430,000		

Example VI-5 (Ward and June). A married couple filing jointly bought their home in 1965 for $50,000; it is now worth $2,000,000. A straight sale produces $1,950,000 of gain; after the $500,000 exclusion, $1,450,000 is taxable. Instead, they move out, rent the home, and within three years after moving out exchange it for a $1,500,000 rental property plus $500,000 cash. Rental depreciation is ignored for simplicity. Reporting is on Form 8824.

Workpaper VI-6. Ward and June (rental depreciation ignored)

Amount realized ($1,500,000 property + $500,000 cash)	$2,000,000
Basis	(50,000)
Realized gain	$1,950,000
Excluded under § 121	(500,000)
Deferred under § 1031	$1,450,000
Cash boot $500,000, not more than $500,000 excluded: taxable	0
Replacement basis: $50,000 + $500,000 - $500,000	$50,000
Check: $1,500,000 FMV - $1,450,000 deferred = $50,000	

Caution: what Ward and June leave out

The example omits rental depreciation, which is small here because depreciable basis at conversion is the lesser of the $50,000 adjusted basis or FMV, less land. It also omits qualified-intermediary and constructive-receipt mechanics and state tax. The replacement property must be identified within 45 days and received by the earlier of 180 days after the transfer or the return due date, including extensions, for the year of the transfer (I.R.C. § 1031(a)(3)). This is a directional illustration, not a return computation.

VII. GIFTS, INHERITANCES, AND FORECLOSURES

A. Gifting the Home or Adding a Child to the Deed

Clients often hear that putting a child's name on the deed avoids probate. It may, but for federal tax purposes it is usually a completed gift of an interest in the home. A gift of a present interest is excluded up to $19,000 per donee for 2026, counting all gifts to that donee during the year.3 Married donors may elect to split gifts, which requires both spouses' consent and eligibility under section 2513.4 A gift above the exclusion requires Form 709 even when no gift tax is payable.5 A transfer-on-death or similar deed under which the parent keeps full power to revoke and sell is generally not a completed gift. Whether a particular state's deed qualifies is a question for the client's attorney.

1 Rev. Proc. 2005-14, §§ 4.02(1)–(3), 4.03, 2005-1 C.B. 528.
2 Rev. Proc. 2005-14, § 4.03, 2005-1 C.B. 528; I.R.C. § 121(b)(5)(C)(ii)(I); IRS Pub. 523 (2025) (like-kind/1031 exchange).
3 I.R.C. § 2503(b); Rev. Proc. 2025-32, § 4.42(1), 2025-45 I.R.B. 695.
4 I.R.C. § 2513(a)–(b).
5 I.R.C. § 6019.

Federal gift and estate tax is rarely the issue for these clients. The basic exclusion amount is $15,000,000 per individual for 2026.1 Whether a particular donor owes gift tax depends on how much of that exclusion remains after prior taxable gifts. The income tax consequences of a lifetime gift of a home, by contrast, are usually bad.

The donee takes the donor's basis rather than a date-of-death value.2 When the donee uses a basis determined by reference to the donor's basis, the donor's holding period carries over; a loss computed using the separate gift-date FMV basis requires a separate holding-period determination. The donee does not take the donor's section 121 ownership and use, which the donee must establish independently.3 If the donor depreciated the property, the donee takes the depreciation history and the recapture that goes with it; a transfer at death eliminates it, a gift does not.4 Basis may be increased for gift tax actually paid on net appreciation.5

Example VII-1 (Steve, Laura, and Greg). Steve and Laura bought a home in 1990 for $500,000 and gave it to their son Greg in 2020 when it was worth $1,000,000. No gift tax was paid. Greg sells within a year for $1,250,000. His basis is $500,000, his holding period is long-term because it includes his parents', and he cannot use section 121 because he never lived there. He reports $750,000 of LTCG. Had Greg inherited the house when it was worth $1,000,000, his gain would have been $250,000 before selling expenses.

When the property is worth less than the donor's basis at the time of the gift, the donee has two bases. The donor's basis is used for computing gain. The FMV at the date of gift is used for computing loss. A sale between the two produces neither gain nor loss.6

Table 9. Dual basis on a gift of a home that has declined in value

Facts: donor basis $500,000; FMV at gift $300,000	Basis used	Result
Greg sells for $1,250,000	$500,000 (gain basis)	$750,000 gain
Greg sells for $400,000	Neither applies	No gain and no loss
Greg sells for $250,000	$300,000 (loss basis)	$50,000 loss; deductible only if Greg held it for investment or rental and the loss limitations are met, not as a personal residence

Debt changes the analysis. Debt relief can make a purported gift partly a sale. Establish the consideration, actual liability relief, and a remaining gift component before applying part-gift rules. If the debt exceeds the donor's basis, the donor has gain equal to the excess. A parent who gives a property with a $20,000 basis subject to a $26,000 mortgage recognizes $6,000 of gain, and the child's basis is $26,000.7 In a part-sale, part-gift, the donee's basis is the greater of the amount the donee paid **(including debt assumed)** or the donor's adjusted basis.8 For computing a loss, that basis may not exceed the FMV at the time of transfer.

1 I.R.C. § 2010(c)(3)(A), as amended by Pub. L. No. 119-21, § 70106(a), 139 Stat. 72, 162 (2025); Rev. Proc. 2025-32, § 2.14, 2025-45 I.R.B. 695. The IRS refers to Pub. L. No. 119-21 as the Working Families Tax Cuts legislation; it is also widely called the One Big Beautiful Bill Act.

2 I.R.C. § 1015(a).

3 I.R.C. § 121(a) (ownership and use "by the taxpayer"); *cf.* I.R.C. §§ 121(d)(3) (tacking only for a spouse or former spouse), 1223(2) (donee tacks donor's holding period, a separate concept).

4 I.R.C. §§ 1250(b)(3), (d)(1)–(2), 1014(a).

5 I.R.C. § 1015(d)(6).

6 I.R.C. § 1015(a); Treas. Reg. § 1.1015-1(a)(2).

7 Treas. Reg. §§ 1.1001-1(e)(1), 1.1001-2(a)(1), 1.1015-4(a); *cf. Diedrich v. Commissioner*, 457 U.S. 191 (1982) (net gift; donee's payment of gift tax treated as amount realized by donor).

8 Treas. Reg. § 1.1015-4(a); id. § 1.1015-4(b), Exs. 1–4.

Workpaper VII-1. Greg: depreciated gift subject to a mortgage

```
Parents' adjusted basis                $500,000
FMV at transfer                        $300,000
Bona fide mortgage assumed by Greg     $200,000
Gift (equity transferred)              $100,000

Parents: amount realized $200,000 < basis $500,000 -> no gain;
  no loss is allowed on a part-sale/part-gift (Reg. 1.1001-1(e)(1))
Greg's basis for gain: greater of $200,000 paid or $500,000 = $500,000
Greg's basis for loss: limited to FMV at transfer = $300,000
Greg sells for $250,000: loss = $250,000 - $300,000 = ($50,000)
  deductible only if profit-motive and loss limitations are met
```

Caution: debt larger than value

If the debt Greg assumed were larger than the property's value, there would be no gift at all, because a gift is measured by value in excess of consideration (I.R.C. § 2512(b)). Do not apply part-gift basis rules until the transfer has been characterized: confirm the debt's terms, recourse status, and actual liability relief.

B. Selling to a Child: Bargain Sale Versus Full-Value Installment Sale

Example VII-2 (Frank and Danny, the bargain sale). Frank, unmarried, owns his home with a $300,000 basis and a $750,000 FMV. He meets the ownership and use tests. He sells the home to his son Danny for $250,000. Four things happen.

(1) Frank's $50,000 shortfall below basis is not a deductible loss, because no loss is allowed on a part-sale, part-gift.1 **(2)** Frank uses none of his section 121 exclusion. A full-price sale would have produced $450,000 of gain, of which he could exclude $250,000 and would recognize $200,000. **(3)** Frank makes a $500,000 gift **($750,000 – $250,000)**. Assuming no other 2026 gifts to Danny, $481,000 is a taxable gift reportable on Form 709 after the $19,000 annual exclusion; whether any gift tax is due depends on Frank's remaining basic exclusion. **(4)** Danny's basis for gain is the greater of the $250,000 he paid or Frank's $300,000 basis, which is $300,000, leaving $450,000 of built-in gain.2

Caution: two common errors in this computation

First, the gross gift is FMV minus price, $500,000; the annual exclusion is then subtracted to reach the taxable gift. Using an earlier year's exclusion amount produces the wrong taxable gift. Second, the child's basis is not the price paid when the parent's basis is higher. Under Treas. Reg. § 1.1015-4(a)(1), Danny's basis for gain is $300,000, not $250,000.

Example VII-3 (Sam, Diane, and Frasier, the full-value sale). Married parents Sam and Diane own a home with a $300,000 basis and a $750,000 FMV that they have owned and lived in for many years. They sell it to their son Frasier for its full $750,000 value: $150,000 down and a $600,000 note secured by a recorded mortgage.

Assume the note is enforceable, is intended to be repaid, bears adequate interest under the applicable rules, and is worth its face amount.3 On those assumptions, the full-value sale is not a bargain gift. Their $450,000 gain is fully excluded under the $500,000 joint ceiling, so neither the down payment nor the principal payments produce taxable gain.4 The interest is taxable to them. Frasier's basis is his $750,000 cost.5

Warning: planned forgiveness can recharacterize the sale

Parents who intend to forgive each year's note payment up to the annual exclusion should understand the risk. Where forgiveness was prearranged, the Tax Court has treated the notes as not real consideration and the transfer as a gift (Minnie E. Deal, 29 T.C. 730 (1958); see Estate of Maxwell v. Commissioner, 3 F.3d 591 & n.6 (2d Cir. 1993) ("Deal is still good law")), and the IRS follows that approach (Rev. Rul. 77-299, 1977-2 C.B. 343). Other Tax Court decisions have reached a different result (e.g., Haygood v. Commissioner, 42 T.C.

1 Treas. Reg. § 1.1001-1(e)(1); see also I.R.C. §§ 165(c), 267(a)(1).
2 Treas. Reg. § 1.1015-4(a)(1).
3 I.R.C. §§ 1274(d), 2512(b), 7872; Rev. Rul. 77-299, 1977-2 C.B. 343.
4 I.R.C. § 121(b)(2).
5 I.R.C. § 1012(a); *see* I.R.C. § 61(a)(4) (interest income).

936 (1964); Estate of Kelley v. Commissioner, 63 T.C. 321 (1974)), which the IRS does not follow (Rev. Rul. 77-299). Any forgiveness program should be designed by the client's attorney.

C. Inherited Homes

An inherited home generally takes a basis equal to its FMV at the date of death **(or alternate valuation date)**, and the heir's holding period is automatically long-term.1 Determine whether the property is subject to the estate-tax basis-consistency rule; that rule applies to property whose inclusion increased the estate tax and is narrower than the fact that a Form 706 was filed.2 Depreciation recapture does not survive a transfer at death.3

Two important situations can prevent the expected basis adjustment. The first is appreciated property given to the decedent within one year of death that passes back to the donor or the donor's spouse.4 The second is assets of an irrevocable grantor trust that are not included in the grantor's gross estate.5 This text does not survey every exception.

An heir does not inherit the decedent's section 121 eligibility, except that a surviving spouse tacks the decedent's ownership and use.6 A child must independently satisfy the section 121 requirements: generally two years of ownership and use, or a reduced exclusion under section 121(c) if the child made the home a principal residence and a qualifying early-sale circumstance occurred.7 A child who never uses the property as a principal residence gets no relief merely by inheriting it. Usually the heir does not need it, because the new basis leaves little gain.

More often, the heir has a loss. A house appraised at $400,000 at death and sold six months later for $400,000, with $28,000 of commissions and closing costs, produces a $28,000 realized loss. Whether it is deductible depends on how the property was used after death:

(1) Personal use by the heir, or family occupancy treated as the owner's personal use, makes the loss nondeductible.8 Not every family occupancy is personal use: a family member renting at fair rent as a principal residence requires a separate rental and profit-motive analysis.9 **(2)** If it was never used personally and was held for sale or investment, the Tax Court has allowed a capital loss on specific facts.10 **(3)** If it was converted to rental property used in a trade or business and meets the section 1231 holding-period requirement, the sale is reported on Form 4797, using the lesser of basis or FMV at conversion to compute the loss.11 Investment property not used in a trade or business generally produces capital gain or loss.

Who reports the sale also matters. Determine who owned and sold the property under the will, the deed, probate authority, and state law. Review the sale contract and closing statement. Do not decide between Form 1041 and an heir's return solely from how the proceeds were spent.12 A capital loss reported by an estate does not flow to beneficiaries on an interim Schedule K-1; unused capital loss carryovers pass to beneficiaries when the estate terminates.13

Practice Pointer: the inherited-house interview

Ask three questions: Did anyone live in the house after the death? Was it listed for sale or for rent, and when? Whose name was on the deed at the sale? The answers determine whether the loss is deductible and whose return it goes on. Keep the date-of-death appraisal and the listing agreement in the file.

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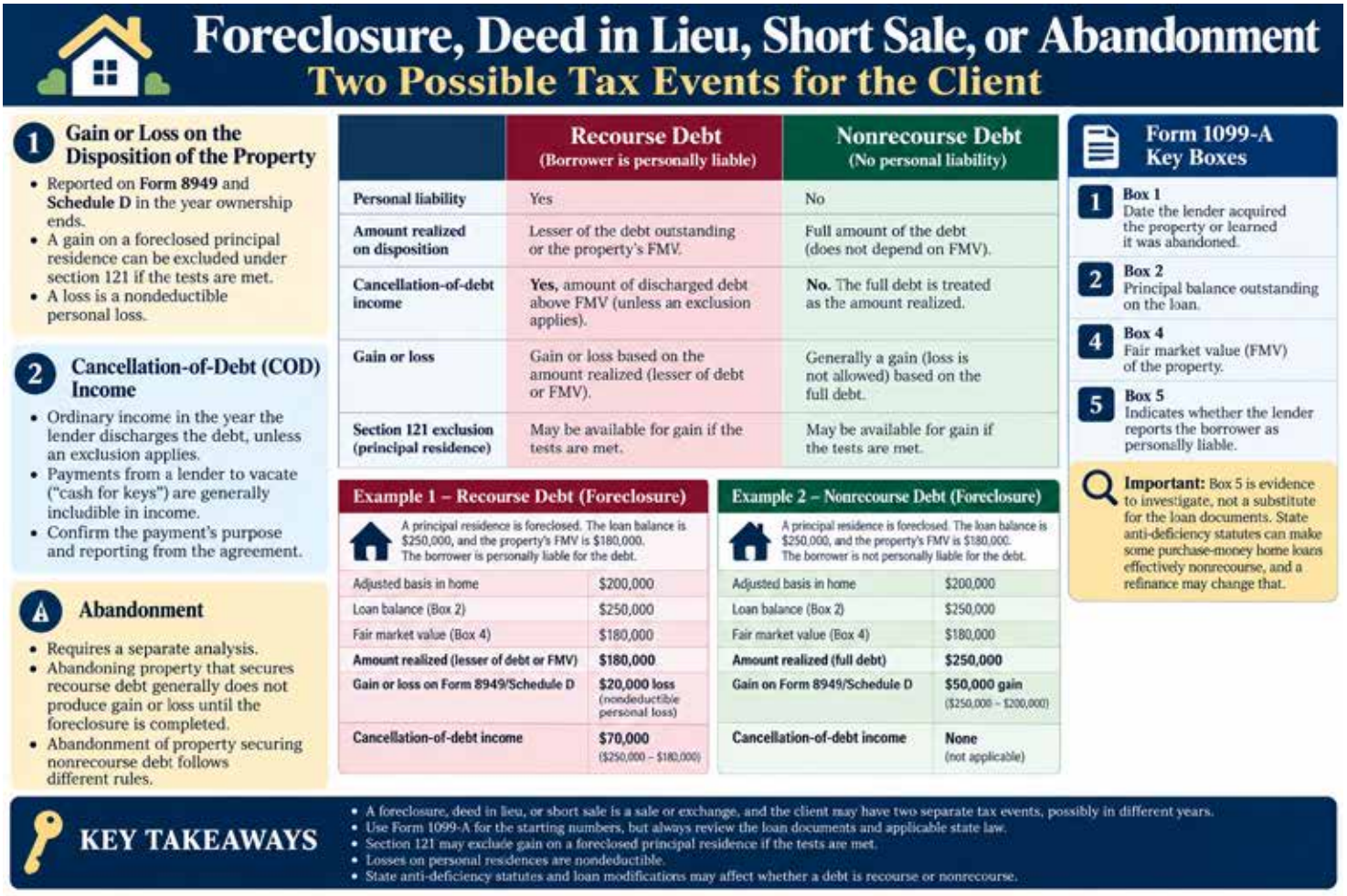
1 I.R.C. §§ 1014(a)(1)–(2), 1223(9).
2 I.R.C. § 1014(f)(1)–(2).
3 I.R.C. § 1250(d)(2); Treas. Reg. § 1.1250-3(b)(2)(i).
4 I.R.C. § 1014(e).
5 Rev. Rul. 2023-2, 2023-16 I.R.B. 658 (Holding); *see* I.R.C. § 1014(a)–(b).
6 I.R.C. § 121(d)(2).
7 I.R.C. § 121(c)(1)–(2).
8 I.R.C. §§ 165(c), 280A(d)(2)(A).
9 I.R.C. § 280A(d)(3)(A).
10 *Campbell v. Commissioner*, 5 T.C. 272 (1945) (heirs made no personal use; loss allowed).
11 I.R.C. §§ 165(c)(1)–(2), 1231(b)(1); Treas. Reg. § 1.165-9(b)(1)–(2).
12 SCA 1998-012 (Apr. 7, 1998) (not precedent, I.R.C. § 6110(k)(3)).
13 I.R.C. § 642(h)(1).

D. Foreclosures, Short Sales, and Forms 1099-A and 1099-C



A foreclosure, deed in lieu of foreclosure, or short sale of a home is a sale or exchange, and the client may have two separate tax events, possibly in different years.[1] Abandonment requires a separate analysis. Abandoning property that secures recourse debt generally does not produce gain or loss until the foreclosure is completed; abandonment of property securing nonrecourse debt follows different rules.[2]

The first event is gain or loss on the disposition, reported on Form 8949 and Schedule D in the year ownership ends. A gain on a foreclosed principal residence can be excluded under section 121 if the tests are met; a loss is a nondeductible personal loss. The second event is cancellation-of-debt income, ordinary income in the year the lender discharges the debt, unless an exclusion applies.[3] Payments from a lender to vacate **("cash for keys")** are generally includible in income; confirm the payment's purpose and reporting from the agreement.[4]

Form 1099-A gives the starting numbers. Box 1 is the date the lender acquired the property or learned it was abandoned. Box 2 is the principal balance outstanding. Box 4 is the FMV of the property. Box 5 indicates whether the lender reports the borrower as personally liable. For nonrecourse debt, the amount realized is the full debt, regardless of the property's value, and there is no cancellation-of-debt income.[5] For recourse debt in a foreclosure, the amount realized is the lesser of the debt or the property's FMV, and debt discharged above the FMV is cancellation-of-debt income.[6] Box 5 is evidence to investigate, not a substitute for the loan documents.

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1 *Helvering v. Hammel*, 311 U.S. 504 (1941); Treas. Reg. § 1.1001-2(a); IRS Pub. 4681.
2 IRS Pub. 4681 ("Abandonments"); see Treas. Reg. § 1.6050J-1T, Q&A-18 (Form 1099-A abandonment definition not controlling for other purposes).
3 I.R.C. §§ 61(a)(11), 108(a).
4 I.R.C. § 61(a).
5 Treas. Reg. § 1.1001-2(a)(1), (b), (c), Ex. 7; *Commissioner v. Tufts*, 461 U.S. 300 (1983).
6 Treas. Reg. § 1.1001-2(a)(2), (c), Ex. 8; IRS Pub. 4681.

State anti-deficiency statutes can make some purchase-money home loans effectively nonrecourse, and a refinance may change that.

Table 10. Reading Form 1099-A in a foreclosure

	Nonrecourse (box 5 "No")	Recourse (box 5 "Yes")
Amount realized	Box 2 (debt), even if box 4 is lower	Lesser of box 2 or box 4
Cancellation-of-debt income	None	Box 2 minus box 4, if discharged (Form 1099-C)
Section 121	Can exclude gain if tests met	Can exclude gain if tests met

Simplified foreclosure or debt-satisfaction comparison. Do not use it as the amount-realized formula for every short sale; confirm the actual consideration, liability relief, and any separately discharged recourse debt.

Example VII-4 (Jill, nonrecourse). Jill's basis is $250,000, her nonrecourse loan balance is $300,000, and the home is worth $200,000 when the lender forecloses. Her amount realized is $300,000 and her gain is $50,000; she has no cancellation-of-debt income. Jill owned the home from June 1, 2020 to June 3, 2021, so she fails the two-year tests. The $50,000 is taxable unless she qualifies for a reduced exclusion. A job loss with unemployment eligibility, or an employment change leaving her unable to pay basic living expenses, could qualify.1 Had she owned and lived in the home for two of the last five years, she would enter code H and **($50,000)** in column **(g)** and owe nothing on the disposition.

Example VII-5 (Jack, recourse). Jack's basis is $175,000, his recourse loan balance is $300,000, and the home is worth $200,000. He owned and lived in it from June 1, 2016 to June 2, 2021. The lender forecloses and cancels the remaining $100,000.

Workpaper VII-2. Jack: two transactions

```
Transaction 1: foreclosure (Form 8949, Part II, box F)
  Amount realized: lesser of $300,000 debt or $200,000 FMV   $200,000
  Basis                                                     (175,000)
  Gain                                                       $25,000
  Code H, column (g) (25,000); column (h)                          0

Transaction 2: cancellation of debt (Form 1099-C)
  $300,000 - $200,000                                        $100,000
  Ordinary income unless excluded on Form 982
```

The exclusion for qualified principal residence indebtedness covers acquisition debt on a principal residence, up to $750,000 **($375,000 married filing separately)**.2 It applies only if the debt was discharged before January 1, 2026, or under an arrangement entered into and evidenced in writing before that date. Public Law 119-21 did not extend it. As of October 23, 2026, H.R. 917, the Mortgage Debt Tax Forgiveness Act of 2025, remained introduced and referred to the House Committee on Ways and Means. It had not become law. Recheck before relying on this sentence.3

For a 2026 discharge, work through the exclusions in statutory order. A discharge in a Title 11 bankruptcy case is excluded and takes precedence over the others.4 Next, look for a written workout, short-sale, or deed-in-lieu agreement signed before January 1, 2026. If there is one, the principal-residence exclusion may still apply **(Form 982, line 1e)**. It takes precedence over insolvency unless the taxpayer elects otherwise.5 If the loan includes debt that is not qualified principal residence debt, such as cash-out refinance proceeds not used on the home, the exclusion applies only to the amount discharged that exceeds the nonqualifying portion.6 Otherwise, test for insolvency. Debt is excluded to the extent liabilities exceeded the FMV of all assets, including retirement accounts and exempt assets, immediately before the discharge **(Form 982, line 1b, with the**

1 Treas. Reg. § 1.121-3(e)(2)(iii)(B)–(C).
2 I.R.C. § 108(a)(1)(E), (h)(2); Pub. L. No. 116-260, div. EE, § 114, 134 Stat. 1182 (2020).
3 H.R. 917, 119th Cong. (introduced Feb. 4, 2025; referred to H. Comm. on Ways & Means).
4 I.R.C. § 108(a)(1)(A), (a)(2)(A).
5 I.R.C. § 108(a)(2)(C).
6 I.R.C. § 108(h)(4).

Publication 4681 insolvency worksheet).1 Excluded amounts reduce tax attributes under the rules for the exclusion used.2

Warning: 2021 facts, 2026 law
Jack's foreclosure occurred in 2021, when the qualified principal residence exclusion was available. A client with the same facts, a 2026 discharge, and no pre-2026 written arrangement owes tax on the $100,000 unless bankruptcy or insolvency applies. Do not carry forward a prior-year Form 982 approach without checking the date.

VIII. PROFESSIONAL RESPONSIBILITY AND THE INTAKE CHECKLIST

A. The Preparer's Obligations

The signature on a return carries the responsibility for it, whatever software or worksheet produced the numbers. A paid preparer may be penalized for an understatement due to an unreasonable position the preparer knew or reasonably should have known about.3 A position is unreasonable unless it has substantial authority or, if disclosed, a reasonable basis; tax shelters and reportable transactions require a more-likely-than-not standard.4 The penalty is the greater of $1,000 or 50 percent of the income derived from the return. There is a reasonable-cause and good-faith exception.5 For willful or reckless conduct, the penalty is the greater of $5,000 or 75 percent.6 An error does not automatically establish a penalty, but a missed nonqualified-use computation or missed recapture is the kind of error reasonable diligence should catch.

Enrolled agents, CPAs, and attorneys practicing before the IRS are subject to Circular 230's due diligence and competence rules, its standards for return positions, and its standards for written advice.7 Unenrolled preparers who participate in the Annual Filing Season Program consent to be subject to Subpart B and section 10.51 of Circular 230.8 For every preparer, the practical standard is the same:

(1) ask the questions the facts suggest; **(2)** document the answers; and **(3)** do not rely on a client's assurance that a sale is tax-free when a Form 1099-S, a depreciation schedule, or a deed says otherwise. Home-sale files contain closing statements, Social Security numbers, and bank records. Their handling is governed by the preparer's disclosure restrictions and data-security obligations, including a written information security plan.9

B. The Intake Checklist and Three Formulas

Table 11. Section 121 intake checklist

Question	Why it matters	Authority
Owned 730 days in the last 5 years? (Either spouse, on MFJ)	Ownership test	§ 121(a), (b)(2)(A)(i)
Lived there 730 days in the last 5 years? (Both spouses for $500,000)	Use test; care-facility rule	§ 121(a), (b)(2)(A)(ii), (d)(7)
Excluded gain on another home in the last 2 years?	Look-back	§ 121(b)(3)
Taxpayer or spouse on uniformed services, Foreign Service, intelligence, or Peace Corps duty?	Up to 10-year suspension	§ 121(d)(9), (d)(12)
Acquired in a § 1031 exchange (or from a donor who did) within 5 years?	Absolute bar	§ 121(d)(10)

1 I.R.C. § 108(a)(1)(B), (a)(3), (d)(3); IRS Pub. 4681.
2 I.R.C. § 108(b), (h)(1).
3 I.R.C. § 6694(a)(1)–(2).
4 I.R.C. § 6694(a)(2)(A)–(C).
5 I.R.C. § 6694(a)(1), (a)(3).
6 I.R.C. § 6694(b)(1)–(2).
7 31 C.F.R. §§ 10.22, 10.34, 10.35, 10.37.
8 Rev. Proc. 2014-42, § 4.05(4), 2014-29 I.R.B. 192.
9 I.R.C. §§ 6713, 7216; 16 C.F.R. pt. 314 (FTC Safeguards Rule); IRS Pub. 4557, Safeguarding Taxpayer Data.

Question	Why it matters	Authority
Ever rented, used for business, or depreciated? Which home-office method?	Recapture; NQ use; allocation	§ 121(b)(5), (d)(6); Reg. § 1.121-1(e)
Moved early for job, health, or an unforeseen event?	Reduced exclusion	§ 121(c); Reg. § 1.121-3
Divorce, separation, or death of a spouse? Remarried?	Tacking, imputed use, $500,000 window, basis at death	§§ 121(b)(4), (d)(2)–(3), 1014, 1041
Acquired by gift or inheritance? Debt on the property?	Carryover vs. date-of-death basis; part-gift	§§ 1014, 1015; Reg. § 1.1015-4
Form 1099-S, 1099-A, or 1099-C received?	Reporting and COD	§§ 108, 6045(e); Reg. § 1.1001-2

Table 12. Three formulas not to confuse

Formula	Computation	Applies the fraction to
A. Reduced exclusion (§ 121(c))	Ceiling x shortest qualifying period / 730 days	The ceiling, never the gain
B. Nonqualified use (§ 121(b)(5))	(Gain – gain nonexcludable under § 121(d)(6)) x post-2008 NQ days / total days owned. Determine the § 121(d)(6) amount using § 1250(b)(3), including its adequate-records exception; it cannot exceed total gain.	Gain after removing the § 121(d)(6) amount
C. § 121 + § 1031 (Rev. Proc. 2005-14)	**§ 121 first; boot taxed only above excluded gain. For the simplified examples only:** replacement basis = relinquished adjusted basis + § 121-excluded gain + additional taxable gain recognized – cash received. Assumes no cash paid, liabilities, other boot, or exchange costs; use the full § 1031(d) computation for an actual exchange.	No fraction; ordering rule

Dolores's Case, Resolved

Dolores brought in her documents the following week:

(1) the 2004 closing statement; **(2)** the depreciation schedules from the 2004 through 2012 returns; **(3)** contractor invoices; **(4)** the 2023 Form 5695; **(5)** the date-of-death appraisal ordered by the estate attorney; **(6)** the September 2026 closing statement; and **(7)** the Form 1099-S. The facts below are stipulated for teaching: the property ceased to be held for rent on June 30, 2012, and the depreciation amounts are those on the historical schedules. Dolores has no dependent and files as single for 2026, and her MAGI other than the home sale is $64,000.

Ownership and use. Dolores and Walter owned the home from June 1, 2004. They lived in it from July 1, 2012 until Walter's death, and Dolores lived there until the sale. Within the five years ending September 30, 2026, Dolores owned and used the home throughout. The look-back test is met. The home was not acquired in an exchange.

The ceiling. The sale closed September 30, 2026, not later than two years after Walter's August 15, 2025 death. Dolores has not remarried. Immediately before Walter's death, at least one spouse met the ownership test, both met the use test, and neither had excluded gain on another sale in the prior two years. Her ceiling is $500,000.1

Basis. The computation assumes the 2004 deed created a qualified joint interest under section 2040(b): only the spouses were joint owners, with right of survivorship.2 Walter's half received a basis equal to half the $1,120,000 appraised value.3 Dolores's retained half does not receive a new basis. It keeps its adjusted

1 I.R.C. § 121(b)(4), (b)(2)(A).
2 I.R.C. § 2040(b)(1)–(2).
3 I.R.C. § 1014(a)(1), (b)(9).

historical basis: half the cost, half the improvements, half the energy credit, and her half of the depreciation deducted on their joint returns.1 Walter's half of the depreciation was eliminated at his death.2 The home office does not affect basis, because Dolores used the simplified method every year and allowable depreciation for the office was deemed zero.3

Workpaper R-1. Dolores: depreciation and adjusted basis

Cost incl. settlement charges (06/01/2004)	$242,000
Assessor ratio: 75% building -> depreciable basis	$181,500
Depreciation, 27.5-yr SL MM, placed in service June 2004:	
2004: $181,500 x 1.970%	3,576
2005-2011: $181,500 x 3.636% = $6,599 x 7	46,193
2012 (rental ended June 30): $181,500 x 3.636% x 5.5/12	3,025
Total depreciation	52,794
Kitchen remodel (2015)	48,276
Roof (2020)	16,850
Heat pump (2023)	11,874
Less § 25C credit allowed (2023)	(2,000)
Unadjusted basis ($242,000 + $77,000 - $2,000)	$317,000
Dolores's half: $317,000 / 2 = $158,500 - $26,397	$132,103
Walter's half: $1,120,000 / 2 (date-of-death FMV)	$560,000
Dolores's adjusted basis at sale	$692,103

Nonqualified use. The rental period from June 1, 2004 through December 31, 2008 is not nonqualified use, because the statute disregards periods before 2009. The rental period from January 1, 2009 through June 30, 2012 is nonqualified use: 1,277 days. Total ownership from June 1, 2004 through September 30, 2026 is 8,157 days. The fraction applies to the gain remaining after Dolores's share of depreciation is removed.4

Workpaper R-2. Dolores: gain, recapture, nonqualified use, exclusion

Sale price (Form 1099-S, box 2a)	$1,175,000
Selling expenses (6%)	(70,500)
Amount realized	$1,104,500
Adjusted basis	(692,103)
Realized gain	$412,397
Step 1: § 121(d)(6) depreciation (Dolores's share)	(26,397)
Remaining gain	$386,000
Step 2: NQ use $386,000 x 1,277 / 8,157	(60,429)
Qualified gain	$325,571
Ceiling (§ 121(b)(4))	$500,000
Excluded	$325,571
Recognized: $26,397 unrecaptured § 1250 + $60,429 LTCG =	$86,826
Check: $86,826 + $325,571 = $412,397	

Table 13. Dolores's Form 8949, Part II (box F)

(a) Description	(b) Acquired	(c) Sold	(d) Proceeds	(e) Basis	(f) Code	(g) Adj.	(h) Gain
Principal residence	06/01/2004	09/30/2026	1,175,000	692,103	EH	(396,071)	86,826

Column **(g)** = $70,500 selling expenses + $325,571 exclusion. Column **(h)** flows to Schedule D, line 10; $26,397 goes on the Unrecaptured **Section** 1250 Gain Worksheet for Schedule D, line 19. Schedule D and Form 8949 instructions: final 2026 version unavailable at publication; confirm these references before filing, check the software's route against them, and do not report the depreciation-related gain twice.

Table 14 compares the correct return with four other outcomes the same facts could produce. The delayed-sale row holds proceeds, selling expenses, basis, and other income constant solely to isolate the ceiling. A real later sale would need a new computation.

1 I.R.C. §§ 1016(a)(1), (a)(2), (a)(33), 2040(b).
2 I.R.C. §§ 1014(a)(1), 1250(b)(3); *see* id. § 1250(d)(2); Treas. Reg. § 1.1250-3(b)(2)(i).
3 Rev. Proc. 2013-13, § 4.06.
4 I.R.C. § 121(b)(5)(B)–(D); IRS Pub. 523 (2025), Worksheet 3.

Table 14. What each fact was worth (controlled comparison of recognized gain)

Scenario	Recognized gain	Difference from correct return
Correct return (above)	$86,826	Not applicable
Same sale closing after August 15, 2027 ($250,000 ceiling)	$162,397	+$75,571 of LTCG
Preparer ignores Walter's basis adjustment and recaptures all $52,794	$340,294	+$253,468 (overstated)
Preparer omits the nonqualified-use computation	$26,397	–$60,429 (understated; § 6694 exposure)
Sale not reported	$0 on return	Form 1099-S mismatch on $1,175,000 gross proceeds

Simplified directional comparison; not final Form 1040 results. Omits bracket stacking of the 25% unrecaptured § 1250 gain, other deductions, and state tax. Basis-adjustment row: basis $264,206, gain $840,294, NQ gain $123,285, qualified gain $664,215, excess over $500,000 ceiling $164,215.

Table 15. Hypothetical tax effect of the $250,000 ceiling (illustration only)

Item	Correct return	$250,000 ceiling
Recognized gain	$86,826	$162,397
MAGI ($64,000 other MAGI + recognized gain)	$150,826	$226,397
NIIT base (lesser of NII or MAGI over $200,000)	$0	$26,397
NIIT at 3.8%	$0	$1,003
Added capital gains tax on $75,571 at an assumed 15%	Not applicable	$11,336
Approximate added federal tax	Not applicable	$12,339

Hypothetical. The 15% rate is an assumption for illustration, not a computed liability; actual tax depends on the full 2026 return.

Caution: the depreciation split rests on the stipulated deed

Dolores's retained half keeps its adjusted historical basis and depreciation history. Walter's inherited half receives the date-of-death basis adjustment. The stipulated modern qualified joint interest is the basis for this computation. The older section 1250 entirety example illustrates surviving depreciation history but uses different estate-inclusion facts. Document the deed, the appraisal, and the depreciation schedules.

Dolores asked again: "So it wasn't tax-free?" Most of it was. $325,571 of her $412,397 gain is excluded. Walter's half took a basis equal to its value at his death. Her simplified home-office method created no depreciation-related gain at sale. What remained taxable was her share of the depreciation from the rental years and the share of gain allocated to the rental years after 2008. Missing Walter's basis adjustment would have overstated recognized gain by $253,468 on these facts. The Form 1099-S was the reason to call.

2026 FEDERAL INCOME TAX UPDATE



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(04) Program # A5BAX-U-00140-26-I

Course Details	
Name of the CE Provider	AmData
Program name	2026 Federal Income Tax Update
IRS program number	A5BAX-U-00140-26-I
CE	4
Prerequisite	Basic understanding of individual income tax principles and joint tax filing. **Field of Study:** Taxes
Advanced Preparation	None
Program Level	Intermediate
Delivery Method:	Live in-person
Field of Study:	Federal Tax Law Update - A program that provides a practical working knowledge of the latest legislative tax law changes and associated IRS forms/ instructions/publications.



ABSTRACT

This text is a four-hour federal update for return preparers whose practice is mostly individual returns: wage earners, Schedule C gig and small-business filers, families claiming the child tax credit, and seniors. It covers the 2026 changes that affect Form 1040 or a supporting schedule for tax year 2026: the Schedule 1-A deductions for tips, overtime, car-loan interest, and seniors; the child tax credit, Trump accounts, and other family provisions; the rebuilt itemized deductions; HSAs and the premium tax credit; provisions and energy credits that ended; information reporting and form changes; depreciation and the qualified business income deduction for small businesses; the proposed treatment of refundable credits as federal public benefits and the draft Schedule 3-A; and the new automatic exemption from penalty.

Definitions:

- **Fact-Driven Education:** This program is focused on providing accurate, up-todate information about tax laws, regulations, and administrative updates as they stand today.
- **Non-Political Content:** All discussions are strictly factual and are not intended to express or imply any political opinions or preferences.
- **Commitment to Professionalism:** Our shared responsibility as tax professionals is to understand and apply the law, ensuring compliance and effective client representation.
- **Focus on Practice:** This program prioritizes practical, actionable knowledge to support your work, free from bias or interpretation beyond what the law provides.

PROGRAM DESCRIPTION AND LEARNING OBJECTIVES

The 2026 Federal Income Tax Update, Four-Hour Edition, is a 200-minute program in the Federal Tax Update field of study, at the update level, for preparers of individual returns. There are no prerequisites and no advance preparation. It covers the 2026 effect of Public Law 119-21 and the regulations, notices, revenue procedures, and forms issued to carry it out, as they reach the individual return, along with the 2026 penalty-relief and refund-delivery changes. Due diligence, representation, and collection are covered in a separate program.

Table 1. Learning objectives

No.	Upon completing the program, participants will be able to:
1	Apply the 2026 rules for the Schedule 1-A deductions for qualified tips, qualified overtime compensation, passenger-vehicle loan interest, and seniors, including the Form W-2 reporting the tips and overtime deductions depend on and the Form 1098-VLI reporting that supports, but does not establish, the car-loan deduction.
2	Apply the 2026 child tax credit, Trump account, dependent care, educational assistance, and educator expense rules to individual returns.
3	Compute the 2026 limits on state and local taxes, charitable contributions, mortgage insurance premiums, casualty and theft losses, and wagering losses, and decide whether a client should itemize.
4	Apply the HSA eligibility changes and reconcile advance premium tax credit with no repayment cap.
5	Identify the provisions and energy credits that ended or narrowed for 2026, and the 2026 information-reporting thresholds and form changes.
6	Apply the 2026 depreciation, section 179, and qualified business income rules to a small Schedule C business.
7	Explain the proposed treatment of refundable credits as federal public benefits and work the draft Schedule 3-A.
8	Distinguish statute, final guidance, administrative positions, proposed rules, and pending legislation; apply the preparer-penalty standard to positions that rest on unsettled authority; and apply the automatic exemption from penalty and other penalty-relief options.

Table 2. Time allocation

Part	Topic	Minutes
I	Filing-season orientation	3
II	The 2026 numbers	9
III	Tips and overtime	32
IV	Car-loan interest	11
V	Senior deduction	9
VI	Child tax credit	12
VII	Trump accounts	8
VIII	Other family and educator provisions	9
IX	Household deductions	17

X	HSAs and the premium tax credit	17
XI	What ended or narrowed	10
XII	Information reporting and forms	10
XIII	**Schedule C:** depreciation and QBI	16
XIV	Refundable credits and draft Schedule 3-A	12
XV	Preparing returns when authority is unsettled	5
XVI	Filing, refund delivery, and penalty relief	10
XVII	Paid family and medical leave	4
XVIII	Long-term care distributions	2
XIX	Putting it together	4
	Total instruction	200

MEET THE CLIENTS

The people and businesses below are composites. No actual client is described, and any resemblance to a real taxpayer is coincidental. Each was built so that its facts trigger several 2026 provisions at once, because that is how the provisions show up in practice. The figures are kept simple so that each derivation can be followed line by line. Where a simplification matters, the text says so.

Marisol Vega is single and tends bar at a full-service restaurant. Her employer reports her wages, the cash tips she reports to it, and the restaurant's mandatory service charge on large parties, part of which goes to her. Marisol raises the threshold question of the year: what the new tips deduction does and does not cover.

Derek and Tanya Okafor file jointly. Derek is an hourly electrician paid time-and-a-half for hours over forty in a workweek. Under his union contract, he is also paid daily overtime for hours over eight in a day. Tanya teaches at a private preschool. They have two children under ten, and a third child was born in February 2026. In March 2026 they bought a new pickup truck assembled in the United States, financed with a loan secured by the truck. Derek also does small electrical jobs on weekends as a sole proprietor.

Walter and June Brennan are both over sixty-five. They live on Social Security, IRA distributions, and investment income. Walter enjoys the casino and gets Forms W-2G. The couple give generously to their church.

Hollis Fabrication, Inc. is an S corporation manufacturer owned by Ray Hollis; it appears in the depreciation example in Part XIII. Lena Kowalski is single and owns a hair salon as a sole proprietor. Her stylists receive tips. She buys individual health coverage through the Marketplace with advance premium tax credits. She owns her home, which carries private mortgage insurance, and she had a federal student loan balance forgiven in 2026.

Mateo and Sofia Herrera file jointly. Mateo is a machinist and Sofia a stylist at Lena's salon. They are a mixed-status family with three U.S.-born children, and they are the subject of the Schedule 3-A exercise in Part XIV.

I. FILING-SEASON ORIENTATION

A. What is different about 2026

Public Law 119-21, enacted July 4, 2025, is cited in this text as the 2025 reconciliation act or by its public-law number.1 It made permanent most of the individual rate and deduction structure enacted in 2017, which was scheduled to expire after 2025. It added temporary deductions that run from 2025 through 2028. It changed a number of business provisions retroactively to 2025 and others prospectively from 2026. And it ended several energy credits on fixed dates in late 2025 and 2026.

For most practitioners, 2025 returns, filed in 2026, were the first look at the new deductions, under transition relief. Tax year 2026 returns will be prepared in the 2027 filing season. The 2026 year differs in three practical ways. First, the transition relief is mostly over: employers must report qualified overtime and tips in coded boxes on Form W-2. The IRS has said that without that reporting there is no 2026 workaround. Second, a group of provisions takes effect only for taxable years beginning after December 31, 2025. These include the

1 Pub. L. No. 119-21, 139 Stat. 72 (2025). IRS releases refer to the same law as the "Working Families Tax Cuts."

new limitation on itemized deductions, the charitable floors, the 90 percent wagering-loss rule, the higher AMT phase-out rate, the end of the deduction for employer-provided meals, and the restored mortgage-insurance-premium deduction. Third, Treasury and the IRS issued a large volume of regulations, notices, and revenue procedures in 2026. Some of that guidance is final, and some is only proposed.

HOW THIS TEXT COMPUTES TAX: For taxable income under $100,000, this text computes tax from the 2026 Tax Table in the August 28, 2026 draft of Publication 1040, which the IRS marks as a draft not for filing. The final table is published with the 2026 Form 1040 instructions, usually in December, and the IRS can change it before then; check the final table before filing a return. For taxable income of $100,000 or more, the text uses the Tax Computation Worksheet in the same draft, which gives the same result as the 2026 rate schedules. As of October 22, 2026, the IRS had not released its 2027 inflation adjustments; examples that look ahead to 2027 use 2026 amounts unless a 2027 figure had been published, and they say so.[1]

B. Weight of authority

Table 3. Authority labels used in this text

Label	Meaning for practice
STATUTE	Enacted Code text. Controlling, subject to its effective date.
FINAL	**Final or temporary regulation (T.D.). Also guidance published in the Internal Revenue Bulletin (revenue ruling, revenue procedure, notice), which are recognized types of authority for the substantial-authority standard. Citing one does not by itself establish substantial authority:** under Treas. Reg. § 1.6662-4(d)(3), the weight of the authorities supporting a position must be substantial in relation to the weight of contrary authorities, and weight depends on relevance, persuasiveness, and the type of document. I.R.B. guidance does not carry the same weight as a final or temporary regulation. The label groups these for convenience; weigh a regulation above a notice when they conflict.
ADMIN	Fact sheet, FAQ, publication, form instructions, IRM, or news release. An administrative position; news and information releases are listed authority of limited weight, and the others are not authority. Each shows how the IRS will process the return.
PROPOSED	Notice of proposed rulemaking, or an announced intent to issue guidance. Teach and plan around as proposed. Express reliance protection applies only to the extent the proposal permits it. Separately, a proposed regulation can be weighed as authority under Treas. Reg. § 1.6662-4(d)(3)(iii).
PENDING	A bill not yet enacted. Legislative watch only.
LITIGATION	A court decision under appeal, or an issue now in litigation.
OPERATIONAL	Findings of the National Taxpayer Advocate, the Taxpayer Advocate Service, and TIGTA, and IRS service statistics. Context for advising clients and setting expectations, not authority for a return position. Figures taken from newsletters or the trade press and not checked against the source are marked “as reported.”

Abbreviations used in this text

Abbreviation	Meaning
AEP	Automatic Exemption from Penalty
AGI	adjusted gross income
AMT	alternative minimum tax
AMTI	alternative minimum taxable income
AOC	American opportunity credit

[1] I.R.C. § 3(a); I.R.S., Pub. 1040, *Tax and Earned Income Credit Tables*, for use in preparing 2026 returns, Tax Table and 2026 Tax Computation Worksheet (draft Aug. 28, 2026, marked as a draft not for filing; subject to change) (ADMIN); Instructions for Form 1040 (2025), line 16 (ADMIN).

Abbreviation	Meaning
APTC	advance premium tax credit
CBA	collective bargaining agreement
CNC	computer numerical control (machining)
CTC	child tax credit
DPC	direct primary care
EBL	excess business loss
ERC	employee retention credit
FICA	Federal Insurance Contributions Act
FLSA	Fair Labor Standards Act
FPL	federal poverty line
FSA	flexible spending arrangement
FUTA	Federal Unemployment Tax Act
GST	generation-skipping transfer
HDHP	high-deductible health plan
HOH	head of household
HSA	health savings account
IDR	income-driven repayment
IRA	individual retirement arrangement
IRM	Internal Revenue Manual
ISO	incentive stock option
ITIN	individual taxpayer identification number
M&IE	meals and incidental expenses
MACRS	Modified Accelerated Cost Recovery System
MAGI	modified adjusted gross income
MFJ	married filing jointly
MFS	married filing separately
MIP	mortgage insurance premiums
NHTSA	National Highway Traffic Safety Administration
NIIT	net investment income tax
NOL	net operating loss
OZ	opportunity zone
PTC	premium tax credit
PTET	pass-through entity tax
PTIN	preparer tax identification number
QBI	qualified business income
QCD	qualified charitable distribution
SALT	state and local tax
SE	self-employment
SSN	Social Security number
TC	transaction code (on an IRS account transcript; an action code, AC, further identifies it)
TIGTA	Treasury Inspector General for Tax Administration
TIN	taxpayer identification number
TPS	temporary protected status
TSP	Thrift Savings Plan

Abbreviation	Meaning
VIN	vehicle identification number
WISP	written information security plan

C. Responsibility follows the signature

The provisions covered here produce many new opportunities for an error to appear on a return, especially in the first full year of reporting. When an employer reports overtime in the wrong box, a lender issues a Form 1098-VLI for a used vehicle, or a client's software computes a deduction from the wrong figure, the employer's, lender's, or vendor's error does not relieve the preparer. A tax return preparer, whether or not the preparer signs the return, is subject to penalty under section 6694 for an understatement due to an unreasonable position. For a practitioner subject to Circular 230, including an Annual Filing Season Program participant, who consents to its Subpart B duties and section 10.51, Circular 230 separately requires due diligence **(section 10.22)** and competence **(section 10.35)**. Return preparation alone does not make an unenrolled preparer a Circular 230 practitioner **(Loving v. IRS, 742 F.3d 1013 (D.C. Cir. 2014)**).1 A preparer may generally rely in good faith, without verification, on information the client furnishes. But the preparer may not ignore the implications of information furnished or actually known, and must make reasonable inquiries if the information appears incorrect, inconsistent, or incomplete.2 Many of the examples below are built around information that should prompt that inquiry.

II. THE 2026 NUMBERS

A. The core table

Table 4 collects the 2026 figures most practitioners use. Rev. Proc. 2025-32 is the main inflation-adjustment release for 2026 and reflects the 2025 act's amendments. IRS releases identify it as IR-2025-103; some early sources cited IR-2025-102 in error. Retirement-plan figures come from Notice 2025-67. Health Savings Account **(HSA)** figures come from Rev. Proc. 2025-19. Mileage comes from Notice 2026-10 and Announcement 2026-11.

Table 4. Selected 2026 figures

Item	2026 amount	Source
Standard deduction: MFJ / HOH / single and MFS	$32,200 / $24,150 / $16,100	Rev. Proc. 2025-32, § 4.14
Additional standard deduction, aged or blind	$1,650 ($2,050 if unmarried and not a surviving spouse)	Rev. Proc. 2025-32, § 4.14
Dependent's standard deduction	Greater of $1,350 or earned income + $450, not more than the regular basic standard deduction	Rev. Proc. 2025-32, § 4.14
Kiddie tax reference amount under § 1(g)(4)(A)(ii) (not the trigger; parental rate generally applies to net unearned income over $2,700)	$1,350	Rev. Proc. 2025-32, § 4.02
37% bracket begins: MFJ / single	$768,700 / $640,600	Rev. Proc. 2025-32, § 4.01
Child tax credit / refundable portion	$2,200 / $1,700	Rev. Proc. 2025-32, § 4.05
Earned income credit, maximum (3+ children)	$8,231	Rev. Proc. 2025-32, § 4.06
EIC investment income limit	$12,200	Rev. Proc. 2025-32, § 4.06

1 I.R.C. § 6694(a)–(b); Treas. Reg. § 301.7701-15(b) (signing and nonsigning tax return preparers); 31 C.F.R. §§ 10.22(a), 10.34(a), 10.35(a) (2014).

2 31 C.F.R. § 10.34(d); Treas. Reg. § 1.6694-1(e)(1) (good-faith reliance; reasonable inquiries when information appears incorrect, inconsistent, or incomplete).

Item	2026 amount	Source
Adoption credit	$17,670; phase-out $265,080-$305,080; refundable portion up to $5,120 (§ 4.04(3))	Rev. Proc. 2025-32, § 4.04
AMT exemption: MFJ / unmarried / MFS	$140,200 / $90,100 / $70,100	Rev. Proc. 2025-32, § 4.10
AMT phase-out begins: MFJ / others (50% rate)	$1,000,000 / $500,000	Rev. Proc. 2025-32, § 4.10
SALT cap / MAGI threshold (MFS: half the threshold, then half the reduced cap)	$40,400 / $505,000	I.R.C. § 164(b)(7)
§ 199A threshold: MFJ / MFS / all other	$403,500 / $201,775 / $201,750	Rev. Proc. 2025-32, § 4.26
§ 461(l): joint / others	$512,000 / $256,000	Rev. Proc. 2025-32, § 4.31
§ 179 limit / phase-out / SUV	$2,560,000 / $4,090,000 / $32,000	Rev. Proc. 2025-32, § 4.24
§ 448(c) gross receipts test	$32,000,000	Rev. Proc. 2025-32, § 4.30
Educator expenses (above the line)	$350	Rev. Proc. 2025-32, § 4.12
Student loan interest: maximum deduction; phase-out single / MFJ (no deduction if MFS)	$2,500; $85,000-$100,000 / $175,000-$205,000	§ 221(b)(1), (e)(2); Rev. Proc. 2025-32, § 4.29
Health FSA salary reduction / carryover	$3,400 / $680	Rev. Proc. 2025-32, § 4.15
Qualified transportation and parking (monthly)	$340	Rev. Proc. 2025-32, § 4.16
Dependent care exclusion (§ 129)	$7,500 ($3,750 MFS)	I.R.C. § 129(a)(2)(A)
Educational assistance (§ 127)	$5,250 (indexed from 2027)	I.R.C. § 127; FS-2026-10
Annual gift exclusion	$19,000	Rev. Proc. 2025-32, § 4.42
Estate and gift basic exclusion amount	$15,000,000	I.R.C. § 2010(c)(3), as amended by Pub. L. No. 119-21
Foreign earned income exclusion	$132,900	Rev. Proc. 2025-32, § 4.39
401(k) / 403(b) / 457 / TSP elective deferral	$24,500	Notice 2025-67
Catch-up, age 50+ / ages 60-63	$8,000 / $11,250	Notice 2025-67
IRA contribution / IRA catch-up	$7,500 / $1,100	Notice 2025-67
§ 415(c) defined contribution / § 415(b) defined benefit	$72,000 / $290,000	Notice 2025-67
HSA: self-only / family	$4,400 / $8,750	Rev. Proc. 2025-19
HDHP minimum deductible / out-of-pocket maximum (self / family)	$1,700 / $3,400; $8,500 / $17,000	Rev. Proc. 2025-19
Social Security wage base	$184,500	SSA 2026 COLA fact sheet
Standard mileage, Jan. 1-June 30: business / medical and moving / charity	72.5¢ / 20.5¢ / 14¢	Notice 2026-10
Standard mileage, July 1-Dec. 31: business / medical and moving / charity	76¢ / 23.5¢ / 14¢	Ann. 2026-11

Item	2026 amount	Source
Per diem high-low, from Oct. 1, 2026 (lodging + M&IE)	$329 high-cost / $230 other; M&IE $86 / $74	Notice 2026-60
ACA required contribution percentage	9.96% (2026); 10.22% (2027)	Rev. Proc. 2026-26
Failure-to-file minimum penalty, income tax return more than 60 days late (returns due in 2027)	Lesser of $535 or 100% of tax required	Rev. Proc. 2025-32, § 4.52
PTIN fee (IRS user fee + contractor)	$18.75 ($10.00 + $8.75)	T.D. 10035 (90 FR 46759); REG-108673-25; IRS PTIN FAQ (Oct. 15, 2026)

The research behind this text did not independently re-verify the 2026 adoption, EIC, foreign-earned-income, and kiddie-tax amounts against a second source. They were read from Rev. Proc. 2025-32. Also not verified: the Affordable Care Act **(ACA)** § 4980H assessable payment, the 2026 depreciation limits for passenger automobiles under Rev. Proc. 2026-15, § 911 housing amounts under Notice 2026-25, and IRS user fees. Confirm against the source before use.

B. The mid-year mileage change

Announcement 2026-11 raised the business standard mileage rate to 76 cents and the medical and moving rate to 23.5 cents, for expenses paid or incurred on or after July 1, 2026. The charitable rate is fixed by statute and stays at 14 cents.1 A mid-year change has happened before, in 2008, 2011, and 2022, and the preparer response is the same as in those years. Mileage logs must separate the two periods. For a mileage allowance paid to employees, both the payment and the expense must be on or after July 1 for the higher rate to apply.

III. THE TIPS AND OVERTIME DEDUCTIONS

A. Where the new deductions sit in the computation

The four temporary individual deductions created in 2025 are for qualified tips, qualified overtime compensation, qualified passenger-vehicle loan interest, and seniors. None of them is an above-the-line deduction, so none reduces adjusted gross income. None is an itemized deduction either. Each is allowed in computing taxable income whether or not the taxpayer itemizes. For all four, MAGI is AGI increased by amounts excluded under sections 911, 931, and 933. The premium tax credit uses a different definition **(Part X.B)**. The 2025 act added them to section 63(b), which lists the deductions allowed to taxpayers who do not itemize. **Section** 63(d) defines itemized deductions to exclude any deduction referred to in section 63(b). On the 2025 and 2026 returns they are computed on Schedule 1-A and carried to Form 1040. Two consequences follow, and both come up in the examples. Because the deductions do not reduce adjusted gross income **(AGI)**, they do not help the client with any AGI-based threshold: the medical-expense floor, the taxable portion of Social Security, the net investment income tax, or the premium tax credit. And because they are not itemized deductions, the new overall limitation on itemized deductions in section 68 does not reach them.

⚠ **CAUTION: The tips and overtime phase-outs reduce the deduction by $100 "for each $1,000" of MAGI over the threshold. Unlike the car-loan provision, they do not say "or portion thereof." The examples in this text use excess amounts in exact multiples of $1,000 so the answer does not depend on how partial steps are treated. For a client with a partial step, follow the rounding in the final 2026 Schedule 1-A instructions, and note that the instructions are an administrative position.**

1 Ann. 2026-11, 2026-29 I.R.B. (rates from July 1, 2026); Notice 2026-10 (Jan.–June rates); I.R.C. § 170(i).

Table 5. Same 2025-2028 window, four different caps and phase-outs

Deduction	Cap	Phase-out begins (single / joint MAGI)	Reduction	Reporting and identity
Qualified tips (§ 224)	$25,000 per return	$150,000 / $300,000	$100 per $1,000	Form W-2 Code TP or statement; SSN; joint return if married
Qualified overtime (§ 225)	$12,500; $25,000 joint	$150,000 / $300,000	$100 per $1,000	Form W-2 Code TT (no Form 4852 route for 2026); SSN; joint return if married
Car-loan interest (§ 163(h)(4))	$10,000 of interest per return	$100,000 / $200,000	$200 per $1,000 or part, applied to the deduction, not the cap	VIN on the return (statute); lender reports on Form 1098-VLI, which does not establish eligibility
Seniors (§ 151(d)(5)(C))	$6,000 per qualified individual	$75,000 / $150,000	6% of MAGI over the threshold, for each individual	SSN; age 65 by year-end; joint return if married

Source: I.R.C. §§ 151(d)(5)(C), 163(h)(4), 224, 225 **(STATUTE)**; FS-2026-13 **(ADMIN)**. All four apply for 2025 through 2028.

B. Qualified tips: the statutory frame

Section 224 allows a deduction equal to the qualified tips the individual received during the year and that are included on a statement furnished to the individual, such as a Form W-2 or Form 1099, or reported by the taxpayer on Form 4137.1 The deduction may not exceed $25,000 for the year.2 It is reduced, but not below zero, by $100 for each $1,000 by which modified adjusted gross income exceeds $150,000, or $300,000 on a joint return.3 The $25,000 limit applies per return, not per spouse. A married couple with two tipped earners shares a single $25,000 limit, and claims that the joint limit is $50,000 are wrong. The taxpayer must include a valid Social Security number on the return, and a married taxpayer must file jointly.4 The deduction ends for taxable years beginning after December 31, 2028.5

Qualified tips are cash tips received in an occupation that customarily and regularly received tips on or before December 31, 2024. The tip must be paid voluntarily, with no consequence for nonpayment, and its amount must not be the subject of negotiation; the payor decides how much to pay. The statute also excludes tips received in the course of a specified service trade or business, as section 199A defines that term.6 For a self-employed tipped worker, qualified tips count only to the extent the gross income from that trade or business, including the tips, exceeds the deductions allocable to it. The tips deduction cannot create or increase a loss.7

C. The final regulations (T.D. 10044)

Treasury finalized the occupation list and the definition of qualified tips in T.D. 10044, published April 13, 2026, and effective June 12, 2026. The regulations apply to taxable years beginning after December 31, 2024, so they govern both the 2025 and 2026 returns.8 Four points from the final rules come up most often in practice.

1 I.R.C. § 224(a) (STATUTE).
2 I.R.C. § 224(b)(1).
3 I.R.C. § 224(b)(2).
4 I.R.C. § 224(e) (SSN), (f) (joint return).
5 I.R.C. § 224(h).
6 I.R.C. § 224(d)(1), (d)(2)(A)–(B).
7 I.R.C. § 224(c); Treas. Reg. § 1.224-1(e).
8 T.D. 10044, 91 Fed. Reg. 19026 (Apr. 13, 2026); 2026-18 I.R.B. (FINAL).

The first is digital assets. The final regulations keep the exclusion in the proposed rules: cash tips do not include digital assets, as defined for broker reporting.1 The IRS news release on the final rules left that phrase out of its summary, and some commentary has read the omission as a change. The regulation text controls. A tip paid in a stablecoin is not a qualified tip.

The second is service charges. Service charges, automatic gratuities, and any other mandatory amounts are not qualified tips, even when the employer passes them through to employees. An amount is voluntary only if the customer can disregard or modify it, including reducing it to zero. Where a customer pays a voluntary amount on top of a mandatory charge, the voluntary portion can qualify.2

The third is the occupation list. The final list of tipped occupations is exhaustive, and each occupation carries a Treasury Tipped Occupation Code. The final rules added visual artists, floral designers, and gas pump attendants to the proposed list, removed none, and clarified the treatment of doormen, banquet staff, rideshare and delivery workers using apps and platforms, eyebrow and eyelash technicians, and pet caretakers.3

The fourth is the specified-service-business exclusion, which the final regulations did not address. **Section** 1.224-1(g) is reserved. Under Notice 2025-69, the IRS will not treat a listed-occupation worker as receiving tips in a specified service trade or business until January 1 of the first calendar year after final regulations on that exclusion, and the related employer reporting rules, are issued. No such regulations had issued by the research cutoff, so in practice the exclusion is not enforced for 2026. The 2026-2027 Priority Guidance Plan lists no section 224 project.

⚠ **CAUTION: The specified-service-business carve-out has been suspended administratively; it has not been repealed. The statute still excludes those tips. If final regulations issue during 2027, the exclusion would apply starting January 1 of the following calendar year. Do not tell a client who works in a specified service business that the carve-out "does not apply to them." Tell them it is not being enforced under current IRS transition guidance.**

D. Form W-2 reporting for tips: what Code TP does not tell you

The 2026 Form W-2 specifications are in Rev. Proc. 2026-27. Box 12, Code TP, reports the total cash tips the employee reported to the employer. Box 14 is now split into Box 14a, Other, and Box 14b, which reports up to two Treasury Tipped Occupation Codes.4 Notice 2025-62 relieved employers of penalties for 2025 reporting, but it covered 2025 only, and no comparable relief has been announced for 2026.5

Code TP is the starting figure, not the deductible amount. It is the employee's total cash tips reported to the employer, before any test under section 224 is applied. The deduction is then limited by occupation, by the voluntary-payment test, by the $25,000 cap, and by the MAGI6 phase-out. A preparer or software routine that carries Code TP straight to Schedule 1-A will get the right answer only when none of those limits applies.

E. Worked example: Marisol Vega's tips

Marisol tends bar, a listed occupation. Her 2026 Form W-2 shows Box 1 wages of $81,900. That total is $48,000 of hourly wages, $2,400 of her share of the restaurant's mandatory 18 percent service charge on parties of eight or more, and $31,500 of cash tips she reported to her employer. Box 12, Code TP, shows $31,500. The restaurant is not a specified service trade or business. Her only income is the W-2, so her AGI and her MAGI are both $81,900, and she takes the standard deduction.

A seasonal preparer enters the return and claims $33,900 as qualified tips, treating the $2,400 service-charge share as a tip because the restaurant calls it a "gratuity" on the guest check. That is two errors. The service charge is a mandatory amount, not a tip, under the final regulations. And even the correct tip figure exceeds the statutory cap.

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1 Treas. Reg. § 1.224-1(c)(2) (cross-referencing I.R.C. § 6045(g)(3)(D) and Treas. Reg. § 1.6045-1(a)(19)).

2 Treas. Reg. § 1.224-1(c)(4); see Rev. Rul. 2012-18, 2012-26 I.R.B. 1032 (tips vs. service charges).

3 T.D. 10044, 91 Fed. Reg. 19026 (Apr. 13, 2026) (final occupation list, preamble).

4 Rev. Proc. 2026-27, 2026-32 I.R.B. (FINAL); 2026 Instructions for Forms W-2 and W-3 (ADMIN).

5 Notice 2025-62 (penalty relief limited to 2025 returns).

6 MAGI means modified adjusted gross income.

WORKPAPER: Marisol Vega: 2026 qualified tips deduction (single)

```
Tax from the draft 2026 Tax Table (Aug. 28, 2026); see Part I.
Box 1 wages (48,000 + 2,400 + 31,500)              81,900
Box 12 Code TP (cash tips reported to employer)    31,500

Flawed entry
  Tips claimed (31,500 + 2,400 service charge)     33,900   <- wrong on two counts

Corrected computation
  Qualified tips (Code TP; service charge excluded) 31,500
  Statutory cap, I.R.C. 224(b)(1)                   25,000
  Lesser of the two                                 25,000
  MAGI 81,900 vs. 150,000 threshold: no reduction        0
  Tips deduction (Schedule 1-A)                     25,000

Taxable income
  AGI                                               81,900
  Less standard deduction (2026, single)           (16,100)
  Less tips deduction                              (25,000)
  Taxable income                                    40,800

Tax, draft 2026 Tax Table (single)
  Row 40,800-40,850, single column                   4,651.00
  Tax                                                4,651.00

Same return without the tips deduction (TI 65,800)
  Row 65,800-65,850, single column         9,194.00

Federal income tax reduction from the deduction      4,543.00
```

The deduction saves Marisol $4,543 of federal income tax: $9,194 without the deduction minus $4,651 with it equals $4,543. It does not change her Social Security and Medicare taxes on the tips. Federal Insurance Contributions Act **(FICA)** tax applies to all of her tips exactly as before, and the employer still owes its share. The 2026 standard deduction and rate brackets used here come from Rev. Proc. 2025-32.

PRACTICE POINTER: For any tipped client, ask the employer, or check the guest checks, whether the restaurant adds a mandatory service charge on large parties, banquets, or room service. If it does, ask how the employer reports it. Some employers put service-charge distributions in Code TP by mistake. In that case the TP figure overstates qualified tips, and the preparer who knows about the service charge cannot simply carry the Code TP figure to Schedule 1-A.

F. Self-employed tips: the net-income limit

For a self-employed tipped worker, such as a rideshare driver, an independent stylist, or a musician paid tips at events, the statute limits qualified tips to the gross income of the tipped trade or business, including the tips, less the deductions allocable to it. The final regulation repeats that general standard, other than the section 224 deduction itself.1 Neither the statute nor the regulation says whether the deductible half of self-employment tax, self-employed retirement contributions, and the self-employed health insurance deduction are allocable deductions. The preamble to T.D. 10044 states that this question was beyond the scope of the regulations.2 The IRS instructions require all three to be subtracted. That is an administrative position; form instructions are not on the list of authorities in Treas. Reg. § 1.6662-4(d)(3)(iii). Treas. Reg. § 1.199A-3(b)(1)(vi), which treats the same deductions as attributable to a trade or business for purposes of section 199A only, gives analogous but not controlling support.3 Prepare the return using the IRS computation, and confirm it against the final 2026 Schedule 1-A instructions. **Section** 199A(c)(4)(D) excludes from qualified business income any amount for which

1 I.R.C. § 224(c); Treas. Reg. § 1.224-1(e).

2 T.D. 10044, 91 Fed. Reg. 19026 (Apr. 13, 2026) (preamble: whether these deductions are allocable under § 224(c) is "beyond the scope of these regulations") (FINAL).

3 Treas. Reg. §§ 1.6662-4(d)(3)(iii), 1.199A-3(b)(1)(vi) ("for purposes of section 199A only"); 2025 Form 1040 Instr. p. 104 and Schedule 1-A instructions (ADMIN); Gorczynski commentary (Mar. 3, 2026) (secondary).

a section 224(a) deduction is allowable. Do not count that amount as qualified business income, or toward the $1,000 active-QBI test for the minimum deduction **(Part XIII.C)**.

Tomas Reyes drives for a rideshare platform, a listed occupation for app-based drivers. He also earns $30,000 of W-2 wages from a part-time warehouse job, so his taxable income falls in the 12 percent bracket. In 2026 he collected $6,800 in tips through the app. After fees, fuel, and depreciation, his Schedule C net profit, including the tips, was $7,500. He paid $1,200 of self-employed health insurance premiums; assume they are deductible under section 162(l).

WORKPAPER: Tomas Reyes: self-employed tips limit (single)

Qualified tips received (app-reported)	6,800.00
Schedule C net profit, including tips	7,500.00
Half of SE tax: 7,500 x 0.9235 x 0.153 / 2	529.86
SE health insurance deduction	1,200.00
Net-income limit: 7,500.00 - 529.86 - 1,200.00	5,770.14
Tips deduction: lesser of 6,800 or 5,770.14	5,770.14

Because the net-income limit is below the tips received, Tomas deducts $5,770.14, not $6,800. The difference is about $1,030 of deduction, worth roughly $124 in tax at a 12 percent bracket. A preparer who carries the app-reported tips straight to Schedule 1-A overstates the deduction. Part XV discusses the preparer-penalty exposure on a contrary position.

G. Qualified overtime: the statutory frame

Section 225 allows a deduction for qualified overtime compensation that appears on a statement furnished to the individual. The deduction is capped at $12,500, or $25,000 on a joint return. It is phased out by $100 for each $1,000 by which MAGI exceeds $150,000, or $300,000 on a joint return. The SSN1 and joint-return requirements match the tips deduction, and so does the 2028 sunset. The definition has two limits. Qualified overtime compensation is overtime compensation required under section 7 of the Fair Labor Standards Act, and only the part that exceeds the regular rate.

The first limit means overtime paid under a union contract, a state daily-overtime law, or employer policy does not qualify unless the FLSA2 itself required it. The second limit is the “half” rule. When an employee is paid time-and-a-half, only the premium half qualifies; the straight-time portion of the overtime hour does not. This is a common overtime error on 2025 returns. It is easy to see why: pay stubs and some payroll reports show total overtime pay, not the premium.

H. Form W-2 Code TT, and why Form 4852 does not work for 2026

Starting with tax year 2026, employers must report qualified overtime compensation in Box 12 of Form W-2 using Code TT. FS-2026-13, released in August 2026, says that no relief is available after 2025 and that the employee may not claim more than the Code TT amount. If Code TT is missing or understated, the employee needs a corrected Form W-2c from the employer. Form 4852 does not work, because it is not a statement furnished under section 6051(a)(19), and section 225(a) requires one.3 An employer that fails to report Code TT correctly has filed an incorrect information return and furnished an incorrect payee statement. Penalties under sections 6721 and 6722 apply, reduced if the employer corrects on time.4

⊗ **WARNING: For 2026, the overtime deduction depends on the employer reporting it. A client with qualifying FLSA overtime and no Code TT on the W-2 has no deduction until the employer issues a Form W-2c. Do not reconstruct the premium from pay stubs and claim it, the way some preparers did under the 2025 transition relief. Under current IRS guidance, that claim will be disallowed, and the preparer has been told in writing why.**

1 SSN means Social Security number.
2 FLSA means Fair Labor Standards Act.
3 FS-2026-13 (Aug. 2026) (supersedes FS-2026-01) (ADMIN); Rev. Proc. 2026-27, 2026-32 I.R.B. (Code TT).
4 I.R.C. §§ 6721(a), 6722(a); FS-2026-13 (ADMIN).

I. Worked example: Derek Okafor's overtime

Derek's regular rate is $36.00 an hour. In 2026 he worked 2,080 regular hours and 300 hours over forty in a workweek, paid at $54.00 an hour. His union contract also pays a daily-overtime premium for hours over eight in a day. In 2026 that premium added $1,260 in weeks when his total hours did not exceed forty. His employer reports Code TT correctly. Derek brings his year-end pay stub to the appointment, and the "OT" line shows $16,200.

WORKPAPER: Derek Okafor: 2026 qualified overtime compensation

```
Regular pay: 2,080 hrs x $36.00                    74,880
Weekly FLSA overtime: 300 hrs x $54.00             16,200
CBA daily-overtime premium (weeks <= 40 hrs)        1,260
Box 1 wages (74,880 + 16,200 + 1,260)              92,340

Flawed claim: total "OT" on pay stub               16,200   <- includes straight time
Flawed claim (variant): 16,200 + 1,260             17,460   <- also includes non-FLSA premium

Corrected computation
  Premium over regular rate: $54.00 - $36.00 = $18.00/hr
  300 hrs x $18.00                                  5,400
  CBA daily premium: not FLSA-required                  0
  Qualified overtime compensation                   5,400
  Should match Box 12, Code TT                      5,400
  Joint cap, I.R.C. 225(b)(1)                      25,000
  Joint MAGI 139,000 vs. 300,000: no reduction          0
  Overtime deduction (Schedule 1-A)                 5,400
```

Counting only wages and interest, the Okafors' joint MAGI is $139,000: Derek's $92,340, Tanya's $46,000 in wages, and $660 of bank interest. Part XIX.A adds Derek's Schedule C profit and the adjustments; final MAGI on the assembled facts is $140,322.83. Either figure is well below the phase-out. If Derek's employer had reported $16,200 in Code TT, the employer would have made an error, and the preparer would see it by comparing Code TT with the pay stub. Rather than accept the overstated figure, the preparer should ask the employer to correct it. The statute limits the deduction to qualified overtime compensation; Code TT is the reporting mechanism, not the definition.

J. Withholding and the intake interview

None of the four new deductions reduces withholding unless the employee claims it on Form W-4. The 2026 Form W-4 already carries lines for qualified tips, qualified overtime compensation, qualified passenger-vehicle loan interest, and the senior deduction in its Step 4(b) Deductions Worksheet, and the draft 2027 form has the same lines. An employee who does not complete those lines, or who has not furnished a new Form W-4, has withholding computed as though no deduction existed.1 A client who claimed a large tips or overtime deduction for 2025 and changed nothing may get a large 2026 refund, because the employer withheld as though no deduction existed. A client who reduced withholding for the deductions and then lost them may owe, for example a server who moved to a specified service business after final regulations issue, or an hourly worker whose employer reports no Code TT. The Form W-4 deduction worksheet is the tool for this. Treat withholding as part of the 2026 engagement. It is not a year-end afterthought.

Getting the new deductions right starts with the intake interview. Most of the errors in the examples above come from documents a client did not bring or questions nobody asked, not from the statute. A short, specific set of intake questions prevents most of them. This section describes the questions in prose, because each follow-up question depends on the client's answer.

For tips, the first question is the occupation and the employer's business. The client should describe the actual job, not the job title on a pay stub. A "server" at a catering company that charges a mandatory 20 percent service fee is in a different position from a server at a restaurant where tipping is voluntary. Ask whether the client receives any mandatory charges or automatic gratuities, and how the employer reports them. Ask whether any tips come in a form other than cash, check, or card, such as digital assets or gift cards. Ask whether the client also has self-employed tip income, because that requires its own net-income computation. Finally,

1 Form W-4 (2026), Step 4(b) Deductions Worksheet; draft 2027 Form W-4 (created June 10, 2026) (ADMIN).

compare the Form W-2, Box 12, Code TP, with the client's own tip records and Form 4070 reports. A large difference between the two means one of them is wrong.

For overtime, start with whether the client is paid by the hour and covered by the FLSA. Then ask whether any overtime is paid under a union contract, a state law, or employer policy for hours that do not exceed 40 in a workweek. Ask whether the client works for two related employers, and whether the client receives bonuses or shift differentials that should be in the regular rate. Then compare the Form W-2, Box 12, Code TT, with the year-end pay stub. Code TT should be roughly one-third of total overtime pay at time-and-a-half **(the $0.50 premium divided by the $1.50 total rate)**, adjusted for bonuses in the regular rate. If Code TT equals total overtime pay, the employer has almost certainly included straight time.

PRACTICE POINTER: Put these questions in the organizer or intake questionnaire the client completes before the appointment, and keep the client's answers in the workpapers. The answers support the reasonable inquiries that section 1.6694-1(e) expects when information appears incomplete, and they also save the preparer from asking the same questions again next year.

IV. CAR-LOAN INTEREST

A. The statute

For taxable years 2025 through 2028, section 163(h)(4) removes qualified passenger-vehicle loan interest from the definition of nondeductible personal interest.1 The interest qualifies only on debt incurred after December 31, 2024, to buy an applicable passenger vehicle for personal use, secured by a first lien on that vehicle. Under the final regulations, the vehicle is bought for personal use if, when the debt is incurred, the taxpayer expects to use it for personal purposes more than 50 percent of the time; later actual use does not change that **(Treas. Reg. § 1.163-16(f)**(1)). For a financed purchase, original use begins with the buyer only if the loan documentation treats the vehicle as new **(Treas. Reg. § 1.163-16(e)**(2)(i)). Interest does not qualify if the loan finances a fleet sale, a commercial vehicle not used for personal purposes, a lease, a vehicle with a salvage title, or a vehicle bought for scrap or parts. The taxpayer must report the vehicle identification number on the return.2 An applicable passenger vehicle is one whose original use begins with the taxpayer, has final assembly in the United States, is a car, minivan, van, SUV, pickup truck, or motorcycle, and has a gross vehicle weight rating under 14,000 pounds.3

The interest taken into account may not exceed $10,000 for the year.4 The income-based reduction is applied to the deduction, not to the cap. The statute reduces "the amount which is otherwise allowable as a deduction" after the $10,000 cap, by $200 for each $1,000, or portion of $1,000, by which MAGI exceeds $100,000, or $200,000 on a joint return.5 One widely circulated description says the deduction falls by "20 percent for each additional dollar." That wording is wrong. The statutory rate is $200 per $1,000 step, and a partial step counts as a full step. The difference matters for a client whose interest is well below $10,000, which is nearly everyone.

B. The final regulations (T.D. 10054)

Treasury published final regulations on September 8, 2026, in T.D. 10054, effective November 9, 2026. **Section** 1.163-16 applies to taxable years beginning after December 31, 2024, and before January 1, 2029, so it governs the 2025 and 2026 returns. **Section** 1.6050AA-1, the lender-reporting rule, applies to calendar years 2025 through 2028.6 The final rules settle the original-use questions that practitioners asked most often.

The final rules declined to extend the deduction to used or nearly-new vehicles. A vehicle that a lessee later buys at the end of the lease generally does not qualify, because the original use began with the lessee under the lease. A dealer demonstrator that the dealer holds primarily for sale does not begin original use with the dealer, even if the dealer titled or registered it, so a later retail buyer can qualify. A dealer's service loaner, held for some

1 I.R.C. § 163(h)(4)(A), added by Pub. L. No. 119-21, § 70203(a) (STATUTE).
2 I.R.C. § 163(h)(4)(B)(i)–(iii).
3 I.R.C. § 163(h)(4)(D).
4 I.R.C. § 163(h)(4)(C)(i).
5 I.R.C. § 163(h)(4)(C)(ii) (reduction applied after the clause (i) cap).
6 T.D. 10054, 91 Fed. Reg. (Sept. 8, 2026) (Treas. Reg. §§ 1.163-16, 1.6050AA-1) (FINAL); see REG-113515-25, 91 Fed. Reg. 67 (Jan. 2, 2026).

other purpose, does begin original use with the dealer, and a later buyer cannot qualify. A buyer who returns a vehicle within 30 days is not treated as having begun original use.1

C. Form 1098-VLI

A lender that receives $600 or more of interest during the year on any one specified passenger-vehicle loan from an individual must file Form 1098-VLI with the IRS and furnish a statement to the borrower. The threshold applies loan by loan.2 Form 1098-VLI is a new form for calendar year 2026, and the IRS has posted final instructions. Notice 2025-57 relieved lenders of penalties for 2025 reporting only.3 By regulation, the borrower statement is due January 31, and the IRS copy is due February 28 on paper or March 31 if filed electronically. For calendar 2026, January 31 and February 28, 2027, both fall on Sundays. Under the weekend rule, the deadlines become February 1 and March 1, 2027; March 31, 2027 is a Wednesday. Confirm against the 2027 General Instructions for Certain Information Returns.4

CAUTION: The amount on Form 1098-VLI is what the lender received. It does not establish that the interest qualifies. A lender will not always know whether the vehicle was new, assembled in the United States, or bought for personal use, and some captive-finance lenders will issue the form on loans that do not qualify. The preparer still has to confirm original use (including that the loan documents treat the vehicle as new), final assembly, the VIN, the first lien, and the expected personal use of more than 50 percent when the loan was made. For final assembly, the NHTSA VIN decoder or the vehicle's label is the practical check.

D. Worked example: the Okafors' pickup

In March 2026 the Okafors bought a new pickup truck that was assembled in the United States. Assume the truck meets the statutory vehicle requirements, including the weight limit. They financed it with a $52,000 loan secured by a first lien on the truck, and they use the truck for personal purposes. Their 2026 Form 1098-VLI reports $2,940 of interest. Their joint MAGI is $139,000 counting wages and interest only, or $140,322.83 on the assembled return in Part XIX.A.

WORKPAPER: Okafors: 2026 car-loan interest deduction (joint)

Interest received by lender (Form 1098-VLI)	2,940	
Cap, I.R.C. 163(h)(4)(C)(i)	10,000	
Interest after cap	2,940	
MAGI 139,000 vs. 200,000 joint threshold	0	
Deduction (Schedule 1-A)	2,940	
Variant: same interest; joint MAGI 212,400		
Excess MAGI: 212,400 - 200,000	12,400	
$1,000 steps (portion counts as full): 12.4 -> 13	13	
Reduction: 13 x $200	2,600	
Flawed: reduce the $10,000 cap, not the deduction		
10,000 - 2,600 = 7,400 cap; deduction stays	2,940	<- wrong
Correct: reduce the amount otherwise allowable		
2,940 - 2,600	340	

The variant shows why the order matters. A client with $2,940 of interest and MAGI of $212,400 keeps only $340. The flawed reading keeps all $2,940. With $2,940 of interest, the deduction is fully phased out once the reduction reaches $2,940, which takes 15 steps of $200, because 14 steps give only $2,800. That happens at any MAGI above $214,000.

1 T.D. 10054 (original-use rules; demonstrators, loaners, lease buyouts, 30-day returns).
2 I.R.C. § 6050AA (STATUTE); Treas. Reg. § 1.6050AA-1 (T.D. 10054).
3 Instructions for Form 1098-VLI (2026) (ADMIN); Notice 2025-57 (2025 relief only).
4 I.R.C. § 7503 (weekend/holiday rule); Gen. Instr. for Certain Info. Returns (2027) (verify when posted).

E. Rolled-in amounts

Rolled-in amounts are the second common error. In June 2025, Lena Kowalski bought a new car assembled in the United States. The $38,000 loan was secured by the car and included $32,000 of purchase price, $4,000 of negative equity from her trade-in, and a $2,000 service contract. Her lender reported $2,280 of 2026 interest on Form 1098-VLI. Her MAGI is $104,500, above the $100,000 single threshold, so the income-based reduction applies as well.

WORKPAPER: Lena Kowalski: car-loan interest with rolled-in amounts (single)

Loan principal at purchase	38,000
Purchase price of vehicle	32,000
Negative equity from trade-in (not qualifying)	4,000
Service contract (qualifying)	2,000
Qualifying principal: 32,000 + 2,000	34,000
Interest reported on 1098-VLI	2,280.00
Qualifying portion: 2,280 x 34,000 / 38,000	2,040.00
MAGI 104,500 - 100,000 = 4,500 -> 5 steps x $200	1,000.00
Deduction: 2,040.00 - 1,000.00	1,040.00

The final regulations require the pro rata allocation; they do not permit another allocation method.1 The regulation applies any down payment or other purchase consideration first against negative equity and other nonqualifying purchase amounts, and then allocates principal and interest pro rata between the qualifying and nonqualifying portions of the remaining debt. Had Lena made a down payment, it would first have reduced the $4,000 of negative equity. The point is that the Form 1098-VLI figure overstated the starting amount by $240, the interest on the rolled-in negative equity, and the phase-out took nearly half of what was left.

V. THE SENIOR DEDUCTION

A. The rule

For taxable years beginning before January 1, 2029, section 151(d)(5)(C) allows a deduction of $6,000 for each qualified individual. That is the taxpayer and, on a joint return, the spouse, in each case if age 65 or older before the close of the taxable year.2 Each $6,000 is reduced, but not below zero, by 6 percent of MAGI over $75,000, or $150,000 on a joint return. Here MAGI is AGI increased by any amounts excluded under sections 911, 931, or 933.3 The qualified individual's SSN must be on the return, and married taxpayers must file jointly.4

Because each spouse has a separate $6,000 and the reduction applies to each one, a couple who both qualify lose $720 of combined deduction for every $6,000 of MAGI over the threshold, at 6 percent on each spouse's amount. Each $6,000 is fully phased out at joint MAGI of $250,000, which is $150,000 plus $6,000 divided by 6 percent. For a single filer it is $175,000. The deduction is in addition to the regular additional standard deduction for age, and itemizers can take it too. The IRS routes it through Part V of Schedule 1-A and restates the rules in Publication 6142.5 The research for this text found no regulations or notices on the senior deduction. The Joint Committee staff says a technical correction may be necessary to make clear that the senior deduction is treated as a personal exemption. The General Explanation does not say which rules that would affect, and this text does not speculate.6

Rosa Delgado, a 68-year-old widow, has MAGI of $121,000. Her deduction is $6,000 less 6 percent of $46,000 **(her MAGI in excess of $75,000)**, or $6,000 less $2,760, which leaves $3,240. If Rosa had remarried and filed jointly with a spouse under 65, only her own $6,000 would be available, phased out from the $150,000 joint threshold. The deduction is computed separately for each qualified individual; it is not a household allowance.

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1 T.D. 10054, preamble (final regulations "require the use of the pro rata allocation method and do not provide for any other allocation method"); Treas. Reg. § 1.163-16(d)(2)(iii)(A)–(B) (FINAL).

2 I.R.C. § 151(d)(5)(C)(i)–(ii), added by Pub. L. No. 119-21, § 70103(a) (STATUTE).

3 I.R.C. § 151(d)(5)(C)(iii)(I)–(II).

4 I.R.C. § 151(d)(5)(C)(iv)–(v).

5 I.R.S. Pub. 6142 (2026); I.R.S., Check Your Eligibility for the Enhanced Deduction for Seniors (updated Sept. 21, 2026) (ADMIN).

6 Joint Comm. on Taxation, General Explanation of the Tax Provisions of Public Law 119-21, JCS-1-26 (May 28, 2026), at 9 n.26.

B. Worked example: the Brennans

Walter is 74 and June is 71. Their 2026 income is $133,800 of IRA distributions, pension income, investment income, and gambling winnings, plus $52,000 of Social Security benefits, of which $44,200 **(85 percent)** is taxable. Their AGI and MAGI are $178,000. They give $6,000 in cash to their church each year and take the standard deduction. The 2026 joint standard deduction is $32,200, and each spouse adds $1,650 for age.1

WORKPAPER: Brennans: 2026 senior deduction (joint), as filed

MAGI	178,000
Excess over 150,000	28,000
Reduction per qualified individual: 6% x 28,000	1,680
Walter: 6,000 - 1,680	4,320
June: 6,000 - 1,680	4,320
Senior deduction	8,640
Taxable income	
AGI	178,000
Standard deduction 32,200 + (2 x 1,650)	(35,500)
Senior deduction	(8,640)
Non-itemizer cash charitable deduction, 170(p)	(2,000)
Taxable income	131,860

The $2,000 non-itemizer charitable deduction, new for 2026, is discussed in Part IX.B. Now suppose Walter makes the $6,000 gift as a qualified charitable distribution **(QCD)** directly from his IRA instead of in cash. A QCD is excluded from gross income, so it reduces AGI and MAGI by $6,000.2 The distribution must go directly from the IRA trustee to a public charity, not a donor-advised fund or a supporting organization, and the owner must be age 70½ or older when it is made; Walter is 74. For 2026 the QCD limit is $111,000 per IRA owner. At their income, Social Security stays 85 percent taxable either way: provisional income is well above the second base amount, so the 85 percent cap controls both computations. The Brennans lose the $2,000 non-itemizer deduction, because the gift is no longer a deductible cash contribution. But they gain a larger senior deduction and a lower taxable income.

WORKPAPER: Brennans: same facts, $6,000 gift made as a QCD

MAGI (178,000 - 6,000)	172,000	
Excess over 150,000	22,000	
Reduction per individual: 6% x 22,000	1,320	
Senior deduction: 2 x (6,000 - 1,320)	9,360	
Taxable income		
AGI	172,000	
Standard deduction	(35,500)	
Senior deduction	(9,360)	
Non-itemizer charitable (gift is now a QCD)	0	
Taxable income	127,140	
Regular tax, 2026 joint rates (no preferential income assumed)		
As filed, TI 131,860:		
2,480.00 + 9,120.00 + 22% x 31,060 = 6,833.20		18,433.20
With QCD, TI 127,140:		
2,480.00 + 9,120.00 + 22% x 26,340 = 5,794.80		17,394.80
Difference		1,038.40

PRACTICE POINTER: The senior deduction makes any reduction in MAGI worth more inside the phase-out band. For a couple who both qualify, each dollar of MAGI between $150,000 and $250,000 costs 12 cents of senior deduction (6 cents per spouse) on top of the ordinary tax on the dollar itself. QCDs, timing IRA distributions, choosing tax-exempt over taxable interest, and harvesting losses all gain value in that band. Frame this as planning arithmetic, not a rule of thumb. The value depends on

1 Rev. Proc. 2025-32, § 4.14 (2026 standard deduction; additional amount for aged).

2 I.R.C. § 408(d)(8)(A) (QCD exclusion), (B)(i) (made directly by the trustee to a section 170(b)(1)(A) organization, other than a section 509(a)(3) organization or a fund or account described in section 4966(d)(2)), (B)(ii) (age 70½); Notice 2025-67, 2025-49 I.R.B. 765 ($111,000 for 2026; $55,000 one-time split-interest election).

the client's bracket and on whether other AGI-sensitive items move as well.

C. Math-error notices for a missing SSN

The IRS has math-error authority over an omitted or incorrect Social Security number **(SSN)** required for the senior deduction. **Section** 6213(g)(2)(W), added by Public Law 119-21, section 70103(b), treats the omission of a correct SSN required under section 151(d)(5)(C) as a mathematical or clerical error, for taxable years beginning after December 31, 2024. The math-error authority for missing or invalid SSNs on the new tips and overtime deductions does not come from the math-error-notice content statute. The 2025 act added those items to the definition of math or clerical error in section 6213(g)(2). The new notice-content rules will govern those notices once they take effect.

Here is how the change works. The Brennans' 2025 return claimed the senior deduction for both spouses. Their 2025 modified adjusted gross income **(MAGI)** was under $150,000, so each spouse's full $6,000 was at stake. June's SSN was transposed on the return, so the IRS's matching failed for her $6,000. In a notice dated September 25, 2026, the IRS disallowed it as a math or clerical error. That notice predates the date the new notice-content rules apply, so the prior content rules govern it, and it describes the change only generally. The Brennans have 60 days after the notice is sent, through November 24, 2026, to request abatement. A request filed on time forces the IRS to abate the assessment and, if it still disagrees, to issue a notice of deficiency, which carries the right to petition the Tax Court. The simpler course is to correct the SSN, and the IRS can do that through the abatement process. If the same error appears on a notice sent after November 25, 2026, the notice must identify the senior deduction, the Code section, and the line by name, and the abatement deadline must appear in bold next to the address.

PRACTICE POINTER: Calendar the 60-day abatement deadline on every math-error notice from the date on the notice, not the date the client opens the envelope. Once the 60 days pass, the assessment stands. The taxpayer's remaining options are an audit reconsideration request, a claim for refund after paying, or collection due process if collection begins. All of them are slower and weaker than a timely abatement request.

VI. THE CHILD TAX CREDIT

The 2025 act made the child tax credit framework of section 24(h) permanent and set the credit at $2,200 per qualifying child, indexed after 2025. For 2026 the credit stays at $2,200, and the refundable additional child tax credit is up to $1,700 per child.1 The Okafors have three qualifying children in 2026, counting the February newborn: 3 × $2,200 = $6,600. Their MAGI is far below the $400,000 joint phase-out threshold. The newborn needs an SSN issued by the return's due date, including extensions. A child without the required SSN cannot qualify for the $2,200 child tax credit. The child may qualify for the $500 nonrefundable credit for other dependents using a timely issued individual taxpayer identification number **(ITIN)**, if all other requirements are met. An ITIN identifies the dependent; it does not establish dependency or the other eligibility conditions.2 Check the SSN requirement for each child before the client's software assumes the full credit. The return must also include the taxpayer's SSN, or on a joint return the SSN of at least one spouse, for the $2,200 credit **(section 24(h)**(7)(A)(i)).

Two bills would change the refundable portion. The Stronger Start for Working Families Act is S. 3596, introduced January 8, 2026, and H.R. 10282, introduced September 3, 2026. As of October 18, 2026, each remains introduced and referred to committee **(Senate Finance; House Ways and Means)**, so both are PENDING. A separate proposed regulation would treat the refunded portion of the credit as a "federal public benefit." It is covered in Part XIV.

VII. TRUMP ACCOUNTS

The 2025 act created a new tax-favored account for children under section 530A. The surrounding rules are in section 128, which covers employer contributions, and section 6434, which covers a federal $1,000 pilot

1 I.R.C. § 24(h), as amended by Pub. L. No. 119-21, § 70104; Rev. Proc. 2025-32, § 4.05 (STATUTE; FINAL).

2 I.R.C. § 24(h)(4) (credit for other dependents), (h)(7) (SSN required for child credit).

contribution for children born in 2025 through 2028. On September 30, 2026, Treasury issued temporary regulations, T.D. 10056, under sections 1.530A-1T and 1.530A-7T, effective September 30, 2026. They apply to taxable years beginning on or after January 1, 2026, and expire September 30, 2029.1 Companion proposed regulations repeat the text of the temporary regulations and withdraw the earlier proposal, REG-117270-25; comments are due November 30, 2026.2

Automatic enrollment (FINAL, temporary regulations). On or about October 1, 2026, the Secretary elected to establish an "auto account" for each child the Secretary determined meets the age and Social Security number requirements. The Secretary is deemed to have activated each auto account with the trustee the Secretary selected, so no action by the family is needed for the account to exist. On October 7, 2026, the White House reported that nearly 70 million Trump accounts had been created, more than 60 million of them through automatic enrollment, and that every child under 18 with a valid Social Security number now has one.3 Until it is claimed, an auto account may accept only qualified general contributions, described below, and, in limited cases, the $1,000 pilot contribution. Parents, grandparents, and employers cannot contribute to it. A guardian or legal custodian, or a beneficiary with legal capacity, claims an auto account through the electronic application or web page the Secretary provides, the Trump Accounts app or trumpaccounts.gov, and must authenticate identity and authority. If more than one person claims the same account, the responsible party is the first person who activates the claimed account, and activation includes signing the account agreement. The regulations set no deadline for claiming. A claim does not make the pilot election. The pilot proposed regulations, REG-117002-25, which remain proposed as of October 22, 2026, state that the pilot contribution cannot be made without an election, and that opening an account is a separate election from claiming the pilot contribution.

Where the pilot election is made. In an October 7, 2026 paperwork notice, the IRS described Form 4547 and Form 8879-TA as the forms used to make the elections to claim the $1,000 pilot contribution.4 As reported, taxpayers can also view and make Trump account elections, and check the status of a submitted Form 4547, in their IRS individual Online Account.5 A family that filed Form 4547 to open an account but did not check the pilot election box **(Part III, line 7)** does not amend the return. It files Form 4547 again, separately, to make the election; the instructions say not to amend a return or attach the form to Form 1040-X solely to make an election. Filing electronically through the IRS Online Account is the preferred route.6

Contribution limits (FINAL, temporary regulations). During the growth period, contributions to a Trump account are generally limited to $5,000 a year, adjusted for inflation after 2027. Employer contributions under section 128 count toward that limit, and the employee's exclusion for them is limited to $2,500 a year. **Section** 128(c) requires the employer's program to be a separate written plan for the exclusive benefit of employees **(STATUTE)**; REG-101355-26 proposes rules to implement it **(PROPOSED)**. The $1,000 pilot contribution and qualified general contributions from governments and charities do not count toward the $5,000 limit.7

Qualified general contributions and donated stock (FINAL, temporary regulations). **Section** 530A(f) allows a "qualified general contribution" from an eligible donor to every account in a qualified class. Under section 1.530A-7T, an eligible donor is a governmental entity described in section 170(c)(1), an Indian tribal government, or a section 501(c)(3) organization. An individual or a for-profit company cannot be the donor, although either can give to a charity that is. A qualified class is all beneficiaries still in their growth period, those residing in specified states or other qualified geographic areas, or those born in specified calendar years. A qualified

1 T.D. 10056, 91 Fed. Reg. 61705 (Sept. 30, 2026) (FR Doc. 2026-20026) (FINAL, temporary regulations).

2 Trump Accounts, Notice of proposed rulemaking and withdrawal of proposed rulemaking, 91 Fed. Reg. 61812 (Sept. 30, 2026) (FR Doc. 2026-20027) (PROPOSED).

3 The White House, *A Financial Stake in the Future for Nearly 70 Million American Children: Trump Accounts Made It Possible* (Oct. 7, 2026) (ADMIN).

4 Agency Information Collection Activities; Comment Request on Trump Account Election(s), 91 Fed. Reg. 64241 (Oct. 7, 2026) (FR Doc. 2026-20538) (ADMIN; comments due Dec. 7, 2026).

5 ThinkAdvisor, *IRS: Taxpayers Can Now Make Trump Account Elections in IRS Accounts* (June 4, 2026, updated Oct. 20, 2026) (as reported).

6 NATP, *You Make the Call* (Oct. 15, 2026) (as reported), applying the Instructions for Form 4547 (ADMIN). No deadline for the separate election is stated.

7 T.D. 10056, 91 Fed. Reg. 61705 (Sept. 30, 2026) (FR Doc. 2026-20026), preamble (FINAL, temporary regulations).

geographic area must have at least 5,000 eligible beneficiaries. A separate approved class combines geography and birth years and must include at least 5,000 beneficiaries. Each account in the class must receive an equal amount. The temporary regulations also permit qualified stock contributions: publicly traded stock of a domestic corporation, free of pre-existing transfer restrictions, contributed directly into the accounts in the class. The stock may not be sold before the earlier of five years after the contribution or the end of the growth period. If it is sold early, the trustee must repurchase the same number of shares, subject to limited exceptions such as tender offers and cash acquisitions. The companion proposal asks for comments on further narrow exceptions. Families cannot choose or refuse donated stock.1 Donors apply to Treasury on the Trump Accounts Qualified Class Contribution Application. A Treasury paperwork notice, FR Doc. 2026-21643, scheduled for publication October 23, 2026, requests comments for 60 days on extending that information collection **(OMB Control No. 1505-0285)** without change. Treasury estimates 100 respondents, each taking 30 minutes **(ADMIN)**.2

Alabama, Mississippi, and Louisiana. As of October 22, 2026, no research for this text found a state-funded, employer, or foundation pledge directed to children in Alabama, Mississippi, or Louisiana. Mississippi's Attorney General concluded on March 30, 2026, that "there currently exists no statutory framework in Mississippi law for state agencies to provide contributions to Trump accounts as an employment benefit," and that the Legislature could authorize them. Alabama's Governor encouraged families to open accounts on June 10, 2026, without committing state funds. Louisiana Executive Order JML 26-021 **(Feb. 24, 2026)** bars the Department of Children and Family Services from using any portion of a child's federal benefits to reimburse itself or a contractor for the child's care while in its custody, and requires implementing policies by October 1, 2026. It also directs the department to "explore the use of 503A Trump Accounts" **(the order's wording)** for children in its custody.3 On October 21, 2026, Senator Bernie Moreno announced a plan to extend Trump accounts to people under 40; no bill had been introduced as of October 22 **(PENDING)**.4

PRACTICE POINTER: For every client with a child under 18, ask whether the auto account has been claimed in the Trump Accounts app or at trumpaccounts.gov. Until it is claimed and the claimed account is activated under the trustee's instructions, no family or employer money can go in (Treas. Reg. § 1.530A-1T(d)(3)). Separately, for a child born from 2025 through 2028, confirm that the pilot election was made on Form 4547; check the IRS Online Account or the return. Ask clients' employers whether they have announced a contribution or match, because several large employers have.

For gift-tax purposes, Rev. Proc. 2026-25 provides a safe harbor for a calendar year, but only if five conditions are all met. The donor must be an individual. The donor's only taxable gifts that year must be cash contributions to Trump accounts, made before the year the beneficiary turns 18. Total gifts to each beneficiary must not exceed the annual exclusion, which is $19,000 for 2026. No gift or GST tax can result after credits and exemptions. And no gift tax return can otherwise be required or filed for the year. If the conditions are met, the contributions are treated as completed gifts of a present interest, and no Form 709 is needed.5 Derek's father contributes $5,000 to the Okafor newborn's Trump account in 2026 **(assume no other contributions subject to the $5,000 limit are made to that account for 2026)**, and also gives Derek $20,000 in cash toward the truck. The safe harbor is unavailable to him for 2026. The $20,000 gift to Derek exceeds the $19,000 annual exclusion, so $1,000 of it is a taxable gift that is not a Trump-account contribution, and the gift requires a Form 709 in any event. Had his gift to Derek stayed within the annual exclusion, it would not have been a taxable gift,

1 Treas. Reg. § 1.530A-7T(b), (c)(4), (d)(3); T.D. 10056 preamble, Explanation II.B–D (FINAL, temporary regulations); FR Doc. 2026-20027, § III.C (comment request) (PROPOSED). The statement that families cannot choose or refuse donated stock is as reported, PBS NewsHour, *Trump Accounts Expand to Millions of Children, but New Rules Raise Questions* (Oct. 13, 2026).

2 Dep't of the Treasury, Agency Information Collection Activities; Proposed Collection; Comment Request; Trump Accounts Qualified Class Contribution Application, FR Doc. 2026-21643 (filed Oct. 22, 2026; publication date Oct. 23, 2026) (ADMIN).

3 Miss. Att'y Gen. Op. No. OP-26-00026, to State Auditor Shad White (Mar. 30, 2026) (Brief Response 1); Office of Gov. Kay Ivey, *Governor Ivey Encourages Alabama Families to Open a Trump Account* (June 10, 2026); La. Exec. Order No. JML 26-021, §§ 5, 6, 11 (Feb. 24, 2026).

4 Fox Business, *GOP Senator Unveils Plan to Expand Trump Accounts to People Under 40* (Oct. 21, 2026) (as reported).

5 Rev. Proc. 2026-25, 2026-29 I.R.B. (FINAL).

and the safe harbor could have covered the $5,000 contribution, provided the other conditions were met. The planning lesson for grandparents is to test all five conditions against the donor's whole year; paying the gifts separately or from different accounts does not cure a disqualifying gift. Falling outside the safe harbor does not by itself mean a Form 709 is required for the Trump-account contributions; that turns on the present-interest analysis discussed below. The growth period ends December 31 of the year the beneficiary turns 17. After that, most Trump-account rules stop applying, and the account is generally governed by the traditional-IRA rules of section 408(a).1

Outside the safe harbor, Rev. Proc. 2026-25 does not settle every case, but it is not silent. Its section 6 example varies the facts so that the donor's gifts to one grandchild exceed the annual exclusion, and it states that the donor "must report the Trump account contributions to A, B, and C as gifts of future interests." Do not claim the annual exclusion for contributions outside the safe harbor without analyzing the facts and that stated IRS position. Whether a Trump-account contribution is a present interest eligible for the annual exclusion, or a future interest that is not, requires separate analysis on the donor's facts.

PRACTICE POINTER: The Okafors' February 2026 newborn is in the pilot birth-year window. The $1,000 federal contribution requires its own election (see "Where the pilot election is made," above). The child must be the client's qualifying child under section 152(c) and a U.S. citizen, the election must include the child's SSN, and no one may already have made a pilot election for that child (section 6434(c), (e)). Put the election on the 2026 return checklist when those conditions are met. Until the auto account is claimed and activated, it cannot accept family contributions such as the $5,000 from Derek's father discussed above.

VIII. OTHER FAMILY AND EDUCATOR PROVISIONS

A. Dependent care assistance

For taxable years beginning after December 31, 2025, the section 129 exclusion for employer-provided dependent care assistance rises from $5,000 to $7,500, or from $2,500 to $3,750 for a married individual filing separately. The $7,500 limit is not indexed for inflation; it changes only if Congress amends section 129. The original 2026 Form W-2 instructions still showed $5,000 for Box 10, and the IRS issued a correction. The higher exclusion is available only if the employer's plan document allows it. Whether a cafeteria plan was amended to $7,500 for 2026 is a question for the plan sponsor. It is a practitioner judgment item for each client. The dollar ceiling is not the only limit. The exclusion cannot exceed the employee's earned income or, for a married employee, the lesser of the employee's and the spouse's earned income, with special rules for a spouse who is a student or incapable of self-care **(section 129(b)**).

B. Educational assistance and student-loan payments (section 127)

The 2025 act permanently made employer payments of principal or interest on a qualified education loan a form of educational assistance under section 127. Before the act, the rule covered only payments made before January 1, 2026. The annual exclusion stays at $5,250 for 2026. That is one combined limit for all educational assistance, including student-loan payments, and the exclusion is available only under a separate written plan that meets section 127(b). It is indexed for inflation for taxable years beginning after December 31, 2026, so 2027 is the first indexed year.2 FS-2026-10 updates the IRS's section 127 FAQs and supersedes FS-2024-22. A government web page that says indexing begins in 2026 is wrong.

C. Educator expenses, including early-childhood educators

For 2026, the above-the-line deduction under section 62(a)(2)(D) for an eligible educator's unreimbursed classroom expenses is $350. Some IRS web pages still show $300, the pre-2026 figure. For the above-the-line deduction, an eligible educator under section 62(d)(1)(A) is an early childhood or kindergarten through grade 12 teacher, instructor, counselor, principal, or aide in a school for at least 900 hours during a school year. A separate rule reaches expenses above that $350. For taxable years beginning after December 31, 2025,

1 See I.R.C. § 530A (growth period); REG-101355-26 (preamble) (§ 408(a) rules thereafter) (PROPOSED).

2 I.R.C. § 127(c)(1)(B), as amended by Pub. L. No. 119-21, § 70412; FS-2026-10 (Apr. 20, 2026) (ADMIN).

the 2025 act added section 67(b)(13), which removes educator expenses from the suspended category of miscellaneous itemized deductions. So otherwise allowable section 162 educator expenses above $350 can be claimed as itemized deductions, subject to actually itemizing and to the new overall limitation in section 68. The special inclusion of interscholastic sports administrators and coaches is part of the section 67(g) itemized rule; it is not written into the section 62(d) above-the-line eligible-educator definition. An educator therefore takes up to $350 above the line, and any excess only by itemizing.

Tanya Okafor teaches at a private preschool. Before 2026, the above-the-line deduction under section 62(d) covered teachers in kindergarten through grade 12, so she did not qualify. H.R. 5334, the SEED Act as introduced, was amended in the Senate, including in its title, and was approved September 18, 2026, as Public Law 119-111, the Lindsey O. Graham Sanctioning Russia and Iran Act of 2026. Division B amends section 62(d)(1)(A) to cover an early childhood or kindergarten through grade 12 teacher. It also adds to the definition of school in section 62(d)(1)(B), for early childhood education, a school or child care facility that provides educational or child care services to more than two children under age 6 **(other than residents)**. The facility must operate at public expense or receive a fee, payment, or grant. The amendments apply to expenses paid or incurred in taxable years beginning after December 31, 2025. Tanya's preschool meets that early-childhood school definition, and she works at least 900 hours during the school year, so she is an eligible educator for 2026. On the example's $910 of expenses she deducts $350 above the line under section 62(a)(2)(D). The remaining $560 is potentially an itemized deduction under the section 67 rule only if it is otherwise deductible under section 162 and she itemizes. The assembled Okafor return uses the standard deduction, so it claims no excess itemized amount; only the $350 above-the-line deduction appears.

D. Adoption credit carryforwards

Treasury has clarified its interpretation of the 2025 act. For tax year 2025 only, adoption credit carryforwards from 2020 through 2024 can increase the refundable portion of the 2025 adoption credit, subject to the $5,000 per qualifying child limitation. According to the IRS, refunds and adjustments began in late September 2026, more than 50,000 taxpayers have already received refunds, and most should be complete by the end of 2026. The IRS adjusts the accounts itself, and taxpayers should not need to file an amended return. A notice generally follows within 30 days of the adjustment and states the amount and whether it was refunded or applied to another tax or non-tax debt. Returns filed before April 15, 2026 generally receive the adjustment automatically; returns filed under an extension, and accounts with identity-theft indicators, freezes, dependency conflicts, or other issues, will be reviewed later in 2026. The release does not identify the authority for the clarified interpretation. **(ADMIN)**1 For a client who carried an adoption credit into 2025, compare the notice with the 2025 return and keep it with the client's records.

IX. HOUSEHOLD DEDUCTIONS

A. The state and local tax cap

The 2025 act amended section 164(b) to replace the flat $10,000 cap of 2018 through 2024 with an "applicable limitation amount." That amount is $40,000 for 2025 and $40,400 for 2026. It then rises by 1 percent a year through 2029 and returns to $10,000 for 2030 and later years. For a married individual filing separately, the statute halves the MAGI threshold and then allows half of the applicable limitation amount; it does not halve every step. At separate MAGI of $300,000, for example, the cap is half of [$40,400 - 30% x **($300,000 - $252,500)**], or $13,075 **(section 164(b)**(6)(B), **(7)**(B)).2 The cap is reduced by 30 percent of the excess of MAGI over a threshold amount. The threshold is $500,000 for 2025 and $505,000 for 2026, and it also rises 1 percent a year. The reduction cannot take the cap below $10,000, or $5,000 for a married individual filing separately.3 The IRS issued a correction to the 2026 Form 1040-ES worksheet after the original version misstated the amount.4

1 I.R.S. News Release IR-2026-123 (Oct. 16, 2026) (ADMIN); IRS.gov/AdoptionCredit.
2 I.R.C. § 164(b)(6)–(7)(A), as amended by Pub. L. No. 119-21, § 70120 (STATUTE).
3 I.R.C. § 164(b)(7)(B) (30% phasedown; $10,000 floor).
4 I.R.S., Correction to State and Local Income Tax Deduction Amount in the 2026 Form 1040-ES (ADMIN).

B. Charitable contributions

One change is a deduction for non-itemizers. For taxable years beginning after December 31, 2025, an individual who does not itemize may deduct up to $1,000, or $2,000 on a joint return, of cash contributions to organizations described in section 170(b)(1)(A). Contributions to a supporting organization described in section 509(a)(3) do not count, and neither do contributions to establish or maintain a donor-advised fund.1 The draft 2026 Form 1040 shows this deduction on line 12f.2 The Brennans' $6,000 cash gift to their church supports a $2,000 non-itemizer deduction, as the worked example in Part V.B showed.

C. Mortgage insurance premiums return

For taxable years beginning after December 31, 2025, the 2025 act permanently restored the treatment of qualified mortgage insurance premiums as qualified residence interest. The definition of qualified mortgage insurance now appears in section 163(h)(5)(E), redesignated from the former paragraph **(4)**. Contracts issued before 2007 are still excluded.3 The phase-out has not changed. Deductible premiums are reduced by 10 percent for each $1,000, or fraction of $1,000, by which AGI exceeds $100,000. For a married individual filing separately, the reduction is 10 percent for each $500, or fraction of $500, by which AGI exceeds $50,000 **(section 163(h)**(3)(E)(ii)). The thresholds are not indexed.4 Lena Kowalski paid $1,800 of private mortgage insurance in 2026, and her AGI is $104,500.

WORKPAPER: Lena Kowalski: mortgage insurance premiums (single)

Premiums paid	1,800
AGI over 100,000: 4,500 -> 5 steps (fraction counts)	5
Reduction: 5 x 10% = 50% x 1,800	900
Deductible premiums (itemized only)	900

The $900 helps Lena only if she itemizes. A practical point: lenders report mortgage insurance premiums of $600 or more per mortgage in box 5 of Form 1098.5

D. Personal casualty and theft losses

For taxable years beginning after December 31, 2025, section 165(h)(5)(A) permanently limits personal casualty losses to losses attributable to a federally declared disaster or a state-declared disaster. A state-declared disaster is a natural catastrophe, or any fire, flood, or explosion, that the governor **(or the mayor of the District of Columbia)** and the Secretary of the Treasury jointly determine is severe enough to warrant section 165 treatment. Personal casualty gains can still absorb other personal casualty losses.6 The research for this text found no IRS procedure for the joint Treasury determination. Public Law 119-108 extended and codified the qualified-disaster-loss rules. An ordinary personal casualty loss is deductible only to the extent each loss exceeds $100 and net losses exceed 10 percent of AGI **(section 165(h)**(1)-(2)). A qualified disaster-related loss uses a $500 floor instead, the 10 percent limit does not apply to the qualified net disaster loss, and a non-itemizer can deduct it **(sections 165(h)**(1), **(h)**(6), 63(b)(8)). The disaster's incident period must begin on or after December 28, 2019, and before January 1, 2027. Verify the declaration and incident period before applying these rules.

Theft losses from scams turn on profit motive. In CCA 202511015, the IRS Chief Counsel concluded that three scam losses were deductible under section 165(c)(2) as losses in transactions entered into for profit: a compromised-account "safeguarding" scam, a "pig-butchering" investment scam, and a phishing scam that drained retirement funds. Each was limited to basis and taken in the year of discovery, when there was no reasonable prospect of recovery. A romance scam and a kidnapping scam lacked a profit motive and were

1 I.R.C. § 170(p), added by Pub. L. No. 119-21, § 70424 (STATUTE).
2 I.R.S., Draft 2026 Form 1040; Modernized e-File (MeF) Assurance Testing System (ATS) Scenario 4 (Sept. 22, 2026) (line 12f) (draft; ADMIN).
3 I.R.C. § 163(h)(3)(E), (h)(5)(E), as amended by Pub. L. No. 119-21, § 70108 (STATUTE).
4 I.R.C. § 163(h)(3)(E)(ii) (10% per $1,000 of AGI over $100,000).
5 Form 1098, box 5; Instructions for Form 1098 (ADMIN) ($600 per mortgage).
6 I.R.C. § 165(h)(5)(A)–(C), as amended by Pub. L. No. 119-21 (STATUTE).

nondeductible personal losses under sections 165(c)(3) and 165(h)(5).1 A Chief Counsel Advice may not be used or cited as precedent. It does show how the IRS will analyze the issue.

E. Wagering losses: the 90 percent rule

For taxable years beginning after December 31, 2025, section 165(d) allows wagering losses only at 90 percent, and only to the extent of wagering gains. "Losses" include the otherwise allowable expenses of carrying on a wagering business, so the rule reaches professional gamblers too.2 The computation takes 90 percent of total wagering losses and then caps the result at gains. Nothing carries over. Proposed regulations under section 1.165-10, REG-113229-25, use the same formulation. For joint filers they combine both spouses' losses and gains. They do not adopt a session or other sub-annual unit for the deduction.3 For payments made in 2026, section 6041(a), as amended by Public Law 119-21, sets a $2,000 information-reporting threshold, and the 2026 Instructions for Forms W-2G and 5754 apply that amount to Form W-2G reporting. The same proposal would conform the game-specific regulations for bingo, keno, and slot-machine winnings to the amended statute, but those conforming regulations remained proposed as of the research cutoff. Do not continue to apply the former $1,200 bingo and slot-machine threshold or the former $1,500 keno threshold.4

H.R. 10357, the Digital Asset Tax Certainty Act, would restore 100 percent deductibility, retroactive to taxable years beginning after December 31, 2025.5 Title VII, section 701 of the bill is called the "Full House Act." It keeps the rule that a professional gambler's business expenses count as wagering losses, so those expenses still cannot produce a loss beyond gains. Ways and Means ordered the bill reported 38-5, as amended by the chairman's substitute, on September 16, 2026. No floor action had occurred by the research cutoff.

WORKPAPER: Walter Brennan: 2026 wagering losses (joint; itemized only)

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Case 1: gains 14,000; losses 16,500
  90% x 16,500                                          14,850
  Capped at gains                                       14,000
  Deduction                                             14,000   (same as prior law)

Case 2: gains 14,000; losses 13,000
  90% x 13,000                                          11,700
  Capped at gains (14,000): not binding
  Deduction                                             11,700
  Prior law: lesser of 13,000 or 14,000                 13,000
  Income taxed without economic gain                     1,300

Losses at which the cap starts to bind: 14,000 / 0.90     15,555.56
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The 90 percent rule costs a gambler something whenever losses are below about 111 percent of gains, which covers most recreational gamblers. There is also a more basic point for the Brennans. Wagering losses are itemized deductions, and the Brennans do not itemize. Their itemized total would be $9,800 of state and local taxes, $5,110 of charitable contributions after the floor **($6,000 less 0.5 percent of $178,000)**, and $11,700 of gambling losses, for $26,610. That is far less than their $35,500 standard deduction. Walter's $14,000 of W-2G winnings is fully taxable, and none of his losses is deducted, both under prior law and under the new rule. The 90 percent limit is not the bigger problem for most retirees who gamble.

A break-even wagering year can produce taxable income. The 90 percent rule taxes a client who lost exactly what he won. Consider a high-volume slot player, single, who itemizes, with $100,000 of wagering gains and

1 CCA 202511015 (Jan. 17, 2025; released Mar. 14, 2025) (not precedential; § 6110(k)(3)).

2 I.R.C. § 165(d), as amended by Pub. L. No. 119-21, § 70114 (STATUTE) (amendment applies to taxable years beginning after December 31, 2025).

3 REG-113229-25, 91 Fed. Reg. 20599 (Apr. 17, 2026) (Prop. Treas. Reg. § 1.165-10) (PROPOSED).

4 I.R.C. § 6041(a), (h), as amended by Pub. L. No. 119-21 (STATUTE); Instructions for Forms W-2G and 5754 (2026) (ADMIN); Prop. Treas. Reg. § 1.6041-10 (REG-113229-25) (PROPOSED).

5 H.R. 10357, 119th Cong. tit. VII, § 701 (as introduced Sept. 14, 2026); Amendment in the Nature of a Substitute to H.R. 10357 (SMITHMO_076.XML, Sept. 14, 2026), tit. VII, § 701 (text unchanged; applies to taxable years beginning after Dec. 31, 2025), ordered reported 38-5 on Sept. 16, 2026; Joint Comm. on Taxation, JCX-50-26 (Sept. 15, 2026) (revenue reduction of $1.213 billion, fiscal years 2026-2036) (PENDING).

$100,000 of wagering losses for 2026. Under prior law, the losses offset the gains in full. Under the 2026 rule, only $90,000 is deductible, so $10,000 is taxed although the client has no economic profit.1

WORKPAPER: High-volume slot player: break-even year (single; itemizes)

Wagering gains (included in gross income and AGI)	100,000
Wagering losses	100,000
Prior law: losses up to gains	100,000
2026: 90% x 100,000 = 90,000; capped at gains	90,000
Income taxed without economic gain	10,000
Federal income tax, assuming all of it is taxed at 24%	2,400
If the client takes the standard deduction instead, all 100,000 of gains is taxed and no loss is deducted	100,000

Winnings raise AGI even when losses offset them. Wagering gains are gross income and count in full in AGI. Wagering losses are an itemized deduction, taken after AGI, so they never bring AGI back down. Every AGI- or MAGI-based computation therefore sees the gross winnings: the taxable portion of Social Security under section 86, the senior deduction phase-out, the 7.5 percent medical-expense floor, the premium tax credit, and the earned income credit phase-out. Medicare premiums two years later are set from MAGI as well. A client who reports the year as "about even" may still have moved across several thresholds.2

The Brennans show the cost. Walter's $14,000 of W-2G winnings is part of the couple's $178,000 of AGI **(Part V.B)**. Their Social Security is already 85 percent taxable, so the winnings do not change that. They do cost senior deduction, and because the Brennans do not itemize, none of Walter's $13,000 of losses **(Case 2)** is deducted.

WORKPAPER: Brennans: what Walter's $14,000 of winnings costs (joint; standard deduction)

AGI / MAGI as filed (Part V.B)	178,000.00
AGI / MAGI without the winnings	164,000.00
Senior deduction as filed: 2 x (6,000 - 6% x 28,000)	8,640.00
Senior deduction without winnings: 2 x (6,000 - 840)	10,320.00
Senior deduction lost to the winnings	1,680.00
Taxable income as filed	131,860.00
Taxable income without winnings (164,000 - 35,500 - 10,320 - 2,000)	116,180.00
Regular tax as filed	18,433.20
Regular tax without winnings: 11,600 + 22% x 15,380	14,983.60
Federal income tax cost of the winnings	3,449.60
of which from the lost senior deduction (1,680 x 22%)	369.60
Wagering losses deducted (no itemizing)	0.00
Social Security stays 85% taxable either way (provisional income far above the second base amount).	

Professional gamblers. A client who gambles full time, in good faith, and with regularity to earn a livelihood is in a trade or business and reports on Schedule C.3 That status no longer escapes the limit. Under section 165(d) as amended, "losses from wagering transactions" include every deduction otherwise allowable in carrying on wagering transactions, including travel, entry fees, and other business expenses, so the 90 percent rule and the cap at gains reach them too. The professional still cannot create a net loss from gambling, and a higher net profit also raises self-employment tax. The statute overrides the result in *Mayo v. Commissioner*, which had held that a professional gambler's business expenses were not limited by section 165(d). How the final 2026 Schedule C and its instructions present the 90 percent computation was not checked for this edition.4

1 I.R.C. § 165(d) (STATUTE). Illustration; no client in the cast.

2 I.R.C. §§ 61(a), 62(a), 63(d), 165(d) (wagering losses deductible only as an itemized deduction) (STATUTE); see I.R.C. §§ 86, 151(d)(5)(C), 213(a), 36B, 32 (AGI- or MAGI-based computations).

3 *Commissioner v. Groetzinger*, 480 U.S. 23 (1987).

4 I.R.C. § 165(d), as amended by Pub. L. No. 119-21, § 70114 (STATUTE); *Mayo v. Commissioner*, 136 T.C. 81 (2011) (superseded by statute); REG-113229-25 preamble (PROPOSED).

WORKPAPER: Professional poker player (single; Schedule C)

Wagering gains	200,000.00
Wagering losses	170,000.00
Travel, entry fees, other business expenses	25,000.00
Losses from wagering transactions (165(d))	195,000.00
2018-2025 rule: 195,000 allowed (below gains); net	5,000.00
2026: 90% x 195,000 = 175,500 allowed; net	24,500.00
SE tax, 2018-2025 rule: 5,000 x 0.9235 x 15.3%	706.48
SE tax, 2026: 24,500 x 0.9235 x 15.3%	3,461.74

Records. The 90 percent rule makes the records matter more, because every dollar of losses that cannot be proven also loses its 90 percent value. Rev. Proc. 77-29 calls for an accurate diary or similar record of winnings and losses: the date and type of each wager or wagering activity, the name and address or location of the establishment, the names of other persons present, and the amounts won or lost. The diary should be supplemented by verifiable documentation.1 Casino win/loss statements from a player's card cover only tracked play, and they are a starting point, not proof of the diary items.

Rev. Proc. 77-29 is a recordkeeping procedure; it is not the source of the session rule. In Shollenberger, the IRS conceded, and the Tax Court accepted, that a slot player who arrived with $500, hit a $2,000 jackpot reported on Form W-2G, and left with $1,600 had $1,100 of gross income, not $2,000; the couple got no deduction for losses from other visits. LaPlante, often cited with it, expressly did not decide the income-recognition theory and turned on substantiation. Chief Counsel takes the same view in AM 2008-011, which is not precedent: a casual slot player recognizes gain or loss on cashing out.2 Notice 2015-21 proposed a safe harbor that would define a session of electronically tracked slot play as play on the same type of game at one establishment within one calendar day. As of October 18, 2026, the draft revenue procedure in Notice 2015-21 remains unfinalized, and T.D. 9807 did not adopt the proposed electronically tracked slot-machine session reporting rules. Notice 2015-21 is PROPOSED and is not reliance authority. The proposed section 1.165-10 regulations do not adopt a session or other sub-annual unit. Session netting matters more now than it did. A client who reports each W-2G jackpot as a gain and every losing session as a loss has larger gross figures than one who nets within each session, and the 10 percent disallowance applies to the larger loss figure. That is analysis, not settled authority. Until final guidance issues, use a consistent, documented method.

Form W-2G triggers for 2026. The 2026 Instructions for Forms W-2G and 5754 state a $2,000 general information-reporting and backup-withholding threshold for payments in 2026, adjusted for inflation after 2026. That $2,000 figure is distinct from the $5,000 regular gambling-withholding threshold for sweepstakes, wagering pools, lotteries, and certain other wagers, and from the game-specific rules, including the 300-times-the-wager test for certain parimutuel and sports wagers. Confirm the applicable threshold for each type of gambling winnings against Pub. 1099 and the current Instructions for Forms W-2G and 5754. For bingo, keno, and slot machines the instructions refer to the applicable reporting threshold rather than stating a figure. The proposed regulations, REG-113229-25, would set all three at the section 6041 threshold, replacing the former $1,200 and $1,500 amounts for payments on or after January 1, 2026. Bingo and slot winnings would be measured without reduction for the wager, and keno winnings would be reduced by the amount wagered on the same game. As of October 22, 2026, REG-113229-25 remains proposed, with a public hearing noticed for July 17, 2026, and no final rule had issued. Winnings from other wagers would be reportable only if they meet the threshold and are at least 300 times the amount wagered. Regular gambling withholding remains 24 percent when winnings minus the wager exceed $5,000 for the wager types the instructions list. Backup withholding at 24 percent applies to reportable winnings that are not already subject to regular gambling withholding when the winner fails to furnish a TIN. A Form W-2G is a reporting trigger, not the measure of income.

1 Rev. Proc. 77-29, § 3, 1977-2 C.B. 538; I.R.C. § 6001.

2 Shollenberger v. Commissioner, T.C. Memo. 2009-306 (IRS concession accepted); LaPlante v. Commissioner, T.C. Memo. 2009-226 (income-recognition theory expressly not decided; substantiation); AM 2008-011 (Dec. 12, 2008) (nonprecedential, I.R.C. § 6110(k)(3)); Notice 2015-21, 2015-12 I.R.B. 765, proposed rev. proc. §§ 3.04, 6.02-6.04 (PROPOSED); T.D. 9807, 81 Fed. Reg. 96374, 96375 (Dec. 30, 2016) (final regulations "do not adopt the proposed rules for electronically tracked slot machine play"); REG-113229-25, 91 Fed. Reg. 20599 (Apr. 17, 2026) (no session unit) (PROPOSED).

CAUTION: If H.R. 10357 is enacted after a client files a 2026 return that reflects the 90 percent limitation, claim any refund under the enacted law and the IRS's correction procedures, which may require an amended return. Do not compute 2026 returns on the assumption that the fix will pass. Keep the client's wagering records intact: win/loss statements, session logs, and online-account histories.

CAUTION: Sports event contracts on prediction markets. Clients increasingly trade yes-or-no contracts on game outcomes through exchanges such as Kalshi, or through Robinhood and Polymarket. Neither Treasury nor the IRS has issued a regulation, revenue ruling, revenue procedure, notice, or Chief Counsel advice on how to tax them, and the proposed wagering regulations do not mention them.[1] **Three positions circulate. The first treats them as wagering: winnings are ordinary income, and losses are deductible only as an itemized deduction, at 90 percent, and only to the extent of gains under section 165(d). The second treats them as section 1256 contracts, marked to market at year end with a 60/40 long-term/short-term split, which requires a regulated futures contract or nonequity option traded on a qualified board or exchange. Section 1256(b)(2)(B) excludes any commodity swap or similar agreement. The CFTC has described these contracts as binary options, and they may be swaps for CFTC purposes; if they are, the exclusion is a major obstacle to that position. The third treats them as capital assets. A sale before settlement then produces capital gain or loss. Settlement itself is a sale or exchange only if section 1234A applies, and it reaches only rights with respect to property that is a capital asset; a contract on a game result may not meet that test.**[2] **The Tax Law Center concludes that sports event contracts "appear to be 'wagers' and 'wagering'" for federal tax purposes.**[3] **An information statement does not determine the tax treatment. Kalshi furnishes a profit-and-loss statement, not a transaction-level information return, for event-contract trades, and Robinhood's annual statement for event contracts is described as "not a substitute tax reporting form." Get the full transaction history, choose a position, document it, and apply it consistently.**[4] **The pending Supreme Court petition in *Flaherty v. KalshiEX, LLC*, No. 26-299, concerns state gambling regulation, not federal tax. A regulated futures contract must also have deposits and withdrawals determined by a system of marking to market (section 1256(g)(1)(A)). Whether fully collateralized event contracts meet that test is unresolved.**[5]

F. Itemize or not

Before 2026, the decision to itemize compared two numbers: total itemized deductions and the standard deduction. In 2026 more provisions affect the comparison. The senior, tips, overtime, and car-loan deductions

1 NATP, *Prediction Market Contracts Are Showing Up on Client Returns* (undated); Grady McMichen, *Will the IRS Issue Prediction Market Guidance Before April 15th?*, Pease Bell (Apr. 1, 2026, updated) (each as reported); REG-113229-25, 91 Fed. Reg. 20599 (Apr. 17, 2026) (PROPOSED); Cong. Research Serv., R49266, Prediction Markets Legislation in the 119th Congress (Aug. 17, 2026) (no pending bill addresses their federal tax treatment).

2 I.R.C. §§ 165(d), 1221, 1234A, 1256(a), (b)(2)(B), (g)(1), (g)(3), (g)(7) (STATUTE); 7 U.S.C. § 1a(47).

3 Tax Law Center at NYU Law, *Are Sports Event Contracts on Prediction Markets Gambling for Federal Tax Purposes?*, Tax Notes Federal (Sept. 30, 2026); Tax Law Center blog (Oct. 1, 2026) ("the best reading of the code is that sports event contracts on prediction markets appear to be 'wagers' and 'wagering'").

4 Kalshi Help Center, *What Tax Documentation Does Kalshi Provide* (June 22, 2026) (lists Forms 1099-INT, 1099-MISC, 1099-B for crypto transfers, 1099-DA, and a profit-and-loss statement); NATP, supra (Robinhood statement, as reported).

5 I.R.C. § 1256(b)(2)(B), (g)(1), (g)(7)(B); Kelly Chan, *Prediction Market Contracts Involve Financial Instruments Taxation*, ABA Tax Times (2026) (report of May 8, 2026 panel; CFTC has described the contracts as binary options, and they may be swaps for CFTC purposes) (as reported); *Flaherty v. KalshiEX, LLC*, No. 26-299 (U.S. petition filed Sept. 2, 2026; response due Nov. 9, 2026), from No. 25-1922 (3d Cir. Apr. 6, 2026).

are available either way, so they do not affect the choice. The $1,000 or $2,000 non-itemizer charitable deduction, however, is available only to a taxpayer who does not itemize. That adds to the value of the standard deduction. On the itemizing side, the 0.5 percent charitable floor and, for high-income households, section 68 both reduce the value of itemizing.

WORKPAPER: Lena Kowalski: itemize or take the standard deduction (single)

Itemized deductions	
State and local taxes (below the 40,400 cap)	7,200.00
Home mortgage interest	9,800.00
Mortgage insurance premiums after phase-out	900.00
Cash gifts to church, 1,500, less 0.5% x 104,500 = 522.50	977.50
Total itemized	18,877.50
Standard-deduction route	
Standard deduction (single)	16,100.00
Non-itemizer cash charitable deduction (up to 1,000)	1,000.00
Total	17,100.00
Advantage of itemizing	1,777.50
(Without the non-itemizer deduction, the gap would be 2,777.50; that deduction narrows it by 1,000.)	

For a client close to the line, these changes can switch the answer from one year to the next. Bunching gifts into alternate years gains value because the itemizing year absorbs the floor once, and in the standard-deduction year the client still gets up to $1,000 of charitable deduction. Mortgage insurance premiums count only in an itemizing year, so a homeowner with private mortgage insurance has one more reason to look at the itemizing alternative.

X. HSAS AND THE PREMIUM TAX CREDIT

A. HSAs

For months beginning after December 31, 2025, an individual-market bronze or catastrophic plan is treated as a high-deductible health plan if it is available as individual coverage through an Exchange, including the same plan bought outside the Exchange **(section 223(c)**(2)(H)). A plan that meets the ordinary high-deductible health plan rules still qualifies on that basis. Separately, an individual has a safe harbor for HSA1 eligibility if he or she has no reason to believe the plan is not available on an Exchange.2 Earlier practitioner descriptions of Notice 2026-5 were each partly right. The rule turns on whether the same plan is available on an Exchange, and the enrollee has a good-faith safe harbor.

For months beginning after December 31, 2025, a direct primary care service arrangement does not disqualify an individual from contributing to an HSA, and its fees can be paid from the HSA. The fee limit is an aggregate: total monthly fees for all of the individual's arrangements may not exceed $150, or $300 if any of them covers more than one individual. In a month the total exceeds the limit, none of the arrangements qualifies, so the individual cannot contribute to an HSA while enrolled. The fees themselves remain reimbursable from the HSA as medical expenses; Notice 2026-5 says there is no specific limit on the fee for that purpose. Fees an employer pays, including through a cafeteria plan, are not the employee's expenses and cannot be reimbursed from the HSA. The amounts are indexed after 2026.3 The Okafors pay $280 a month out of their own pocket, directly to a direct primary care practice, for a family arrangement. It is not part of Derek's union health plan and is not paid through payroll. It stays under the $300 aggregate limit because the arrangement covers more than one individual and no other direct primary care arrangement covers any of them. Assuming the arrangement consists solely of primary care services for a fixed periodic fee, and that the Okafors meet the other HSA eligibility requirements, the arrangement does not disqualify them **(section 223(c)**(1)(E)). Confirm from the contract, not from the services the family actually uses, that primary care practitioners provide the care and that the arrangement does not cover procedures requiring general anesthesia, prescription drugs other than vaccines, or laboratory services not typically administered in an ambulatory primary care setting **(Notice**

1 HSA means health savings account.

2 I.R.C. § 223(c)(2)(H), added by Pub. L. No. 119-21, § 71307; Notice 2026-5 (FINAL).

3 I.R.C. § 223(c)(1)(E)(ii)(II), (d)(2)(C)(v), (g), added by Pub. L. No. 119-21, § 71308; Notice 2026-5, 2026-2 I.R.B. 309, § II.B.3 (aggregate limit) and Q&A-13 (billing periods), -18 (employer-paid fees), -20 (fees over the limit remain reimbursable; contributions disqualified).

2026-5, Q&A-14, -17). Because they pay the fee themselves, they can reimburse it from their HSA. For 2026, their family HSA contribution limit is $8,750. An HSA-eligible spouse who is 55 or older may add a $1,000 catch-up contribution, which is fixed by statute and not indexed; the catch-up belongs to that spouse's own HSA.1 The pre-deductible telehealth safe harbor is now permanent, for plan years beginning after December 31, 2024.2

B. Excess advance premium tax credit: no repayment cap

For taxable years beginning after December 31, 2025, the 2025 act eliminated the caps on repaying excess advance premium tax credit **(APTC)**. All excess APTC must now be repaid. Household income for the premium tax credit uses its own MAGI: AGI plus excluded foreign earned income, tax-exempt interest, and Social Security benefits not included in income. It also includes the MAGI of dependents who are required to file **(section 36B(d)**(2)). That is not the MAGI used for the four Schedule 1-A deductions. The enhanced premium tax credit expired after 2025. H.R. 1834, which would extend it for three years, to cover 2026 through 2028, passed the House 230-196 on January 8, 2026,3 and has been on the Senate calendar since February 10, 2026 **(Calendar No. 319)**. As of October 22, 2026, it remains Passed House and on the Senate Legislative Calendar. It is PENDING.

⚠ **CAUTION: With the enhanced credit gone, the 400 percent of federal poverty line ceiling on eligibility applies again for 2026. A household with income above it gets no premium tax credit at all.**4 **For 2026 coverage, the computation uses the prior year's poverty guidelines. For a single filer in the 48 contiguous states, 400 percent is about $62,600. The repayment caps never applied above 400 percent, so for higher-income clients the loss of the caps changes nothing. Losing the credit altogether is what costs them.**

WORKPAPER: Lena Kowalski: 2026 premium tax credit reconciliation (single)

Projected income at enrollment (Marketplace)	58,000
Advance premium tax credit paid to insurer	9,600
Actual 2026 household income (MAGI)	104,500
includes the 22,000 IDR discharge (Part XI), assuming Lena is not insolvent	
400% FPL ceiling, single, 2026 coverage (approx.)	62,600
Premium tax credit allowed on Form 8962	0
Excess APTC repaid (no cap above 400% FPL)	9,600
Same result without the discharge (MAGI 82,500 > 62,600)	9,600

Lena is self-employed. Her salon had a strong year, and the student-loan discharge added income she had not expected when she enrolled. Neither change was reported to the Marketplace. Because her household income ends up above 400 percent of the poverty line, she is not an applicable taxpayer for 2026 and repays the entire $9,600. That would be true even without the discharge. For a client whose income ends below 400 percent of the poverty line, the end of the repayment caps is the change that matters: any excess APTC is now repaid in full, where prior law capped the repayment by income tier. For self-employed clients on Marketplace coverage, mid-year income updates to the Exchange now affect cash flow in a real way.

C. Eligibility changes and the $500 payments

Four provisions of the 2025 act change who qualifies for the premium tax credit and how enrollment must be verified. Sections 71301, 71302, 71303, and 71304 are enacted law. REG-101576-26, filed October 14, 2026, proposes the regulations that would implement them, and the items below note where a rule is proposed rather than final.

Beginning with 2026 taxable years (STATUTE). **Section** 71302 repealed section 36B(c)(1)(B). The special eligibility rule that had treated a lawfully present alien below 100 percent of the federal poverty line as an

1 Rev. Proc. 2025-19 (2026 HSA limits); I.R.C. § 223(b)(3)(B) ($1,000 catch-up at age 55).

2 Pub. L. No. 119-21, § 71306 (telehealth safe harbor); Notice 2026-5.

3 H.R. 1834, 119th Cong. § 1 (as passed by the House, Jan. 8, 2026) (amending I.R.C. § 36B(b)(3)(A)(iii) and (c)(1)(E) by substituting "before January 1, 2029" for "before January 1, 2026," effective for taxable years beginning after Dec. 31, 2025) (PENDING); H. Res. 780, 119th Cong. (Jan. 8, 2026).

4 I.R.C. § 36B(c)(1)(A) (applicable taxpayer: household income 100%–400% of poverty line).

applicable taxpayer, where that person was ineligible for Medicaid because of alien status, no longer applies. For 2026 and later, that person is not eligible for the premium tax credit.

Beginning with 2026 plan years (STATUTE). Under section 71304, coverage enrolled in during a special enrollment period offered on the basis of expected household income, and not in connection with an event or change in circumstances, is not a qualified health plan for premium tax credit purposes. It applies to plan years beginning after December 31, 2025. Ask which enrollment period the client used; not every special enrollment period is affected. The implementing rule in REG-101576-26 is PROPOSED and would apply only after it is finalized.

Later years (STATUTE). **Section** 71301, which removes the credit for lawfully present aliens who are not eligible aliens, applies to taxable years beginning after December 31, 2026. **Section** 71303, which ties coverage months to Exchange verification and prior-year reconciliation, applies to taxable years beginning after December 31, 2027.

The separate $500 CMS payments (OPERATIONAL). IR-2026-121 reported that CMS had removed more than 760,000 unverified Marketplace enrollees, estimated about $2.2 billion in savings, and was sending nearly one million people $500 each because CMS said they had been overcharged for their coverage. The IRS release presented these payments as a separate CMS administrative action. They are not one of the premium tax credit rules in sections 71301 through 71304 or in REG-101576-26. Their tax treatment is taken up at the end of this Part.

The $500 Marketplace payments and the $90 Medicare rebate: tax treatment unresolved (NOT VERIFIED). Two one-time federal payments reached clients in fall 2026 with no tax guidance attached. The first is $500 per eligible enrollee, paid to federal Marketplace enrollees in the 30 HealthCare.gov states who received no premium assistance; the White House fact sheet calls them "Working Families Obamacare Refunds" and says they are funded from accumulated Marketplace user-fee receipts. The 30 states include Mississippi, Alabama, Louisiana, Texas, and Florida.1 The second is a $90 "Medicare Improvement Fund Premium Rebate," paid in October 2026 to about 20.8 million Original Medicare Part B enrollees who live in the United States. CMS states the remaining criteria as "not receiving premium assistance from Medicaid; or, **(3)** not paying an Income-Related Monthly Adjustment Amount." That wording is ambiguous, so confirm a client's eligibility from the CMS notice rather than from the FAQ. Medicare Advantage enrollees are not eligible. Most recipients were paid by Social Security direct deposit on or around October 8; others receive a Treasury check.2

As of October 21, 2026, neither the IRS nor Treasury had said whether either payment is gross income, whether an information return will be issued, or how either payment interacts with premiums the client deducts. Practitioner commentary reads the payments two ways. One reading treats each payment as a reduction in the price of coverage the recipient bought. On that reading, the payment is not income to a recipient who did not deduct the premiums. It reduces the premiums taken into account for the medical-expense deduction, for the self-employed health insurance deduction under section 162(l), and, for the $500 payment, for the premium tax credit on Form 8962. Commentators rest that reading on the IRS's treatment of medical-loss-ratio rebates as purchase-price adjustments and on the premium-reduction rule in Treas. Reg. **§** 1.36B-3.3 The other reading starts from section 61: income from whatever source is gross income unless an exclusion applies, the fact sheet identifies none, and IR-2026-121 says only that CMS considered the $500 recipients "overcharged" for their coverage.4 Neither reading has been adopted by the IRS. The better view, and the one this text takes, is that each payment is likely not taxable to a recipient who did not deduct the premiums, and that it reduces deductible premiums for a recipient who did. That is a prediction, not settled law. The federal tax treatment

1 The White House, Fact Sheet: President Donald J. Trump Announces the Working Families Obamacare Refunds (Sept. 10, 2026) (not tax guidance); I.R.S. News Release IR-2026-121 (Oct. 14, 2026).

2 Centers for Medicare & Medicaid Services, Medicare Improvement Fund Premium Rebate Frequently Asked Questions (Oct. 3, 2026) (ADMIN; does not address tax treatment).

3 Tom Talks Taxes, *Are the $500 ACA Rebate Checks Taxable?* (Oct. 7, 2026); Foncannon CPA Group, *How the $500 ACA Premium Refund Affects Your 2026 Tax Return* (Oct. 9, 2026); Don't Mess With Taxes, *Tax Consequences of the $90 Medicare Premium Rebate* (Oct. 8, 2026) (each as reported; practitioner analysis, not authority). Treas. Reg. § 1.36B-3(d)(1)(i)(A) reduces enrollment premiums by any amounts "[r]efunded in the same taxable year as the premium liability is incurred" (FINAL).

4 I.R.C. § 61(a); James Ridout CPA, *Is the $500 Obamacare Refund Check Taxable?* (Oct. 1, 2026) (as reported; reaches no conclusion); IR-2026-121.

remains unresolved. The $500 recipients by definition received no advance credit, so Form 8962 matters only for a recipient who claims the credit on the 2026 return.

CAUTION: Tell the client the payment is likely not taxable, and say plainly that the IRS has not yet ruled. Ask the client to keep the payment letter, the deposit record or check, the Marketplace or Medicare enrollment records, and 2026 premium statements, and to bring any information return that arrives. For a client who deducts premiums on Schedule A or under section 162(l), or who claims the premium tax credit, flag the 2026 premium figures for adjustment once guidance is issued. Check again for guidance when the 2026 return is prepared, and document in the file the treatment used and why.

XI. WHAT ENDED OR NARROWED FOR 2026

Several provisions that practitioners relied on through 2025 changed or ended on December 31, 2025. Table 6 collects them. In each case, ask what the 2026 return loses, and whether the actual 2025 facts support an amended 2025 return. A later installation or discharge cannot be treated as occurring in 2025.

Table 6. Provisions that expired or narrowed after 2025

Provision	2026 rule	Authority
Enhanced premium tax credit	Expired December 31, 2025; three-year extension passed House only	H.R. 1834 (PENDING; Passed House, on Senate calendar as of Oct. 18, 2026)
Qualified principal residence debt (§ 108(a)(1)(E))	Only discharges before January 1, 2026, or under a written arrangement entered into before then	I.R.C. § 108(a)(1)(E)
Student-loan discharge (§ 108(f)(5))	General 2021-2025 exclusion ended; for discharges after 2025, permanent exclusion only for death or total and permanent disability, with SSN	I.R.C. § 108(f)(5), as amended by Pub. L. No. 119-21, § 70119
Bicycle commuting (§ 132(f)(5)(F))	Exclusion permanently repealed for taxable years beginning after December 31, 2025	Pub. L. No. 119-21, § 70112
Moving expenses	Exclusion and deduction permanently eliminated for taxable years beginning after December 31, 2025, except for active-duty members of the Armed Forces moving pursuant to a military order and for certain intelligence-community employees who move pursuant to a required change in assignment.	I.R.C. sections 132(g)(2), 217(k), as amended by Pub. L. No. 119-21

The enhanced premium tax credit and student-loan discharge entries remain subject to change through pending legislation and should be re-checked before presentation. Keep Form 8850 procedures in place in case the work opportunity tax credit is retroactively extended.

Lena Kowalski's student loan illustrates the student-loan change. In March 2026 her income-driven repayment plan forgave $22,000 of her federal student loan balance. Before 2026, that discharge would have been excluded from income. For 2026, it is cancellation-of-debt income unless another exclusion applies. Insolvency under section 108(a)(1)(B) is the usual candidate, measured immediately before the discharge.1 Discharges under Public Service Loan Forgiveness rest on a separate exclusion, section 108(f)(1), for loans forgiven because the borrower worked for a period in certain professions. The 2025 change did not affect that exclusion.2

PRACTICE POINTER: For any client with an income-driven repayment discharge in 2026, prepare an insolvency worksheet before you accept the Form 1099-C figure as taxable. Retirement accounts count as assets in the insolvency computation, which surprises clients. If the client is not insolvent, set up a 2026 estimated payment or a withholding change as soon as the discharge happens.

1 I.R.C. § 108(a)(1)(B), (a)(3), (d)(3) (insolvency exclusion and measurement).
2 I.R.C. § 108(f)(1) (discharge conditioned on work in certain professions).

The 2025 act ended most of the individual and several business energy credits on fixed dates. Table 7 gives the termination rules. For the vehicle credits, "acquired" means a written binding contract was entered into and a payment was made. Delivery may come later.

Table 7. Energy credit terminations under Pub. L. No. 119-21

Credit	Not available for	Authority
§ 25E used EV; § 30D clean vehicle; § 45W commercial clean vehicle	Vehicles acquired after September 30, 2025	§§ 25E(g), 30D(h), 45W(g)
§ 25C energy-efficient home improvement	Property placed in service after December 31, 2025	§ 25C(i)
§ 25D residential clean energy	Expenditures made after December 31, 2025 (made when installation is complete)	§ 25D(h); § 25D(e)(8)(A)
§ 30C alternative fuel refueling property	Property placed in service after June 30, 2026	§ 30C(i)
§ 45L new energy-efficient home	Homes acquired after June 30, 2026	§ 45L(h)
§ 179D energy-efficient commercial building	Property whose construction begins after June 30, 2026	§ 179D(i)
§§ 45Y / 48E wind and solar	Construction begins after July 4, 2026, and placed in service after December 31, 2027 (both conditions)	Pub. L. No. 119-21, §§ 70512-70513

Termination dates only; this is not a complete eligibility guide. Termination dates are statutory **(each section as amended by Pub. L. No. 119-21)**. The subsection letters shown were checked against the current Code text for this book. IRS fact sheet FS-2025-05 **(ADMIN)** restates the dates and explains "acquired" and "expenditure made."

The Okafors had a rooftop solar system installed on their home. The contract was signed in November 2025, and the installer finished in January 2026. Under section 25D, an expenditure is treated as made when the original installation is complete, so the Okafors' expenditure was made in 2026, after the credit ended. No credit is available on either their 2025 or their 2026 return.1 A signed contract and a deposit before year-end do not change that.

XII. INFORMATION REPORTING AND FORMS

A. The $2,000 thresholds

For payments made after December 31, 2025, the reporting threshold for payments under sections 6041(a) and 6041A rises from $600 to $2,000. These are the payments reported on Forms 1099-NEC and 1099-MISC. The threshold is indexed after 2026. Not every Form 1099-MISC box uses the new threshold. Royalties, for example, keep their own lower thresholds, and the IRS says thresholds vary by type of payment. Backup withholding on section 6041 and 6041A payments follows the same $2,000 threshold, with two exceptions: it can apply below that amount if the payor had to file an information return for the payee for the preceding year, or made reportable payments to the payee in the preceding year that required backup withholding **(section 3406(b)**(6)(B)-(C)). The backup withholding rate is still 24 percent, and a Form 1099 is required whenever backup withholding is actually applied, regardless of amount.

The same increase applies to Form W-2 for small amounts of wages. For wages paid after 2025, a Form W-2 is not required for wages under $2,000 from which no income, Social Security, or Medicare tax was withheld. The figure was $600, and it is indexed after 2026.2

PRACTICE POINTER: Clients should not read the $2,000 threshold as a reason to stop collecting Forms W-9. Backup withholding still turns on having a TIN. A vendor paid $1,900 in 2026 and $2,400 in 2027 will need a W-9 in 2027 whatever happened in 2026. Collecting the W-9 at onboarding is cheaper

1 I.R.C. § 25D(e)(8)(A) (expenditure made when installation completed); FS-2025-05 FAQs.
2 I.R.S. Pub. 1141 (2026) (W-2 threshold for wages with no withholding) (ADMIN).

than collecting it at year-end.

B. Form 1099-K

The 2025 act retroactively restored the de minimis rule for third-party settlement organizations: reporting is required only above $20,000 and more than 200 transactions. Treasury finalized the related backup-withholding rules in T.D. 10053, effective August 10, 2026, adopting REG-112829-25 without change. The rules apply to payments in calendar years beginning after December 31, 2024. For a payee who received no reportable network-transaction payments from the payor in the preceding year, backup withholding begins only once both thresholds are exceeded, and only if a backup-withholding condition, such as a missing TIN, exists. In that case, withholding reaches the transaction that first causes both thresholds to be exceeded and later transactions that year. A payee who received reportable payments from the payor in the preceding year does not get that threshold protection **(Treas. Reg. § 31.3406(b)**(3)-5(b)(3)).

C. Digital assets

Notice 2026-20 extends through December 31, 2026, the Notice 2025-7 temporary relief for making an adequate lot identification and using standing orders, and it reaches only units of a digital asset held in the custody of a broker. If the taxpayer makes a timely identification on its own books and records, those identified units are the units sold for federal income tax purposes even when the broker's reported acquisition date and basis do not match. The relief does not apply to digital-asset units not held in a broker's custody, and it does not change broker gross-proceeds or basis reporting under section 1.6045-1. That relief is distinct from the backup-withholding relief. Notice 2025-33 extended the backup-withholding relief of Notice 2024-56 so that backup withholding is not required on digital-asset sales effected by a broker during calendar years 2025 and 2026. Brokers report gross proceeds for 2025 and add basis reporting on covered securities for 2026 transactions under the existing section 1.6045-1 rules. Proposed regulations, REG-105064-25, published March 6, 2026, would let brokers furnish Form 1099-DA statements electronically through an optional consent process without offering a paper delivery alternative. Comments were due May 5, 2026. Notice 2026-4, issued at the same time, requests comments on electronic furnishing of Form 1099-B and other payee statements. The applicability date is unsettled. The IRS release says the rules would apply to statements furnished on or after January 1, 2027, but the proposed regulation text, as read for this text, applies them beginning January 1 of the year after final regulations are published. Read the regulation text before teaching a date.

D. 2026 form changes

Table 8. 2026 information-return and form changes

Form / item	2026 rule	Authority
Form W-2, Box 12	Code TA (§ 128 Trump-account contributions); Code TP (total cash tips reported to employer); Code TT (total qualified overtime compensation)	Rev. Proc. 2026-27
Form W-2, Box 14	Split into 14a (Other) and 14b (Treasury Tipped Occupation Code, up to two codes)	Rev. Proc. 2026-27
Form W-2, small wages	No W-2 required for wages under $2,000 with no withholding (indexed after 2026)	Pub. 1141
Form W-2, Box 10	Dependent care exclusion $7,500 ($3,750 MFS); instructions corrected from $5,000	§ 129(a)(2)(A)
Form 1099-R, Box 7	Split into 7a (codes), 7b (IRA/SEP/SIMPLE), 7c (Trump account), 7d (earnings on excess contributions); Code Y (QCD) optional for 2026	2026 Instr. Forms 1099-R and 5498
Form 1098-VLI	New for 2026; $600 per-loan threshold	§ 6050AA; T.D. 10054
Draft Form 1040	Line 12f non-itemizer charitable deduction; citizenship/work-authorization question; new Schedule 3-A	Draft forms (Part XIV)

Form / item	2026 rule	Authority
Form 940	**Draft 2026 instructions (Sept. 22, 2026):** credit reduction states exist for 2026, use Schedule A (states not named in the draft); dependent care exclusion $7,500 ($3,750 MFS); moving and bicycle reimbursements not exempt from FUTA and not reported on line 4; automatic penalty relief (AEP) from July 2026 for filers who timely filed and paid for the prior 3 years	Draft 2026 Instr. Form 940 (DRAFT)

All 2026 forms and instructions cited as drafts were not final at the research cutoff. Re-verify line numbers and box designations against final forms before filing season.

XIII. SCHEDULE C: DEPRECIATION AND THE QBI DEDUCTION

A. Bonus depreciation: the acquisition date controls

The 2025 act permanently restored 100 percent bonus depreciation for property acquired after January 19, 2025. Notice 2026-11, issued January 14, 2026, applies the acquisition-date rules of section 1.168(k)-2 by substituting January 19 and 20, 2025, for the TCJA-era dates of September 27 and 28, 2017. For property acquired under a written binding contract, the acquisition date is determined under the binding-contract rules of section 1.168(k)-2(b)(5); the signature date does not always control. For the first taxable year ending after January 19, 2025, a taxpayer may elect under section 168(k)(10) to claim 40 percent bonus depreciation instead of 100 percent, or 60 percent for longer-production-period property and certain aircraft. Specified plants planted or grafted after January 19, 2025 qualify for 100 percent under the section 168(k)(5) election. A component election is available for larger self-constructed property. For a qualified sound recording production, the acquisition date is the date principal recording begins. Proposed regulations are forthcoming and are item 17 on the 2026-2027 Priority Guidance Plan. Until they issue, taxpayers may rely on the notice.

Verify the acquisition date before applying the bonus percentage. Hollis Fabrication placed a $1,400,000 computer numerical control **(CNC)** machining center in service in June 2026. If Hollis signed the purchase contract after January 19, 2025, the machine qualifies for 100 percent bonus depreciation. If Hollis signed a written binding contract on January 10, 2025, the machine was acquired before the new effective date. It then falls under the TCJA phase-down, which allows 20 percent bonus depreciation for property placed in service in 2026. The example assumes the January 10 contract was binding on that date, meaning enforceable under state law with no cancellation right or open condition that would defeat that status; if not, determine the acquisition date under the binding-contract rules of Treas. Reg. § 1.168(k)-2(b)(5).1

WORKPAPER: Hollis Fabrication: CNC machine, contract date controls

```
Cost of 7-year property placed in service June 2026        1,400,000.00

Contract signed after Jan. 19, 2025
  Bonus depreciation at 100%                             1,400,000.00

Written binding contract dated Jan. 10, 2025
  Bonus depreciation at 20% (TCJA phase-down)              280,000.00
  Remaining basis                                        1,120,000.00
MACRS 7-year, half-year (no mid-quarter), year 1: 14.29%   160,048.00
  First-year depreciation                                  440,048.00

Difference in 2026 deductions                              959,952.00
Alternative: evaluate a section 179 election (limit 2,560,000),
  subject to the taxable-income limit at corporate and shareholder level
```

The contract file is the evidence. A purchase order signed in December 2024, with a deposit, can be a written binding contract even if the machine was delivered and installed in 2026. Ask for the purchase documents before relying on the 100 percent rate. Notice 2026-11 applies the binding-contract rules of section 1.168(k)-2(b)(5).

B. Section 179

For 2026, the section 179 expense limit is $2,560,000. It begins to phase out when qualifying property placed in service exceeds $4,090,000, and the deduction is also limited to business taxable income. The $32,000

1 I.R.C. § 168(k)(6)(A) (TCJA phase-down); Pub. L. No. 119-21, § 70301(c) (acquisition-date rule).

cap applies to sport utility vehicles as section 179(b)(5) defines them, subject to its vehicle exceptions. Verify a qualifying purchase and use in the active conduct of a trade or business. An amount disallowed by the business-income limit carries forward **(section 179(b)**(3)(B)).1

C. The qualified business income deduction

The 2025 act made section 199A permanent. It also widened the phase-in ranges for the wage and capital limitation and the specified-service exclusion from $50,000 and $100,000 to $75,000 and $150,000, and it added a minimum deduction. The rate stays at 20 percent; the House's 23 percent did not survive. For 2026, the phase-in range is $403,500-$553,500 for joint returns, $201,775-$276,775 for married individuals filing separately, and $201,750-$276,750 for all other returns.

The minimum deduction in section 199A(i) applies to an "applicable taxpayer," one whose aggregate qualified business income from all active qualified trades or businesses is at least $1,000 for the year. An active qualified trade or business is one in which the taxpayer materially participates under section 469(h). For such a taxpayer, the deduction is the greater of the deduction otherwise computed and $400. Tips deductible under section 224 are excluded from qualified business income **(section 199A(c)**(4)(D); Part III.F). Both amounts are indexed after 2026. For the figures below, assume the Okafors file jointly and Derek has no suspended qualified business loss carried into 2026. Also assume no other qualified trade or business income or loss, no net capital gain, taxable income high enough that the income limit does not bind, and no wage, property, or specified service trade or business limitation. Derek's weekend electrical business, in which he materially participates, produced $1,800 of net profit in 2026. His net earnings from self-employment are $1,800 times 92.35 percent, or $1,662.30, the self-employment tax is $254.33 **(15.3 percent)**, and half of that, $127.17, is the deduction for one-half of self-employment tax. His qualified business income, after that deduction, is $1,672.83, and 20 percent of that is $334.57. Because his qualified business income is at least $1,000, the minimum lifts his deduction to $400. The minimum therefore adds $65.43 of deduction over the $334.57 he would otherwise claim **($400.00 minus $334.57)**, worth $6 of tax on the Okafors' return under the draft Tax Table **(see Part XIX.A, The Okafors' 2026 return)**. The provision is small, but software that has not been updated will miss it.

D. Tips credit for beauty-service businesses (section 45B)

The 2025 act also amended section 45B, the credit for employer Social Security and Medicare taxes paid on certain tips. The credit now covers tips received for barbering and hair care, nail care, esthetics, and body and spa treatments, where tipping is customary. For these businesses, the credit is computed on tips above the current federal minimum wage under FLSA section 6(a)(1), which is $7.25 an hour. The minimum wage frozen at its January 1, 2007 level applies only to food and beverage establishments. The amendment applies to taxable years beginning after December 31, 2024. So the credit was available on 2025 returns, not starting in 2026 as some sources say.2

WORKPAPER: Lena Kowalski's salon: 2026 section 45B credit (simplified)

```
Tips received by stylists and reported to employer          60,000
Assumptions: each stylist's cash wages meet the $7.25 federal
  minimum each month, and all $60,000 bears both employer FICA taxes
Employer FICA rate on creditable tips: 7.65%
Credit (Form 8846), before general business credit limits: 60,000 x 7.65% 4,590
No deduction for the employer FICA taxes used for the credit
```

PRACTICE POINTER: Many salon owners have not claimed the section 45B credit because it once applied only to food and beverage businesses. If a salon client did not claim it on the 2025 return, consider an amended 2025 return that claims the credit on Form 8846 and Form 3800 (the general business credit) and reduces the employer FICA deduction by the credit, along with the 2026 claim (section 45B(c)). Lena also needs to check that her stylists' tip reporting is complete. The employer must substantiate the tips and taxes used to compute the credit.

1 Rev. Proc. 2025-32, § 4.24 (2026 § 179 amounts) (FINAL).

2 I.R.C. § 45B(b)(2), as amended by Pub. L. No. 119-21, § 70201(e) (effective for taxable years beginning after Dec. 31, 2024).

XIV. REFUNDABLE CREDITS AND DRAFT SCHEDULE 3-A

A. The proposal

Proposed regulations, REG-119882-25, published August 20, 2026, would treat the refunded portion of four credits as a "federal public benefit" under the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 **(PRWORA)**. The four credits are the earned income credit, the additional child tax credit, the refundable American opportunity credit, and the refundable adoption credit. Under PRWORA, an alien who is not a "qualified alien" is generally not eligible for a federal public benefit. The proposal adds one regulation for each credit. **Section** 1.23-2 covers the adoption credit, section 1.24-3 the additional child tax credit, section 1.25A-7 the American opportunity credit, and section 1.32-4 the earned income credit. Each is titled "Application of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996," and they use parallel language.

The proposal has five operative features. Each comes from the proposed regulation text or its preamble, and each is PROPOSED.

The first is what is conditioned. Only the "refunded portion" is. The adoption-credit rule defines it as the part of the refundable credit that exceeds the tax imposed by subtitle A of the Code, reduced by the nonrefundable credits allowable under subparts A, B, D, and G of the income tax credit rules. The other three rules track that definition. The part of a refundable credit that offsets tax is not affected. Subtitle A includes self-employment tax and the net investment income tax as well as the regular income tax. Employment taxes collected on the individual return, such as tip FICA reported on Form 4137, are imposed outside subtitle A. As Part XIV.B shows, the draft schedule is built to match that distinction.

The second is who qualifies. The refunded portion goes only to a taxpayer who is a U.S. citizen, a U.S. national, or a qualified alien, and who so declares under penalties of perjury on the return or schedule the IRS prescribes. "Qualified alien" has the meaning in section 431(b) of PRWORA, which is 8 U.S.C. § 1641(b).

The third is joint returns. According to the preamble, on a joint return only one of the spouses must be a citizen, national, or qualified alien for the couple to receive the refunded portion.1 The draft schedule follows that rule. Line 8 asks whether "you or your spouse" meets the standard.

The fourth is the consequence. An ineligible taxpayer is "not eligible to receive a refund, credit, or offset of the refunded portion." According to the preamble, the overpayment is reduced by the amount of the federal public benefit.2 The credit is still computed and still offsets tax. Only the excess is withheld. Nothing in the proposal carries the withheld amount to another year.

The fifth is verification and timing. The proposal relies on the taxpayer's declaration, backed by the penalties for false statements in sections 7206 and 7207 and 18 U.S.C. § 1001, and on post-filing examination. It does not set up a separate documentation or matching procedure. The rules would apply to taxable years ending on or after the date final regulations are published. They reach 2026 returns only if finalized by December 31, 2026. Comments were due October 5, 2026. A hearing was scheduled for October 14, 2026. The IRS cancelled it on October 9, 2026 because it received no requests to testify or outlines of topics. The rule remained proposed as of October 22, 2026.

⚠ **CAUTION: Read line 8 carefully: the test is whether *either* spouse is a citizen, national, or qualified alien. A mixed-status couple in which one spouse meets the test is eligible for the full refunded portion under the proposal. Software or an intake form that asks each spouse separately and requires both answers to be yes will get mixed-status joint returns wrong.**

B. Draft Schedule 3-A, line by line

The draft Schedule 3-A **(Form 1040)**, "Federal Public Benefit," is dated June 24, 2026, and was posted August 20, 2026. It carries attachment sequence number 3A and attaches to Form 1040, 1040-SR, 1040-NR, or 1040-SS. A caution at the top limits it to returns that claim the earned income credit, the additional child tax credit,

1 REG-119882-25, preamble, 91 Fed. Reg. at 53816 (one joint filer suffices).

2 Prop. Treas. Reg. § 1.23-2(d); REG-119882-25, preamble, 91 Fed. Reg. at 53816 (overpayment reduced).

the refundable American opportunity credit, or the refundable adoption credit.1 It has two parts. Part I computes the federal public benefit, and Part II, line 8, asks the eligibility question. The line references below are to the draft 2026 Form 1040 created August 19, 2026, and the draft 2026 Schedule 2 created April 27, 2026. Draft line numbers often change before release. Check every reference against the final forms.

Table 9. Draft Schedule 3-A, Part I (Form 1040 filers)

Line	What the draft asks	What it captures
1a	Amount from Form 1040, line 32a	Line 32a adds lines 27a (EIC), 28 (ACTC), 29 (refundable AOC), 30 (refundable adoption credit), and 31 (Schedule 3, line 15)
1b	Amount from Form 1040, line 31	Other refundable credits and payments from Schedule 3, line 15
2	Subtract line 1b from line 1a	The four covered refundable credits only
3	Amount from Form 1040, line 24a	**Total tax:** tax after nonrefundable credits (line 22) plus Schedule 2, line 21
4	Amount from Schedule 2, line 20	**Section B of Schedule 2:** "additional employment and other taxes" (e.g., Form 4137 tip FICA, Form 8919 FICA, household employment taxes)
5	Subtract line 4 from line 3	Tax the covered credits must offset first; on the draft, this includes SE tax and NIIT, which sit in Section A
6	**If line 2 is more than line 5, subtract:** this is the federal public benefit. If not, enter **-0-** here and on Form 1040, line 32b, and stop	The refunded portion

Lines 3 through 5 match the regulation's definition. On the April 2026 draft of Schedule 2, **Section** A, "Additional Income Taxes," includes self-employment tax **(line 4)** and the net investment income tax **(line 6)** and is totaled on line 15. **Section** B, "Additional Employment and Other Taxes," begins with Social Security and Medicare tax on unreported tips **(line 16a)** and uncollected tax on wages **(line 16b)** and is totaled on line 20. Subtracting line 20 removes the non-subtitle-A taxes, so the covered credits are measured against subtitle A tax only. Self-employment tax stays in line 5. A self-employed parent therefore has a smaller refunded portion than a wage earner with the same income tax. This reading comes from the draft forms and the proposed definition. Confirm it against the final forms and instructions.

The draft is also built around the overpayment, not the refund itself. Withholding and estimated payments appear nowhere in Part I. A client whose withholding exceeds his or her tax can still have a federal public benefit, because the benefit is the covered credit in excess of tax, not the refund.

Table 10. Draft Schedule 3-A, lines 7 and 8

Line	What the draft asks	Effect of each answer
7	"Do you want to receive your federal public benefit?"	**Yes:** go to line 8. No: stop; enter line 6 on Form 1040, line 32b (the benefit is given up)
8	"Are you or your spouse a U.S. citizen, U.S. national, or qualified alien? See instructions."	**Yes:** enter **-0-** here and on Form 1040, line 32b (benefit received). No: enter line 6 here and on Form 1040, line 32b (benefit withheld)

On the draft Form 1040, line 32b carries the Schedule 3-A amount. Line 32c subtracts line 32b from line 32a, and line 33 adds line 32c to withholding and estimated payments to arrive at total payments. The amount on line 32b therefore reduces total payments, and so reduces the refund dollar for dollar. Line 7 lets a household give up the benefit without answering line 8. The draft does not explain why a taxpayer would choose that, and the instructions, which were not yet available, may address it.

⊗ **WARNING: The draft Form 1040 status question and Schedule 3-A line 8 apply different tests, to different people, with different consequences. The Form 1040 question, in the "Other Information"**

1 I.R.S., Draft 2026 Schedule 3-A (Form 1040) (created June 24, 2026) (draft; line references subject to change).

area, asks whether "you, and your spouse if filing jointly," are each a citizen, national, or "an alien lawfully authorized to work in the U.S." Every filer answers it. Schedule 3-A line 8 asks whether "you or your spouse" is a citizen, national, or "qualified alien," and only filers with a positive line 6 reach it. A spouse can truthfully answer yes to the first and no to the second. Holders of employment authorization in several categories that do not appear in 8 U.S.C. § 1641(b) are in that position.

C. Who is a qualified alien

For Schedule 3-A purposes, the qualified-alien categories are those in 8 U.S.C. § 1641(b). They are **(1)** a lawful permanent resident; **(2)** an asylee; **(3)** a refugee; **(4)** an alien paroled into the United States for at least one year; **(5)** an alien whose deportation or removal is being withheld under the specified provisions; **(6)** an alien granted conditional entry under the pre-1980 provision; **(7)** a Cuban or Haitian entrant as defined by statute; and **(8)** an individual who lawfully resides in the United States in accordance with a Compact of Free Association **(8 U.S.C. § 1641(b)**(8)). The list is narrower than "lawfully present" or "authorized to work." A nonimmigrant worker, a student, or a holder of Temporary Protected Status may be lawfully present and authorized to work without being a qualified alien.

The proposed regulation cross-references subsection **(b)** of section 1641 only. **Section** 1641(c) separately treats certain battered spouses and children as qualified aliens for purposes of PRWORA's benefit restrictions. The proposal does not say whether that treatment applies here, and this text takes no position. The proposed regulatory text also does not mention PRWORA's other exceptions and waiting-period rules. Eligibility under the proposal turns on status, and the declaration is the taxpayer's.

PRACTICE POINTER: Do not decide a client's immigration category. A preparer can explain the question, give the client the statutory list, and record the client's answer. Whether a particular document or pending application places someone in a category is a question for immigration counsel. Ask a referral source before the season, not on April 14.

D. Exercise: the Herrera household

This exercise can be worked in small groups or as a class. The Herreras are tied to the recurring clients: Mateo is a machinist at Hollis Fabrication, and Sofia is a stylist at Lena Kowalski's salon. Like the other clients, they are composites.

Facts. Mateo and Sofia Herrera file jointly for 2026. Both are resident aliens for tax purposes under the substantial presence test, and both have SSNs valid for employment. Each holds an employment authorization document based on Temporary Protected Status. Neither has applied for any other status. They have three children, ages 3, 6, and 9. All three were born in the United States and have SSNs. Mateo's Form W-2 from Hollis shows $52,000 of wages and no overtime. Sofia's Form W-2 from the salon shows $24,000 of wages, including $6,000 of cash tips reported in Code TP. Sofia also received $800 of cash tips in December that she did not report to Lena, and she reports them on Form 4137. Federal income tax withheld totals $1,900. The Herreras have no other income and take the standard deduction. Sofia's occupation is on the tipped-occupation list, and the salon is not a specified service trade or business.

Tasks. First, compute the Herreras' 2026 taxable income, tax, child tax credit, and additional child tax credit. Second, confirm that they have no earned income credit. Third, complete draft Schedule 3-A, lines 1a through 6. Fourth, determine the refund under each answer to lines 7 and 8. Fifth, answer the draft Form 1040 status question for each spouse, and explain why the answer can differ from the line 8 answer. Sixth, list what the preparer should do, and should not do, in the interview.

WORKPAPER: Herrera: 2026 income tax and child credits (joint), solution

```
Tax from the draft 2026 Tax Table (Aug. 28, 2026); see Part I.
Wages (52,000 + 24,000, incl. Code TP 6,000)                  76,000.00
Unreported tips (Form 4137)                                      800.00
AGI / MAGI                                                    76,800.00
Standard deduction (joint)                                   (32,200.00)
Tips deduction: 6,000 + 800 = 6,800 (< 25,000; no phase-out)  (6,800.00)
Taxable income                                                37,800.00

Tax: draft 2026 Tax Table, row 37,800-37,850 (joint)           4,043.00
Child tax credit: 3 x 2,200 = 6,600
  Nonrefundable portion (limited to tax)                      (4,043.00)
  Line 22 (tax after nonrefundable credits)                        0.00
Remaining credit: 6,600 - 4,043                                2,557.00
ACTC = least of 2,557; 3 x 1,700 = 5,100;
  15% x (76,800 - 2,500) = 11,145                              2,557.00
EIC: AGI 76,800 exceeds the 2026 completed phase-out
  for joint filers with 3+ children (70,244)                       0.00
Schedule 2: Form 4137 tip FICA, 7.65% x 800 (Sec. B, line 16a)    61.20
Form 1040, line 24a (total tax): 0.00 + 61.20                      61.20
```

WORKPAPER: Herrera: draft Schedule 3-A and the refund, solution

```
Tax from the draft 2026 Tax Table (Aug. 28, 2026); see Part I.
Line 1a  Form 1040, line 32a (ACTC only)                       2,557.00
Line 1b  Form 1040, line 31                                        0.00
Line 2   1a - 1b                                               2,557.00
Line 3   Form 1040, line 24a                                      61.20
Line 4   Schedule 2, line 20 (tip FICA)                           61.20
Line 5   3 - 4                                                    0.00
Line 6   Line 2 > line 5: federal public benefit               2,557.00

Line 8 "Yes" (either spouse citizen/national/qualified alien)
  Form 1040, line 32b                                              0.00
  Payments: 1,900.00 + 2,557.00                                4,457.00
  Refund: 4,457.00 - 61.20                                     4,395.80

Line 7 "No" or line 8 "No" (Herreras as stated: TPS only)
  Form 1040, line 32b                                          2,557.00
  Payments: 1,900.00 + (2,557.00 - 2,557.00)                   1,900.00
  Refund: 1,900.00 - 61.20                                     1,838.80

Difference in refund                                           2,557.00

Common error: skipping line 4 (5 = 61.20)
  2,557.00 - 61.20 = 2,495.80 benefit                  <- understated
```

Debrief points. The benefit equals the entire additional child tax credit, $2,557, because the child tax credit already brought the Herreras' income tax to zero. The $4,043 of the credit that offset tax is not affected. Their $1,838.80 refund of withholding is not affected either. Only the part of the credit in excess of tax is conditioned. The $61.20 of tip FICA is an employment tax, outside subtitle A. Line 4 takes it out so that it does not reduce the benefit. A preparer who leaves out line 4 will compute $2,495.80. On the Form 1040 question, each spouse would answer yes, because each is lawfully authorized to work. On Schedule 3-A line 8, the answer on these facts would be no if the proposal is finalized as drafted, because Temporary Protected Status is not one of the categories in 8 U.S.C. § 1641(b). Status is tested on the date the taxpayer files the return that first claims the credit. If either spouse is a lawful permanent resident on that date, line 8 is yes for the whole joint return; becoming one after that return is filed does not cure the claim.12 The Okafors make a useful comparison. Their child tax credit is fully absorbed by tax, so line 2 is zero, and they stop at line 6 whatever their status.

1 Prop. Treas. Reg. §§ 1.24-3(e), 1.23-2(f)(4) (Example 4), REG-119882-25 (FR Doc. 2026-16985, Aug. 20, 2026) (PROPOSED).

2 8 U.S.C. § 1641(b)(1) (LPR); REG-119882-25, preamble (one joint filer suffices).

Figure 1. For the Herreras, draft Schedule 3-A turns the whole $2,557 additional child tax credit (ACTC) into a "federal public benefit"

Draft Schedule 3-A (simplified layout; draft form): Herreras, 2026

1a	ACTC (Form 1040, line 32a)	**2,557.00**
1b	Form 1040, line 31	**0.00**
2	Line 1a − line 1b	**2,557.00**
3	Total tax (Form 1040, line 24a)	**61.20**
4	Schedule 2, line 20 (tip FICA)	**61.20**
5	Line 3 − line 4	**0.00**
6	Federal public benefit	**2,557.00**

Common error: skip line 4, so line 5 = 61.20 and the benefit shows $2,495.80.

Line 6 = the entire $2,557 ACTC.

Line 8 "Yes": refund $4,395.80. Line 7 or 8 "No" (TPS only): refund $1,838.80. Difference $2,557.00.

Line numbers are from the draft and can change.

Source: Draft 2026 Schedule 3-A **(DRAFT)** and the refundable-credit proposal **(PROPOSED)**. Figures from the Herrera solution workpapers, Part XIV.D. Simplified layout; line numbers can change. TPS means temporary protected status.

CAUTION: The exercise applies proposed regulations and draft forms that may change or never take effect. Under the proposal's applicability rule, the result reaches the Herreras' 2026 return only if the regulations are finalized by December 31, 2026. If they are not, the Herreras' 2026 refund is $4,395.80 under current law, and Schedule 3-A does not apply. Teach the exercise as preparation, not as the 2026 answer. It is not an instruction to withhold or deny a refundable credit. Before preparing a return, confirm the regulations' status and the final forms and instructions, record the client's own representations about immigration status, and refer the client for qualified immigration advice when those representations call for a legal judgment.

E. Where Schedule 3-A fits in the interview

The paid-preparer due-diligence rules under section 6695(g) already govern three of the four credits Schedule 3-A covers: the earned income credit; the child tax credit, additional child tax credit, and credit for other dependents; and the American opportunity credit. Head-of-household status is covered too. The refundable adoption credit is not. The preparer must complete and submit Form 8867, compute the credit or keep the computation worksheet, meet the knowledge requirement by making reasonable inquiries when information appears incorrect, inconsistent, or incomplete. Retain the records for three years from the latest of the return due date **(without extensions)**, the date the return was filed electronically or presented to the taxpayer for signature, or, for a nonsigning preparer, the date it was submitted to the signing preparer **(Treas. Reg. § 1.6695-2(b)**(4)(ii)). The penalty applies per failure, per credit, at the inflation-adjusted amount in Rev. Proc. 2025-32.

In practice, the steps fit into the existing interview in the following order. Compute the four covered credits first, as now, and complete Form 8867 for the credits it covers. Then compute Schedule 3-A lines 1a through 6. If line 6 is zero, the status question on Schedule 3-A never arises, and the interview proceeds as before. If line 6 is positive, show the client the amount at stake, read the line 7 and line 8 questions as printed, and give the client the statutory categories. Record the client's own answers and the date. If anything in the file contradicts an answer, ask about it and document the response. A prior-year answer, a document the client provided, or

the client's own statement would each be grounds for asking. Do not collect immigration documents the return does not require. Status information the client gives for return preparation is subject to the preparer disclosure and use restrictions of sections 6713 and 7216. **Section** 6103 separately governs returns and return information held by the IRS. Handle the information under the firm's written information security plan **(WISP)** like any other sensitive data.

PRACTICE POINTER: For practices with many mixed-status households, run the line 6 computation on last year's returns now, to see how many clients have a positive federal public benefit and how much is at stake. Schedule the conversations early. A client who learns in February that $2,557 of an expected refund may be withheld needs time to understand the rule and, if appropriate, to consult immigration counsel. That conversation should not happen at the signature appointment.

XV. PREPARING RETURNS WHEN AUTHORITY IS UNSETTLED

Many 2026 positions rest on something less than a statute or final regulation. Examples are the specified-service-business transition for tips, the reliance provisions of the remittance-tax proposed regulations, interim notices under sections 168(k) and 168(n), and Form 1040 instructions that conflict with a regulation. The standards for those positions have not changed. Under section 6694(a), a preparer is subject to penalty for an understatement due to an unreasonable position. A position that is not disclosed is unreasonable unless there is substantial authority for it. A disclosed position is unreasonable unless it has a reasonable basis. A tax shelter or reportable transaction requires a reasonable belief that the position is more likely than not correct. The penalty is the greater of $1,000 or 50 percent of the income derived from the engagement. For willful or reckless conduct under section 6694(b), it rises to the greater of $5,000 or 75 percent. Circular 230 section 10.34(a) separately bars a practitioner from willfully, recklessly, or through gross incompetence signing a return that contains a position lacking a reasonable basis or an unreasonable position under section 6694(a)(2). That disciplinary standard is not the same test as the section 6694 penalty.

Proposed regulations count as authority for substantial-authority purposes. So do revenue rulings, revenue procedures, and notices published in the Internal Revenue Bulletin, and, with less weight, IRS information and press releases. FAQs, publications, and form instructions do not. Counting as authority is not the same as establishing substantial authority. The weight of the supporting authorities must be substantial in relation to the weight of contrary authorities, judged by relevance, persuasiveness, and type of document **(Treas. Reg. § 1.6662-4(d)**(3)(i)–(ii)). Whether a fact sheet is an information release is not settled. A position consistent with a proposed regulation therefore has authority behind it, although proposed regulations carry less weight than final ones. A position that departs from a form instruction but follows the regulation also has authority behind it. The instruction is not authority on the other side, though the IRS will process the return according to its instructions. The difficult cases arise when the IRS's administrative position and the regulation point in different directions. Then the practitioner is weighing authority against an administrative position the IRS will enforce. Tomas Reyes's self-employed tips computation in Part III.F shows a narrower case. The regulation does not decide the question, and the IRS instructions fill the gap with an administrative position the IRS will enforce.

Consider the preparer's exposure on one of these positions. Assume the final 2026 Schedule 1-A instructions keep the IRS computation. Tomas Reyes's return nonetheless claims the full $6,800 of tips without subtracting the self-employment adjustments. For this illustration, assume the preparer has no reasonable basis for that position after evaluating the authorities; the example does not decide the allocation question discussed in Part III.F. The preparer charged $600 for the return. If the IRS disallows the $1,029.86 excess and asserts a section 6694(a) penalty, the penalty would be the greater of $1,000 or 50 percent of the $600 fee, which is $1,000. That is more than the fee and about eight times the client's tax at stake. Disclosure would not help. Adequate disclosure on Form 8275 lowers the standard from substantial authority to reasonable basis, but only for a position that has a reasonable basis, which is a significantly higher standard than merely arguable. The remaining defense is reasonable cause and good faith under section 6694(a)(3).

XVI. FILING, REFUND DELIVERY, AND PENALTY RELIEF

A. Automatic exemption from penalty

Starting in the summer of 2026, the IRS automatically exempts eligible taxpayers from certain penalties, without a request, under a new administrative procedure called Automatic Exemption from Penalty **(AEP)**. The penalties

covered are failure to file under sections 6651(a)(1), 6698(a)(1), and 6699(a)(1); failure to pay under sections 6651(a)(2) and **(a)**(3); and failure to deposit under section 6656. They are covered when assessed on an eligible return. The test resembles first-time abatement. AEP is applied at original return processing. For each of the prior three years, or twelve quarters for a quarterly filer, the taxpayer must have filed the same return type or IRS records must show no requirement to file. No penalty other than the estimated tax penalty may have been assessed for those periods unless it was abated for reasonable cause or IRS error. A penalty removed by AEP, first-time abatement, or tolerance does not count as a clean year. On a joint return, both spouses must meet the history test. The original return must be filed within three years of its original due date; an extension does not enlarge that window. Employment-tax returns must also meet additional deposit-waiver and Electronic Federal Tax Payment System **(EFTPS)** criteria. AEP is not unlimited. Once it is granted on a return, that return type is not eligible again until three more consecutive years, or twelve quarters, of timely filing and payment are established.

AEP applies to eligible original returns for tax year 2025 and for 2026 quarterly returns, and to later returns. First-time abatement ends for eligible original returns due on or after January 1, 2027. It remains available for tax year 2024, quarters in 2025, and earlier periods. It also remains available for tax year 2025 and 2026 quarterly returns that did not receive AEP consideration. Because AEP began in summer 2026, not every 2025 return or 2026 quarterly return will receive AEP consideration; a taxpayer who receives a penalty notice can request first-time abatement. Information-return penalties are not covered. Under Internal Revenue Manual **(IRM)** 20.1.1.3.3.2.6, AEP may be granted manually only when an IRS error, such as a system limitation, a return posted to the wrong TIN or period, or a missed math error, kept an otherwise qualifying return from receiving it.1 AEP rests on no statute, regulation, or revenue procedure. It is administrative only, and the IRS can change it the same way.

WORKPAPER: Lena Kowalski: 2025 Form 1040 filed late; AEP screen

```
2025 return due April 15, 2026; filed July 20, 2026 (no extension)
Balance due with return                                    8,000
Failure to file, 6651(a)(1): 5% per month or part
  Months or parts late: Apr 16 - Jul 20 = 4 (part counts)
  Gross FTF: 4 x 5% x 8,000                                1,600
Failure to pay, 6651(a)(2): 0.5% per month or part
  4 x 0.5% x 8,000                                           160
  FTF reduced by FTP for overlapping months (6651(c)(1)):
  1,600 - 160                                              1,440
Penalties before relief: 1,440 + 160                       1,600

AEP screen
Prior three years clean (2022-2024)? assumed yes
Filed within 3 years of original due date? yes
-> eligible, but filed during the transition: confirm
   AEP on the transcript (TC 971 AC 996) or CP95
Interest on the 8,000 under 6601: not abated by AEP
```

AEP addresses the penalty but not the interest. **Section** 6601 interest on the late payment runs from April 15, 2026, until paid, and generally cannot be abated for reasonable cause. Interest on the penalty itself goes away when the penalty does.2 Lena's case also changes a strategy. Under first-time abatement, practitioners often saved the waiver for a larger penalty in a later year. AEP is applied when the return posts, so there is no choice about when to use it, and once it is granted the return type is ineligible until three more clean years are established. Reasonable cause is still worth documenting where the facts support it. A penalty abated for reasonable cause leaves the history clean; one removed by AEP or first-time abatement does not. If Lena's transcript shows the penalties were assessed, the request is first-time abatement, available for 2025 returns that did not receive AEP consideration, or reasonable cause.

⚠ **CAUTION: AEP depends on IRS systems reading the account correctly. Check the client's transcript after the return posts: an unreversed TC 971 with action code 996, or a CP95 notice, shows AEP was granted. If penalties were assessed, manual AEP is available only where an IRS error kept a qualifying**

1 IRM Procedural Update SBSE-20-0626-0643 (June 17, 2026), adding IRM 20.1.1.3.3.2.5 (Automatic Exemption from Penalty Administrative Relief) and 20.1.1.3.3.2.6 (Manually Grant Automatic Exemption from Penalty - IRS Error) (ADMIN).

2 I.R.C. §§ 6601(a), (e)(2)(A), 6651(a)(1)–(2), (c)(1).

return from receiving AEP. Otherwise, for a 2025 return or 2026 quarter that did not receive AEP consideration, request first-time abatement, or reasonable cause.

B. Penalty relief options compared

AEP has not replaced the other forms of penalty relief. It sits alongside them, and the right request depends on the penalty, the period, and the facts. Table 11 compares the options. The full eligibility and transition rule is stated in Part XVI.A.

Table 11. Penalty relief options for 2026

Option	Covers	Request needed?	Authority
Automatic Exemption from Penalty (AEP)	FTF, FTP, FTD on eligible returns for TY2025, 2026 quarters, and later	No (automatic); manual AEP for IRS error	IRM 20.1.1.3.3.2.5-.6 (ADMIN)
First-time abatement (FTA)	Same penalties, for TY2024, 2025 quarters, and earlier, and later returns not given AEP consideration; ends for returns due on or after Jan. 1, 2027	Yes	IRM 20.1.1.3.3.2.1 (ADMIN)
Reasonable cause	Most penalties with a reasonable-cause defense in the statute, including information-return penalties	Yes, with facts	e.g., I.R.C. §§ 6651(a), 6724(a); Treas. Reg. § 301.6651-1(c)
Statutory exception or correction	Information returns corrected within the statutory windows; de minimis errors	Often self-executing	I.R.C. § 6721(b)-(c)
Reliance on IRS written advice	Penalty attributable to erroneous written advice from the IRS	Yes	I.R.C. § 6404(f)
Disaster postponement	Penalties and interest for postponed periods	Varies	I.R.C. § 7508A

The IRM citation for first-time abatement and the reasonable-cause regulation are given for orientation. Confirm the current IRM section numbers, which changed when the AEP provisions were added in June 2026.

C. Refunds without paper checks: CP53E

How a response works. The IRS's CP53E page tells the taxpayer to sign in to, or create, an IRS Online Account, open the "Add bank account" notification, and enter the account. The account must be in the taxpayer's own name or a joint account the taxpayer shares. A taxpayer without a bank account is pointed to prepaid debit cards and mobile payment applications. The limited exceptions for a paper check are requested through the same Online Account. In May 2026 the IRS added FAQs confirming that a taxpayer may not use an account belonging to a family member or friend. As reported, the FAQs also say the taxpayer has only one opportunity to update the bank information. The Government Accountability Office reported that the IRS had sent about 4.2 million CP53E notices as of early May 2026. That counts notices, not taxpayers. The National Taxpayer Advocate's count of about four million as of April 27, 2026, includes multiple notices on one return, such as to the taxpayer, the spouse, and the return preparer. The National Taxpayer Advocate reported a median recipient AGI of $52,527, with about 62 percent of recipients at $75,000 or less. As of March 30, 2026, the IRS had granted 300,537 exceptions to the electronic payment requirement.[1] **The practical consequence is that the client, not the practitioner, has to respond, although a representative designated on the return may receive a copy and can prompt the client. A client who has never created an Online Account, or who cannot get through identity verification, may need more than 30 days. Tell every client to answer within the 30 days the notice gives.**

1 GAO-26-109074, 2026 Filing Season: Preliminary Observations on IRS Performance, at 7 (July 23, 2026); National Taxpayer Advocate, Fiscal Year 2027 Objectives Report to Congress, Preface at 5 & n.17, at 12 & n.7 (June 24, 2026); TIGTA, Rep. No. 2026-IE-R015, at 3-4 (Sept. 14, 2026).

FS-2026-02 does not address a response that arrives between day 31 and day 42. A client who has not responded by six weeks will receive a paper check.

The IRS CP53E page gives 30 days from the notice date to respond and says a paper check will issue after about six weeks if the taxpayer does not respond. The calendar below runs both periods from the notice date.

WORKPAPER: CP53E calendar (periods run from the notice date)

CP53E notice dated	Mar. 2, 2027
Practitioner check: client has the notice (day 7)	Mar. 9, 2027
Practitioner check: account entered online (day 21)	Mar. 23, 2027
End of 30-day response window	Apr. 1, 2027
Paper check issued after about six weeks (42 days) if no response, about six weeks after the notice	Apr. 13, 2027

PRACTICE POINTER: Add three items to the 2026 return checklist. First, verified routing and account numbers for every refund return, for an account in the client's own name. Second, whether the client has a working IRS Online Account, set up before filing, so a CP53E can be answered in minutes and within 30 days. Third, for a client with no bank account, a prepaid card, credit-union account, or mobile payment option chosen before filing, or a documented reason for an exception. Confirm bank numbers against a voided check or bank letter, not from memory. Remind clients that the practitioner cannot receive the refund for them; section 10.31 forbids it.

XVII. PAID FAMILY AND MEDICAL LEAVE BENEFITS

Rev. Rul. 2025-4 addresses the federal tax treatment of benefits paid under state paid family and medical leave programs. Its treatment of the recipient turns on the type of leave and on who funded the benefit. Family leave benefits are included in gross income and are generally reportable to the recipient on a Form 1099. Medical leave benefits attributable to employee contributions are excluded from gross income under section 104(a)(3). Medical leave benefits attributable to employer contributions are generally included in gross income and are treated as third-party sick pay.1

Notice 2026-6 extends through calendar 2026 the transition relief of Rev. Rul. 2025-4. The relief covers only the withholding, reporting, and employment-tax requirements for medical leave benefits attributable to employer contributions. It does not change the recipient's income tax treatment, and it does not cover an employer's "pick-up" of contributions the employee would otherwise owe.2 An employer in a state with a paid-leave program should confirm with its payroll provider how 2026 benefits and pick-up arrangements will be reported. For an individual client, sort the benefit first: family or medical leave and, for medical leave, employee-funded or employer-funded.

XVIII. LONG-TERM CARE DISTRIBUTIONS FROM RETIREMENT PLANS

SECURE 2.0 section 334 added section 401(a)(39), which lets a defined contribution plan make "qualified long-term care distributions" to pay premiums for certified long-term care insurance, and section 72(t)(2)(N), which exempts those distributions from the 10 percent additional tax. If the coverage is for the employee's spouse, the exemption applies only if the employee and the spouse file a joint return **(section 72(t)**(2)(N)(ii)). The distributions are not eligible rollover distributions for purposes of the direct-rollover, notice, and withholding rules of sections 401(a)(31), 402(f), and 3405 **(section 72(t)**(2)(N)(iii)). Notice 2026-33, published June 8, 2026, is the first guidance. It applies to distributions made after December 29, 2025. The distribution for a year may not exceed the least of three amounts: the premiums paid by or assessed to the employee during the year for the coverage, 10 percent of the participant's vested account balance, or a dollar limit. The notice gives the dollar limit as "$2,600, as adjusted for inflation for 2026." Qualified defined contribution plans **(including profit-sharing, stock-bonus, money-purchase, and 401(k)** plans), eligible 403(b) plans, and governmental 457(b) plans may offer the feature. But IRAs may not, and no plan has to. The distribution is still included in income, and it is not an eligible rollover distribution.

The insurer must furnish a long-term care premium statement under section 6050Z identifying the coverage as certified long-term care insurance and stating the premiums for the year. No distribution is a qualified long-term care distribution unless that statement has been filed with the plan; the issuer files it with the plan the employee

1 Rev. Rul. 2025-4; I.R.C. § 104(a)(3).

2 Notice 2026-6 (extends Rev. Rul. 2025-4 transition relief through 2026).

identifies. The issuer must first have filed its disclosure for the coverage product with the IRS. The plan may rely on the statement **(section 401(a)**(39)(E)(i), **(iii)**; Notice 2026-33, Q&A A-1 to A-3, A-6). The notice refers to the issuer's information return as Form 1099-LPS, which is a draft form. Confirm the form name and due dates against the final form and instructions. Plan amendments are due December 31, 2027, for most plans, with later dates for collectively bargained and governmental plans. The benefit to a participant is modest: avoiding the 10 percent additional tax on about $2,600 a year. It matters for a participant under age 59½ who pays long-term care premiums and has no better source of funds. Before advising a distribution, confirm that the plan has adopted the feature, because a distribution from a plan that has not adopted it gets no exception.

XIX. PUTTING IT TOGETHER

A. The Okafors' 2026 return

The examples in this text each took up one provision at a time. Part XIX.A combines the Okafors' deductions and credits on one simplified return.

WORKPAPER: Okafors: 2026 Form 1040, federal income tax (joint; simplified)

```
Tax from the draft 2026 Tax Table (Aug. 28, 2026); see Part I.
Wages (92,340 + 46,000) and interest (660)            139,000.00
Schedule C net profit (Derek)                           1,800.00
SE tax: 1,800 x 0.9235 x 0.153 = 254.33; half deducted    (127.17)
Educator expenses (Tanya; 62(a)(2)(D); of 910 paid)       (350.00)
AGI (no MAGI add-backs)                               140,322.83

Standard deduction (joint)                            (32,200.00)
Overtime deduction (Code TT)                           (5,400.00)
Car-loan interest (no phase-out below 200,000)         (2,940.00)
QBI: 20% x (1,800 - 127.17) = 334.57 -> 199A(i) min      (400.00)
Taxable income                                         99,382.83

Tax: draft 2026 Tax Table, row 99,350-99,400 (joint)   11,429.00
Child tax credit: 3 x 2,200                            (6,600.00)
Income tax after CTC                                    4,829.00
Plus self-employment tax                                  254.33

Effect of educator deduction (Tax Table):
  (11,471.00 at 99,700-99,750 without it - 11,429.00 = 42.00)
```

The child-credit computation runs as follows. Tentative income tax is $11,429. The maximum child tax credit is 3 x $2,200 = $6,600. The nonrefundable child tax credit used is the lesser of tentative tax and the maximum credit, which is $6,600. Unused child tax credit eligible for the additional child tax credit is $0, so the additional child tax credit is $0. Remaining income tax after the credit is $4,829. Self-employment tax is $254.33, for a total tax of $5,083.33 before withholding and payments. Even with three children, a new truck, and overtime, the Okafors still have a liability before withholding and payments after the child tax credit. The refundable portion of the credit therefore plays no part in their return, and neither does the proposed regulation discussed in Part XIV on refundable credits as a federal public benefit. The $400 minimum QBI deduction and the $2,940 of car-loan interest together are $3,340. Without them, taxable income would be $102,722.83. That is $100,000 or more, so the tax would come from the Tax Computation Worksheet: $102,722.83 x 22% - $10,576.00 = $12,023.02. The two items therefore reduce tax by $594.02 **($12,023.02 - $11,429.00)**, more than 12 percent of $3,340, because without them part of the income would be taxed at 22 percent. Of that, the minimum provision itself adds only $65.43 over the ordinary $334.57 QBI deduction. Without it, taxable income would be $99,448.26 and the Tax Table tax $11,435, so the minimum is worth $6. Tanya's $350 educator deduction saves another $42.00. These are small amounts. Confirm that the software applies the new QBI minimum and the educator rules.

B. Client summary

Table 12. Client summary: 2026 items

Client	2026 items and computed amounts	Watch points
Marisol Vega	Tips deduction $25,000 (Code TP $31,500 capped; $2,400 service charge excluded); federal income tax reduced $4,543	Service charges miscoded in TP; FICA unchanged; W-4 update
Okafors	Overtime deduction $5,400 (premium only; CBA daily premium excluded); car-loan interest $2,940; educator expenses $350; CTC $6,600; § 199A minimum $400; income tax after CTC $4,829; DPC $280/month (under $300 limit; assumes other HSA requirements met); no § 25D credit for January 2026 solar	Code TT must match; 1098-VLI not proof of qualification; Form 4547 pilot election; Tanya's $350 educator deduction (Pub. L. No. 119-111, effective 2026; confirm school definition and 900 hours)
Brennans	Senior deduction $8,640 at $178,000 MAGI ($9,360 with QCD); non-itemizer charity $2,000; gambling winnings fully taxed (no itemizing)	QCD timing; H.R. 10357 retroactivity; keep gambling records
Lena Kowalski	MIP $900 (itemized only); no PTC above 400% FPL, APTC repaid in full $9,600; § 45B credit $4,590; IDR discharge $22,000 taxable except to the extent insolvent	Consider amended 2025 for § 45B; mid-year Marketplace updates; insolvency worksheet

These amounts are simplified directional results from the worked examples, not final Form 1040, 1120-S, or 8962 results. Omitted: state taxes, NIIT, basis and at-risk limitations beyond those stated, and credits and deductions not discussed in the text.



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(05) Program # A5BAX-T-00144-26-I

Course Details	
Name of the CE Provider	AmData
Program name	**Reasonable Means Defensible:** S Corporation Compensation
IRS program number	A5BAX-T-**00144-26**-I
CE	2
Prerequisite	Basic understanding of individual income tax principles and joint tax filing. **Field of Study:** Taxes
Advanced Preparation	None
Program Level	Intermediate
Delivery Method:	Live in-person
Program Category:	Federal Tax Law Topics/Federal Tax Related Matters - A program designed to enhance professional knowledge in Federal Tax related matters.



ABSTRACT

An S corporation shareholder who works in the business, takes distributions, and runs no payroll is making a bet the federal courts have resolved against the taxpayer for more than three decades. This text first traces the "$0 salary" cases: *Radtke*, *Spicer*, and *Grey* and the six clients who followed Grey into Tax Court. It then covers the partial-salary valuation cases: *JD & Associates*, *Watson*, and the non-precedential but instructive *McAlary*. From there it turns to the practitioner's desk. It shows how to apply the three factors the *Dahl* court used to set a wage and how to build a "Many Hats" workpaper from free Bureau of Labor Statistics data. It explains what Circular 230 § 10.21 requires **(and does not require)** when a prior preparer created the problem, and how I.R.C. § 6694 can reach preparers responsible for an understatement. It closes with the two-track § 3509 rule that changes the arithmetic once an employment-tax examination is underway. The analysis is traced throughout the program through a single composite client, a one-truck owner-operator whose prior preparer filed two years of $0-salary returns, and is resolved in the final section.

This text addresses federal law only. Authorities current through October 23, 2026; date-sensitive items should be reconfirmed before live use. Composite clients are fictional.

Definitions:

- **Fact-Driven Education:** This program is focused on providing accurate, up-todate information about tax laws, regulations, and administrative updates as they stand today.
- **Non-Political Content:** All discussions are strictly factual and are not intended to express or imply any political opinions or preferences.
- **Commitment to Professionalism:** Our shared responsibility as tax professionals is to understand and apply the law, ensuring compliance and effective client representation.
- **Focus on Practice:** This program prioritizes practical, actionable knowledge to support your work, free from bias or interpretation beyond what the law provides.

The First Call

Travis Boudreaux came into the office on the second Tuesday of February 2026 with a banker's box, a cup of gas-station coffee, and a question he had clearly rehearsed in the truck. He wanted a new preparer for his company's 2025 return because his old one "got slow." The company is Boudreaux Hauling, Inc., a Gulf Coast corporation that owns one tractor and one dry-van trailer. Travis owns all of the stock and holds every officer title on the corporate minute page. He drives the truck, books his own loads on two freight boards, and changes his own oil and brake chambers. He keeps the books on a laptop at the kitchen table and files his own fuel-tax reports. He has a Class A commercial driver's license, fifteen years behind the wheel, and a clean safety record. Nobody else works for the corporation.

The banker's box told the rest of the story. The corporation elected S status effective January 1, 2023, and the IRS acceptance notice was in the box, unopened past the first page. The prior preparer had prepared the 2023 and 2024 Forms 1120-S. Both returns reported $0 on Line 7, Compensation of Officers. Each January, the prior preparer issued Travis a Form 1099-NEC from his own corporation for "contract driving": $30,000 for 2023 and $36,000 for 2024. Travis reported those amounts on a Schedule C and paid self-employment tax on them. Beyond the Form 1099-NEC amounts, the corporation distributed $62,000 to Travis in 2023 and $78,000 in 2024, reported on Schedule K-1. It also paid the $850 monthly note on Travis's personal pickup truck **($10,200 a year)**, which the books carried as "truck expense." For 2025 the general ledger showed gross receipts of $318,400, operating expenses of $175,800, and therefore $142,600 of ordinary business income before any payment to Travis. The $175,800 excludes every payment to or for Travis, including the $10,200 of 2025 pickup payments the books again carried as truck expense. He had taken $96,000 in distributions during 2025, so his 2025 receipts from the corporation were $106,200. No 2025 Form 1099-NEC had been issued yet, and he expected another one "like always."

Then came the rehearsed question: "My buddy at the truck stop says I don't have to pay myself a salary because I'm the owner. My cousin asked one of those AI apps and it said 40 percent of profit is safe. The old guy just did the 1099 thing. Do I really have to run payroll on myself? And if I do, how much?"

Every part of that question is answered by authority this text walks through. Whether Travis must take a salary is a statutory question with a settled answer. How much is a facts-and-circumstances question that courts have answered with a recognizable method. What the new preparer must say about the 2023 and 2024 returns is governed by Circular 230 § 10.21. Whether the new preparer can sign a 2025 return reflecting the same pattern is a § 6694 question. The IRS may open an employment-tax examination of the years the prior preparer handled. What happens then depends on a two-track rule in the Internal Revenue Manual that turns on whether a Form W-2 was ever issued. Travis's case is resolved in the final section, after each of those pieces is in place.

I. INTRODUCTION AND ROADMAP

A. Why This Program, and Why This Room

The S corporation is the entity of choice for a large share of the small businesses that walk into a storefront tax office. The appeal is easy to explain at the desk: profit that passes through on a Schedule K-1 is not subject to self-employment tax, while the same profit earned on a Schedule C is. The problem is equally easy to state. The owner who performs the services that produce the profit is, by statute, an employee of the corporation. Amounts paid to that owner for those services are wages no matter what the books call them. When the owner

takes distributions and runs no payroll, the corporation has an unfiled employment-tax liability that does not go away with the passage of a filing season.

This text is written for experienced preparers who are not enrolled agents **(EAs)**, certified public accountants **(CPAs)**, or attorneys. That audience matters in two ways. First, the preparer is usually the first professional to see the problem, often on a return the preparer did not prepare. Second, the preparer's own exposure differs from the client's. It arises under § 6694 for returns the preparer prepares or signs, and under Circular 230 for preparers who have consented to it through the Annual Filing Season Program. And an unenrolled preparer has limited or no authority to represent the corporation once an employment-tax examination begins. The text keeps both perspectives in view: what the client owes and why, and what the preparer must do to stay on the right side of the line.

B. What the Reader Should Be Able to Do

By the end of the program the reader should be able to explain why certain S corporation officers are employees. An officer who performs more than minor services for remuneration is an employee under I.R.C. §§ 3121(d)(1), 3306(i), and 3401(c). The reader should also be able to explain why the folklore ratios clients repeat have no legal footing. Second, the reader should be able to trace the case law from the $0-salary cases to the partial-salary valuation cases. Third, the reader should be able to apply the three *Dahl* factor groups and the "Many Hats" cost approach using free government wage data. Fourth, the reader should be able to apply Circular 230 § 10.21 and I.R.C. § 6694 to a client whose prior preparer filed $0-salary returns. Finally, the reader should be able to distinguish the examination in which I.R.C. § 3509 reduced rates apply from the one in which full rates apply. The reader should also know when to refer the matter to an EA, CPA, or attorney.

A word on terms. FICA is the Federal Insurance Contributions Act tax on wages, made up of OASDI **(old-age, survivors, and disability insurance, commonly called Social Security)** and Medicare hospital insurance. SECA is the Self-Employment Contributions Act tax, the self-employed counterpart to FICA. FUTA is the Federal Unemployment Tax Act tax. FITW is federal income tax withholding. AdMT is the 0.9 percent Additional Medicare Tax. TFRP is the Trust Fund Recovery Penalty under § 6672. QBI is qualified business income under § 199A. AFSP is the IRS Annual Filing Season Program. Other acronyms **(OEWS, BLS, SOC, O*NET, OOH, MSA, TIGTA, CIP)** are defined where they first appear.

Caution: Federal Scope Only

This text addresses federal law. A corporation that has never run payroll is usually not registered as an employer with its state, and state withholding, unemployment insurance, and workers' compensation obligations follow their own rules and penalty regimes. Those obligations are real and can exceed the federal exposure in some states, but they are outside the scope of this program. Check the client's state before advising on any catch-up filing.

II. WHY THE SHAREHOLDER MUST TAKE A SALARY

A. The Self-Employment Tax Spread That Drives the Behavior

The client's motive is arithmetic. A sole proprietor pays self-employment tax on net earnings from self-employment.1 The rate is 12.4 percent for OASDI up to the annual contribution and benefit base and 2.9 percent for Medicare with no cap.2 The base is $176,100 for 2025 and $184,500 for 2026. On earnings exactly at the base, the combined OASDI and Medicare tax is $26,943.30 for 2025 and $28,228.50 for 2026, assuming no other wages; Medicare continues above the base.3 An additional 0.9 percent Medicare tax applies to earnings above $200,000 for single and head-of-household filers, $250,000 for joint filers, and $125,000 for married individuals filing separately.4

1 I.R.C. § 1402(a) (defining net earnings from self-employment); I.R.C. § 1401(a)–(b) (imposing SECA tax).

2 I.R.C. § 1401(a) (12.4% OASDI); I.R.C. § 1401(b)(1) (2.9% hospital insurance).

3 Soc. Sec. Admin., Contribution and Benefit Base, https://www.ssa.gov/oact/cola/cbb.html; 90 Fed. Reg. 49047 (Nov. 3, 2025).

4 I.R.C. § 1401(b)(2) (self-employment income); I.R.C. § 3101(b)(2) (wages).

An S corporation shareholder's share of corporate income is a different animal. It passes through to the shareholder under § 1366 and is not net earnings from self-employment.1 Wages paid to the shareholder as an employee are subject to FICA at the same combined 15.3 percent rate, but only on the wages. The employer pays 7.65 percent, and 7.65 percent is withheld from the employee.2 The less the corporation calls wages, the less FICA anyone pays. That is the entire temptation, and it is why the question is never really "salary or no salary." It is "how small a salary can the facts support?"

Workpaper 1. The Spread Travis Is Trying to Capture (2025 Figures, Simplified)

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Ordinary business income before any payment to Travis ......  $142,600

If Travis were a sole proprietor (Schedule C):
  Net SE earnings  $142,600 x 92.35% ......................  $131,691.10
  SE tax           $131,691.10 x 15.3% .....................   $20,148.74
  (Below the $176,100 2025 OASDI base; no AdMT at this level.)

If Boudreaux Hauling pays $0 wages (the client's plan):
  FICA ..................................................        $0.00

Spread the client believes he is capturing ..................   $20,148.74

Conclusion: the spread is the motive. Section II.B explains why the
$0 column is not available to a working officer.
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"SE tax" in Workpaper 1 is the SECA tax described above. The 92.35 percent factor reflects the statutory deduction in computing net earnings from self-employment.3 Workpaper 1 deliberately omits income tax, the deduction for one-half of self-employment tax, and § 199A; it isolates the payroll-tax spread the client is chasing. Unless an example says otherwise, assume no wages from another employer, no other self-employment income, and no other income affecting the Additional Medicare Tax threshold. Apply the stated combined FICA rates only to wages within the Social Security wage base. The employer's $200,000 Additional Medicare withholding threshold is separate from the employee's filing-status-based tax threshold.4

Clients sometimes point to prominent people who used S corporations to limit payroll tax. In 2012, Accounting Today, quoting tax attorney Bob McKenzie, reported that a former Speaker of the House paid himself a salary of $420,000 from his S corporation. According to that report, he distributed about $2.4 million of profit to himself. The 2.9 percent Medicare tax on $2.4 million would be roughly $69,600.5 A former senator's S corporation arrangement drew similar commentary in 2004.6 Whatever one thinks of those structures, the debate was about Medicare tax on profit above a substantial salary. The storefront client is in a different posture entirely: $0 or a token wage against six figures of distributions, with the full OASDI component in play.

B. The Statutory Hook: Corporate Officers Are Employees

The answer to Travis's first question begins with three statutes that use nearly identical words. For FICA purposes, "the term 'employee' means— **(1)** any officer of a corporation; or **(2)** any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee."7 The common-law test asks whether the business has the right to direct and control the worker, both as to the result and as to the details and means of the work.8 The FUTA definition adopts § 3121(d), with

1 I.R.C. § 1366(a)(1); Rev. Rul. 59-221, 1959-1 C.B. 225.
2 I.R.C. § 3101(a)–(b)(1) (employee share); I.R.C. § 3111(a)–(b) (employer share).
3 I.R.C. § 1402(a)(12) (deduction equal to one-half of the combined SECA rate applied to net earnings).
4 I.R.C. §§ 1401(b)(2), 1402(b)(1), 3101(b)(2), 3102(f)(1).
5 Newt Gingrich's Tax Payments Questioned, Accounting Today (Jan. 23, 2012).
6 Kip Dellinger, Edwards's S Corp.: The Beat Goes On, 105 Tax Notes 253 (Oct. 11, 2004) (letter to the editor).
7 I.R.C. § 3121(d)(1)–(2).
8 Treas. Reg. § 31.3121(d)-1(c)(2).

exceptions not relevant here.1 And for income tax withholding, "[t]he term 'employee' also includes an officer of a corporation."2

The word "or" in § 3121(d) does real work. The officer prong and the common-law prong are alternatives. An officer who performs services for remuneration is an employee whether or not the common-law control factors would point that way. The Third Circuit put it plainly in a case arising from the *Grey* audits discussed in Part III: "**Section** 3121(d) defines employee by using the disjunctive 'or' between subparagraphs **(1)** and **(2)**. Thus, an individual may qualify as an employee under either set of circumstances."3 The Internal Revenue Manual **(IRM)** instructs examiners in the same terms: for corporate officers, "[t]he common law standard is not applicable."4

This is why the "I'm the owner, not an employee" argument fails at the threshold. Ownership is not the test. Office is. Travis is the president of Boudreaux Hauling, Inc., and he performs essentially all of its services.

C. The Narrow Minor-Services Exception

The regulations carve out one exception, and its structure matters. "Generally, an officer of a corporation is an employee of the corporation. However, an officer of a corporation who as such does not perform any services or performs only minor services and who neither receives nor is entitled to receive, directly or indirectly, any remuneration is considered not to be an employee of the corporation."5 The exception has two elements joined by "and." The officer must perform no services or only minor services, and the officer must receive no remuneration. The Manual tells examiners that "[t]he officer must meet both requirements to be excepted from employee status."6

A working owner fails the first element by working. Distributions, draws, and personal expenses paid by the corporation usually supply the remuneration that defeats the second. Payments on a documented, bona fide shareholder loan may not, which is why examiners look at every payment.3 The Manual directs examiners to "[e]xamine all payments to the officer, such as amounts labeled as draws, loans, dividends, or other distributions."8 Travis drove roughly 1,900 hours in 2025 and took $106,200 out of the corporation in distributions and pickup payments. He fails both elements, and he needs to fail only one.

D. Who Is an Officer, Including in an LLC Taxed as an S Corporation

For a state-law corporation, officer status is a matter of state corporate law and the corporation's own governing documents. The Form 1120-S instructions say so directly: "The corporation determines who is an officer under the laws of the state where it is incorporated."9 A limited liability company **(LLC)** that has elected to be taxed as an S corporation raises a practical wrinkle. Its operating agreement may designate managers or officers, or it may say nothing. A member who runs the business and performs its services should expect employee treatment. Officer status follows state law and the governing documents, and the common-law test in § 3121(d)(2) applies independently of the officer prong.10 Do not rely on an operating agreement that omits officer titles.

E. There Is No Safe Harbor, and the Folklore Has No Authority

The IRS has said in writing that there is no formula. "There are no specific guidelines for reasonable compensation in the Code or the Regulations. The various courts that have ruled on this issue have based their determinations on the facts and circumstances of each case."11 That sentence disposes of every ratio a client brings to the desk.

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1 I.R.C. § 3306(i) (adopting the § 3121(d) definition, other than paragraphs (3)(B)–(C) and (4)).
2 I.R.C. § 3401(c).
3 Nu-Look Design, Inc. v. Commissioner, 356 F.3d 290 (3d Cir.), cert. denied, 543 U.S. 821 (2004).
4 IRM 4.23.5.7.3(1) (Nov. 22, 2017).
5 Treas. Reg. § 31.3121(d)-1(b); see also Treas. Reg. § 31.3306(i)-1(e) (FUTA); Treas. Reg. § 31.3401(c)-1(f) (income tax withholding).
6 IRM 4.23.5.7.3(2) (Nov. 22, 2017).
3 Scott Singer Installations, Inc. v. Commissioner, T.C. Memo. 2016-161, slip op. at 11, 14; see Part III.E.
8 IRM 4.23.5.7.3(4) (Nov. 22, 2017).
9 Instructions for Form 1120-S (2025), Line 7, Compensation of Officers (rev. Jan. 15, 2026).
10 I.R.C. § 3121(d)(1)–(2); Nu-Look Design, 356 F.3d 290 (disjunctive test).
11 IRS Fact Sheet FS-2008-25, Wage Compensation for S Corporation Officers (Aug. 2008).

Table 1. Compensation "Rules" Clients Repeat, and What Authority Supports Them

Client says	What it really is	Authority for it
"60/40" (or 50/50, or 67/33) split of profit between salary and distributions	Practitioner folklore and vendor marketing	None. No statute, regulation, ruling, IRM provision, or reported decision adopts a ratio.
"Pay yourself the Social Security wage base"	A number that changes every year ($176,100 for 2025; $184,500 for 2026)	None. It is neither a floor nor a ceiling, and for many small businesses it exceeds the entire profit.
"A percentage of gross sales (or net profit) is industry standard"	An unsupported rule of thumb	None. FS-2008-25 lists "the use of a formula" as a factor to examine, not a safe harbor.
"The AI app said 40 percent is safe"	A generated number with no source	None, and the method is its own problem (Part V.J).

The ninth factor on the IRS's own list deserves a precise reading. FS-2008-25 lists "the use of a formula to determine compensation" among the factors courts have considered.1 That factor asks whether the corporation set pay by a formula and what the formula was. It is not an endorsement of arbitrary ratios, and a 60/40 split chosen because it sounds balanced is exactly the kind of formula an examiner will discount.

F. The IRS Has Already Warned the Client, Several Times

The position that "dividends" paid in place of salary are wages is older than most of the people in the room. In Revenue Ruling 74-44, two shareholders of a small business corporation who performed services arranged to draw no salary. Instead, they had the corporation pay them "dividends" roughly equal to what they would have received as reasonable compensation. The IRS treated the payments as wages for FICA, FUTA, and withholding purposes. The IRS has restated that holding in plain terms: "An S corporation cannot avoid employment taxes merely by paying the corporate shareholder 'dividends' in lieu of reasonable compensation for services performed."2

The client has also seen the rule on paper, whether or not he read it. The Form 1120-S instructions state: "Distributions and other payments by an S corporation to a corporate officer must be treated as wages to the extent the amounts are reasonable compensation for services rendered to the corporation."3 The IRS acceptance notice for an S election **(Notice CP-261)** outlines the corporation's obligations for compensation paid to shareholder-employees and, citing Revenue Ruling 74-44, warns: "We may re-characterize distributions paid to a shareholder as salary." The Manual also tells examiners not to assume the notice arrived: "The examiner must verify the taxpayer received the Notice."4 Travis's CP-261 was in the banker's box. The practitioner who is trying to persuade a skeptical client can do worse than to hand the client his own acceptance notice and ask him to read the paragraph aloud.

Practice Pointer: Show the Client the Paper He Already Has
When a client insists that "nobody ever told me," pull the S election acceptance notice (CP-261) and the current Form 1120-S instructions for Line 7. Put copies in the file with a dated note that the client was shown them. The note serves two purposes: it moves the conversation from opinion to the IRS's own words, and it documents the advice you gave, which matters under Circular 230 § 10.21 (Part VI).

The narrow family-member rule in § 1366(e) is sometimes cited as "the reasonable compensation statute" for S corporations. It is not the source of the officer-wage requirement. **Section** 1366(e) allows the IRS to reallocate income among family members when one renders services or furnishes capital to the corporation without reasonable compensation.5 The officer-wage requirement comes from the employment-tax definitions in § 3121(d), § 3306(i), and § 3401(c), not from Subchapter S.

1 FS-2008-25, supra (listing nine factors, the last being "use of a formula to determine compensation").
2 Rev. Rul. 74-44, 1974-1 C.B. 287; IRS Info. Ltr. 2003-0026 (Jan. 7, 2003).
3 Instructions for Form 1120-S (2025), supra, Line 7.
4 IRM 4.23.5.7.3.2 (Nov. 22, 2017).
5 I.R.C. § 1366(e).

The current IRS web pages on S corporation compensation say that reasonable compensation should be paid before non-wage distributions are made.1 Read that as a statement of employment-tax risk rather than a state corporate-law prohibition on distributions. If an officer takes distributions in place of reasonable wages, the IRS will recharacterize the service-related portion as wages, and the recharacterization will not exceed what the shareholder actually received. As FS-2008-25 puts it, "[t]he amount of the compensation will never exceed the amount received by the shareholder either directly or indirectly."2

III. THE "$0 SALARY" CASES: FROM RADTKE AND SPICER TO GREY

A. Why a $0 Salary Is a Predictable Loss

When a working officer takes no wages at all, employee status can be settled without a wage survey. The government needs to show that the officer performed more than minor services and received remuneration. Once those two facts are established, the officer is an employee, and the remaining question is how much of what the officer received is attributable to services. That amount can still require valuation, even when no Form W-2 was issued; *McAlary* **(Part IV.F)** is an example. In the cases that follow, the taxpayers lost on classification, often on summary judgment **(a decision without trial because no material fact was genuinely in dispute)**, without a battle of salary surveys. The lesson for the desk is that a $0-salary officer is fighting the classification question first, and on these facts that fight is usually lost. The practitioner who frames the client conversation as "the IRS might think your salary is a little low" has already understated the problem.

B. Joseph Radtke, S.C. v. United States

Joseph Radtke was an attorney who incorporated his Wisconsin law practice and elected S status. He was the sole incorporator, sole director, sole shareholder, and only full-time employee. His employment contract with his own corporation set his salary at zero. In 1982 he devoted all of his working time to the firm's clients, drew no salary, and withdrew $18,225 in board-declared "dividends." He paid income tax on the dividends but no FICA or FUTA.3

The district court granted summary judgment to the government. It reasoned that a sole director who arranged for the corporation to pay its only significant employee nothing for substantial services could not relabel the compensation: his "dividends" functioned as remuneration for employment.4 The Seventh Circuit affirmed, describing the payments as "clearly remuneration for services."5 Substance controlled over form, and no wage survey was needed. Notice how small the dollars were. The amount was $18,225, and the government litigated it to an appellate decision. The size of the client is not a defense.

C. Spicer Accounting, Inc. v. United States, and Dunn & Clark

Mackey Spicer was a licensed public accountant, and Spicer Accounting, Inc. was owned equally by Spicer and his wife. Spicer was president, treasurer, and a director. He was the corporation's only accountant and the only person who could sign returns and perform audits, and he worked approximately thirty-six hours per week, more during tax season. He had no written employment contract, testified that he "donated" his services to the corporation, took no salary, and withdrew the earnings as dividends. At trial he testified that hiring a replacement accountant would cost $16,000 to $17,000 a year.6

The Ninth Circuit affirmed the government's judgment. An officer who performs substantial services is an employee under § 3121(d) and the regulations, regardless of how the payments are labeled or whether the officer intends to donate the services. The court said so directly: "We agree with the court in *Joseph Radtke,*

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1 IRS, S Corporation Compensation and Medical Insurance Issues (last reviewed Mar. 3, 2026), https://www.irs.gov/businesses/small-businesses-self-employed/s-corporation-compensation-and-medical-insurance-issues.

2 FS-2008-25, supra.

3 Joseph Radtke, S.C. v. United States, 712 F. Supp. 143 (E.D. Wis. 1989), aff'd per curiam, 895 F.2d 1196 (7th Cir. 1990).

4 Radtke, 712 F. Supp. at 145.

5 Radtke, 895 F.2d at 1197.

6 Spicer Accounting, Inc. v. United States, 918 F.2d 90, 92–93 (9th Cir. 1990).

S.C. v. United States, that a corporation's sole full-time worker must be treated as an employee."1 The court also rejected relief under **Section** 530 of the Revenue Act of 1978, holding that the corporation had no reasonable basis for treating its only full-time accountant as a non-employee.2

Two features of *Spicer* recur. First, the owner's own testimony about replacement cost became the floor of the analysis. A client who says "I could hire somebody to do this for $X" is giving evidence. Second, Spicer owned only half the stock. A second shareholder does not dilute the officer-employee rule. The point was confirmed a few years later when two attorney-shareholders of an Idaho firm who took no wages and withdrew "dividends" lost on summary judgment under *Spicer* and *Radtke*.3

D. The "1099 Yourself" Strategy: Grey and Grey's Clients

Some owners try a different route around payroll. Instead of calling the payments dividends, they have the corporation issue the owner a Form 1099 as if the owner were an independent contractor. This is the strategy Travis's prior preparer used, and it has a well-documented history.

Joseph M. Grey was the sole shareholder and president of an accounting firm organized as an S corporation, and he performed its accounting and tax work. Rather than receive wages, he had the corporation pay him fees reported on Form 1099-MISC. The Tax Court held in a reported opinion that, as a corporate officer performing substantial services, Grey was a statutory employee. Here that term means an employee by force of the officer rule in **§** 3121(d)(1), not the separate occupational category of statutory employees in **§** 3121(d)(3) that is flagged in Box 13 of Form W-2. The court also held that the payments were wages subject to FICA and FUTA and that **Section** 530 relief was unavailable. The Third Circuit affirmed, and the Supreme Court denied certiorari, meaning it declined to hear the case; a denial is not an endorsement of the lower court's reasoning.4

Grey had advised clients to use the same structure, and the IRS examined them too. The clients came from different industries, and their cases were decided by the Tax Court in a series of opinions. Every taxpayer in Table 2 lost.

Table 2. Grey's Clients in the Tax Court

Case	Industry	Result and note
Veterinary Surgical Consultants, P.C. v. Commissioner, 117 T.C. 141 (2001), aff'd sub nom. Yeagle Drywall Co. v. Commissioner, 54 F. App'x 100 (3d Cir. 2002)	Veterinary surgery	Sole shareholder-officer surgeon; reported no wages. Held a statutory employee; the court rejected the non-wage label as disguising what the payments were. Section 530 relief denied.
Mike J. Graham Trucking, Inc. v. Commissioner, T.C. Memo. 2003-**49**, aff'd, 93 F. App'x 473 (3d Cir.), cert. denied, 543 U.S. 821 (2004)	Trucking	President and 60% owner drew funds as needed; no Form W-**2** or Form 1099 issued to him. Payments held wages.
Superior Proside, Inc. v. Commissioner, T.C. Memo. 2003-**50**, aff'd, 86 F. App'x 510 (3d Cir.), cert. denied, 543 U.S. 821 (2004)	Siding installation	Working officer took distributions and no wages. Held wages.
Specialty Transport & Delivery Services, Inc. v. Commissioner, T.C. Memo. 2003-**51**, aff'd, 91 F. App'x 787 (3d Cir. 2004)	Transport and delivery	Working officer took distributions and no wages. Held wages.

1 Spicer, 918 F.2d at 95.

2 Spicer, 918 F.2d at 95; see Revenue Act of 1978, Pub. L. No. 95-600, § 530, 92 Stat. 2763, 2885–86, as amended.

3 Dunn & Clark, P.A. v. United States, 853 F. Supp. 365 (D. Idaho 1994), aff'd, 57 F.3d 1076 (9th Cir. 1995) (unpublished table decision).

4 Joseph M. Grey Pub. Accountant, P.C. v. Commissioner, 119 T.C. 121 (2002), aff'd, 93 F. App'x 473 (3d Cir.), cert. denied, 543 U.S. 821 (2004).

Case	Industry	Result and note
Nu-Look Design, Inc. v. Commissioner, T.C. Memo. 2003-52, aff'd, 356 F.3d 290 (3d Cir.), cert. denied, 543 U.S. 821 (2004)	Home improvement	**Published Third Circuit opinion:** the officer prong of § 3121(d) stands on its own.
Water-Pure Systems, Inc. v. Commissioner, T.C. Memo. 2003-53, aff'd, 93 F. App'x 473 (3d Cir.), cert. denied, 543 U.S. 821 (2004)	Water purification	Officer drew funds as needed; K-1 distributions; Forms 1099-MISC for 1997–98; no W-2. Held wages.

Sean McAlary Ltd. **(Part IV.F)** is another $0-W-2 case, but one that reached valuation; it is nonprecedential under § 7463(b). The *Mike J. Graham Trucking* facts are worth a closer look for this program because Travis is a trucker. Graham was the president of a Pennsylvania trucking corporation and held 60 percent of the stock, with family members holding the rest. He drew money from the corporation as he needed it, and no Form W-2 or Form 1099 was issued to him.1 The Tax Court treated the draws as wages. Nothing about trucking, siding, home improvement, delivery, or water treatment changed the analysis. Reasonable compensation is not a rule for doctors, lawyers, and CPAs only. *Grey* and its companion cases treated working officers as employees whether they were paid through Forms 1099, K-1 draws, or no information return at all.

Warning: A Form 1099 to the Owner Is Not a Middle Ground
Issuing a Form 1099-NEC (or, in older years, Form 1099-MISC) from the corporation to its own working officer does not convert the officer into an independent contractor. The officer prong of § 3121(d)(1) applies regardless of common-law status, and the *Grey* line of cases rejected the structure across six industries. If you see a Form 1099 from an S corporation to its own president in the client's file, treat it as an unreported-wage problem, not as a compensation plan.

E. Disguised Wages: "Loans" and Their Repayment

When the dividend label and the Form 1099 label both fail, the next label is often "loan." In *Glass Blocks Unlimited v. Commissioner*, the sole shareholder and president of an S corporation that distributed glass blocks worked full time and reported no wages. He moved money into and out of the corporation in 2007 and 2008, while the corporation reported net income of $877 and $8,950. He argued that the money he took out was a tax-free repayment of loans he had made to the corporation. There were no promissory notes, no interest, no repayment schedule, and no collateral. The Tax Court found "that the transfers in question were capital contributions and not bona fide loans," and sustained the treatment of the corporation's payments to him of at least $30,844 and $31,644 as wages.2

Documentation can change the result. *Scott Singer Installations, Inc. v. Commissioner* involved the sole shareholder-officer of a recreational vehicle **(RV)** parts and service corporation. He had advanced personal funds to the corporation over several years, recorded on the books as shareholder loans. Those advances were made while the business was profitable and repayment was reasonably expected. When the business later suffered losses and paid his personal expenses with no wages, the Tax Court treated payments that reduced the earlier, bona fide loan balance as loan repayments rather than wages. The IRS acquiesced in the result only, signaling disagreement with the reasoning.3 *Singer* prevailed despite having no promissory notes, interest charges, or maturity dates; other objective evidence established the debt and the repayments.4 The IRS's Paying Yourself page discusses loans by a corporation to an officer. For shareholder advances to the corporation, document the actual debtor-creditor relationship and the reasonableness of repayment expectations.5

Travis's file has a version of this problem in a different costume. The corporation paid his personal pickup note and booked it as a business expense. This text assumes those payments were remuneration for Travis's

1 Mike J. Graham Trucking, Inc. v. Commissioner, T.C. Memo. 2003-49.
2 Glass Blocks Unlimited v. Commissioner, T.C. Memo. 2013-180.
3 Scott Singer Installations, Inc. v. Commissioner, T.C. Memo. 2016-161, action on dec., 2017-04 (Apr. 10, 2017) (acq. in result).
4 Scott Singer Installations, T.C. Memo. 2016-161.
5 IRS, Paying Yourself (last reviewed May 8, 2026), https://www.irs.gov/businesses/small-businesses-self-employed/paying-yourself.

services, not repayment of any debt the corporation owed him. On that assumption the payments are remuneration. As Part VII explains, an unreported personal expense paid by the corporation lands in a more expensive rate bracket under § 3509 than a payment reported on a Schedule K-1.

F. Management Companies and Other Relabeling

Blossom Day Care Centers, Inc. v. Commissioner involved a married couple who were the only officers of an S corporation operating a group of child-care centers near Tulsa, Oklahoma, from 2005 through 2008. They worked long weeks supervising a staff of more than ninety employees. The operating corporation paid them no wages, issued them no Forms 1099, and paid a separate corporation the couple controlled, Hacker Corp., which paid them modest wages. The IRS determined additional officer wages of $209,200, $220,210, $231,800, and $244,000 for the four years. The Tax Court sustained those amounts because the taxpayer failed to carry its burden of proof. It also sustained failure-to-deposit and accuracy-related penalties, and it held that "wages paid by Hacker Corp. do not offset reasonable compensation requirements" for the officers' services to the operating corporation. The court also noted that the corporation "has submitted no evidence of a management agreement, either written or oral, with Hacker Corp."1

The burden-of-proof point is the practical lesson. The IRS's wage figure was sustained in full because the taxpayer offered nothing better. A practitioner who has built a contemporaneous wage workpaper **(Part V)** has given the client something to offer.

In *Ward*, the law firm argued that payments to its officer were partnership draws or dividends. The court treated them as wages and denied **Section** 530 relief. The firm had filed Forms 941, which showed awareness of its employment-tax obligations.2

G. What the $0-Salary Cases Teach About Travis

Map Travis onto the cases and the answer to his first question is not close. He is the corporation's president and only worker, like Radtke and Spicer. He has been paid through a Form 1099 from his own corporation, like Grey and Water-Pure. He drives a truck, like Mike Graham. Part of his remuneration came as a personal expense booked as a business deduction, the kind of indirect payment the Manual tells examiners to find. **Section** 530 is not a realistic escape. The Manual tells examiners that taxpayers "will have difficulty satisfying the reasonable basis requirement" in officer cases, and the courts in *Spicer*, *Grey*, and *Veterinary Surgical Consultants* denied it.3 Whether Travis must take a salary is settled. The open question, and the subject of Parts IV and V, is how much.

IV. THE PARTIAL-SALARY CASES AND THE THREE DAHL FACTORS

A. From "Whether" to "How Much"

Once a corporation issues its officer a Form W-2, it has conceded employee status. The dispute moves from classification to amount. The Manual reflects the shift procedurally. Where a Form W-2 was issued, "there is no controversy under IRC 7436 because the issue is only the amount of reasonable compensation subject to employment taxes." The exceptions are cases in which the taxpayer raises **Section** 530 or claims the payments were for non-employee services.4 The cases in this Part are about amount. They are also where the method for setting a defensible wage comes from.

B. The Inversion: Why C Corporation Cases Point the Wrong Way

Most of the famous reasonable-compensation cases are not S corporation cases at all. They are C corporation cases about the deduction for compensation. **Section** 162(a)(1) allows a deduction for "a reasonable allowance for salaries or other compensation for personal services actually rendered." The regulations describe reasonable compensation as "only such amount as would ordinarily be paid for like services by like enterprises under like circumstances."5 In a C corporation, the owner wants a large salary because salary is deductible and dividends

1 Blossom Day Care Ctrs., Inc. v. Commissioner, T.C. Memo. 2021-86; see also T.C. Memo. 2021-87 (companion income tax case).

2 Ward v. Commissioner, T.C. Memo. 2021-32, slip op. at 8. No valuation analysis.

3 IRM 4.23.5.7.3(5) (Nov. 22, 2017).

4 IRM 4.23.5.7.3.1(5) (Nov. 22, 2017).

5 I.R.C. § 162(a)(1); Treas. Reg. § 1.162-7(b)(3).

are not; the IRS argues the salary is excessive, a disguised dividend. The factor lists that practitioners know by heart grew out of that posture.

Table 3. The Classic C Corporation Factor Cases (Background Only)

Case	Why it matters here
Mayson Mfg. Co. v. Commissioner, 178 F.2d 115 (6th Cir. 1949)	Origin of the classic multi-factor list (qualifications, nature and scope of work, size and complexity of business, comparison to gross and net income, economic conditions, comparison to distributions, prevailing rates for comparable positions, salary policy for all employees, prior compensation). Reversed for the taxpayer.
Elliotts, Inc. v. Commissioner, 716 F.2d 1241 (9th Cir. 1983)	Organized the factors into five categories, including an "independent investor" inquiry into return on equity. Reversed and remanded.
Exacto Spring Corp. v. Commissioner, 196 F.3d 833 (7th Cir. 1999)	Rejected the multi-factor test and held that an investor return well above expectation makes a high salary "presumptively reasonable." Reversed for the taxpayer.
Menard, Inc. v. Commissioner, 560 F.3d 620 (7th Cir. 2009)	Applied the *Exacto Spring* return-on-equity approach to a very large executive salary. Reversed for the taxpayer.
Clary Hood, Inc. v. Commissioner, T.C. Memo. 2022-15, aff'd in part, vacated in part, and remanded, 69 F.4th 168 (4th Cir. 2023)	Capped a large catch-up bonus; the Fourth Circuit vacated part of the accuracy-related penalty. Not authority for an S corporation officer wage, and not an endorsement of catch-up pay as a wage method.

In an S corporation the positions flip. The shareholder wants a small salary to minimize FICA, and the IRS argues the salary is inadequate. Factors that measure investor return need care in an S corporation, because high residual profit can reflect capital or employees rather than underpaid owner services. Use the factors, but apply them to the owner's actual services. In *Exacto Spring*, the Seventh Circuit reasoned that when investors earn a far higher return than expected, the executive's high salary is presumptively reasonable.1 *Exacto Spring* addressed an excessive-compensation deduction. It does not establish a minimum S corporation wage or a reverse presumption. A large residual profit is a reason to investigate the source of earnings, not proof by itself that salary was too low.

S corporation employment-tax cases still borrow the C corporation factors. The Eighth Circuit acknowledged as much in *Watson*, noting that while reasonable compensation usually arises as an income tax deduction issue, "the IRS finds the concept equally applicable to FICA tax cases."2 The factors come along; the direction of the argument does not.

C. JD & Associates, Ltd. v. United States (Dahl)

Jeffrey Dahl was a CPA with about twenty years of experience and the sole shareholder, president, and director of JD & Associates, Ltd., an accounting firm in Fargo, North Dakota, taxed as an S corporation. He hired and fired staff, paid bills, set fees, prepared the firm's tax returns, reviewed client returns his staff prepared, and kept the corporate records. For 1997 through 1999 he paid himself salaries of $19,000, $30,000, and $30,000 and took dividends of $47,000, $50,000, and $50,000.3

The court framed the analysis with factors drawn from Eighth Circuit precedent and grouped them, following an earlier Nebraska decision, into three categories: "(1) performance of the employee, **(2)** salary comparisons, and **(3)** company conditions."4 Those three groupings are what this text calls the *Dahl* factors. They are not exclusive and not a statute, but they are a usable organizing frame because each one maps onto evidence a practitioner can gather.

1 Exacto Spring, 196 F.3d at 839.

2 David E. Watson, P.C. v. United States, 668 F.3d 1008, 1017 (8th Cir. 2012).

3 JD & Assocs., Ltd. v. United States, No. 3:04-cv-59 (D.N.D. May 19, 2006) (findings of fact) (Doc. 45, filed June 5, 2006).

4 JD & Assocs., supra (citing Charles Schneider & Co. v. Commissioner, 500 F.2d 148 (8th Cir. 1974), and Trucks, Inc. v. United States, 588 F. Supp. 638 (D. Neb. 1984), aff'd, 763 F.2d 339 (8th Cir. 1985)).

Employee performance asks what the owner actually does: qualifications, experience, duties, hours, and personal responsibility for the firm's success. Salary comparisons ask what comparable businesses pay for comparable work, in the industry and in the local market, and what the firm pays its own non-owner employees. The court found that Dahl was "compensated slightly above" his employees and received no raise from 1998 to 1999 while every other employee did. Company conditions ask about size, complexity, revenue, profitability, and how the company compares to its peers. The government's valuation expert used published financial-ratio studies of accounting firms and North Dakota wage data to support his figures. The court concluded that "Dahl's compensation is not congruent to his performance," and entered judgment for the United States of $22,385.92 on its counterclaim.1

The precise compensation figures require care, because the opinion reports two sets of numbers and my prior materials reflect only one of them.

Table 4. JD & Associates: Two Sets of Figures in the Same Opinion

Year	W-2 salary	Dividends	IRS figure in findings table (salary + additional)	Additional wages in findings table (assessment basis)	Higher figure found reasonable (Finding 39; Conclusion 12)
1997	$19,000	$47,000	$61,817	$42,817	$69,584
1998	$30,000	$50,000	$63,672	$33,072 (arithmetic yields $33,672)	$79,823
1999	$30,000	$50,000	$65,582	$35,582	$79,711

Source: JD & Assocs., Ltd. v. United States, No. 3:04-cv-59 (D.N.D. 2006), findings of fact and conclusions of law. The court found the IRS's higher valuations reasonable and upheld the lower amounts on which the assessments rested; Conclusion 12 nonetheless labels the higher figures "amounts assessed," an internal inconsistency. The findings table contains a $600 discrepancy for 1998, which this text preserves rather than corrects.

Caution: Teaching Dahl From the Right Numbers

My earlier slide decks reported $42,817, $33,072, and $35,582 as the amounts reclassified. Those figures come from the opinion's findings table and are the bases of the assessments the court upheld, though the 1998 figure does not foot (the table's total less salary is $33,672). The court separately found the higher normalized figures ($69,584, $79,823, and $79,711), which are benchmark-adjusted compensation figures and not wages actually paid, to be reasonable salaries. Teach the method and the result, and show both sets only if numbers come up.

D. After Dahl: FS-2008-25, the Nine Factors, and the Three Sources of Gross Receipts

In August 2008 the IRS published a fact sheet that remains the most-cited administrative statement on the subject. In addition to stating that there is no formula, FS-2008-25 lists nine factors courts have used. The first three are training and experience; duties and responsibilities; and time and effort devoted to the business. The next three are dividend history; payments to non-shareholder employees; and timing and manner of paying bonuses to key people. The last three are what comparable businesses pay for similar services; compensation agreements; and the use of a formula to determine compensation.2 Every one of the nine fits inside one of the three *Dahl* groupings, which is one reason the three-group frame is useful at the desk.

The IRS's current web guidance adds an organizing question: "The key to establishing reasonable compensation is determining what the shareholder-employee did for the S corporation by looking to the source of the S corporation's gross receipts." The page identifies three sources: services of the shareholder, services of non-shareholder employees, and capital and equipment.3 Receipts generated by the owner's own work point toward wages. Receipts generated by employees the owner supervises, or by significant capital and equipment, can support distributions beyond the owner's wage **(though the owner's supervisory and management work**

1 JD & Assocs., supra (conclusions of law).
2 FS-2008-25, supra.
3 IRS, S Corporation Compensation and Medical Insurance Issues, supra.

is itself compensable). No statute, regulation, or case supplies a formula for splitting receipts among the three sources. Use the framework qualitatively, in prose, in the workpaper.

Apply it to Travis. Boudreaux Hauling's receipts come from hauling freight in one truck that Travis drives. The services-of-employees source is empty for 2025: the corporation has no other workers. The capital source is real. A tractor and trailer represent a significant investment, and a portion of freight revenue is a return on that equipment. That is the honest basis for Travis taking distributions on top of a wage. It is not a basis for taking no wage, because without Travis behind the wheel the truck earns nothing.

E. David E. Watson, P.C. v. United States

David Watson was a CPA with a bachelor's degree, an advanced degree, and about twenty years of experience in partnership taxation. He was the sole shareholder, president, director, and only employee of David E. Watson, P.C. **(DEWPC)**, an Iowa S corporation. DEWPC held a partnership interest in a West Des Moines accounting firm, Larson, Watson, Bartling & Juffer, LLP **(LWBJ)**, with more than $2 million in annual revenue. Watson worked full time for LWBJ through DEWPC. DEWPC paid him a salary of $24,000 in each of 2002 and 2003. Through DEWPC, Watson received $203,651 **(2002)** and $175,470 **(2003)** in profit distributions from LWBJ; after paying his salary and other expenses, DEWPC distributed its remaining cash to him as dividends.1

The government's valuation engineer started with a survey of accounting-practice compensation showing that a director-level accountant with no ownership interest in a comparable firm would earn about $70,000. Because owners billed at rates about 33 percent higher than non-owner directors, he adjusted upward to about $93,000, then adjusted down to $91,044 to account for non-taxable fringe benefits. The district court accepted $91,044 a year, and the Eighth Circuit affirmed.2

Workpaper 2. Watson by the Numbers

```
Survey compensation, non-owner director ....................  $70,000
Owner billing-rate premium   $70,000 x 1.33 ................  $93,100
  (the court described the result as "about $93,000")
Fringe-benefit adjustment (downward) to ....................  $91,044
Salary actually paid .......................................  $24,000
Reclassified to wages per year   $91,044 - $24,000 ..........  $67,044

2002 LWBJ profit distributions to DEWPC ..................... $203,651
Remainder after $91,044 wage   $203,651 - $91,044 ......... $112,607
  (55.3% of 2002 distributions, before DEWPC's other expenses)
2003 LWBJ profit distributions to DEWPC ..................... $175,470
Remainder after $91,044 wage   $175,470 - $91,044 ......... $ 84,426
  (48.1% of 2003 distributions, before DEWPC's other expenses)

Conclusion: the IRS won, and about half of each year's LWBJ
distributions still stayed outside wages.
```

Watson carries two lessons for the storefront client. First, the comparisons matter. The court described his $24,000 salary as "unreasonably low compared to other similarly situated accountants." It also contrasted that salary with the roughly $200,000 LWBJ distributed to his corporation. His qualifications, hours, and contributions to the firm mattered too.3 The second is that reasonable compensation is not all of the profit. Even after losing, about half of each year's LWBJ distributions to DEWPC remained outside wages, before DEWPC's other expenses. The client who refuses payroll because he believes "they'll make me take it all as salary" needs to see Workpaper 2.

Note also the direction of the fringe-benefit adjustment. The only adjustment the court accepted for fringe benefits ran downward. That is consistent with the way the Bureau of Labor Statistics wage data discussed in Part V is built: it measures straight wages, not employer benefit costs, so do not add a benefits percentage automatically.

F. Sean McAlary Ltd., Inc. v. Commissioner: A Teaching Case, Not a Precedent

McAlary is a small tax case, and that status controls how it may be used. A decision in a case conducted under the Tax Court's small tax case procedure "shall not be reviewed in any other court and shall not be treated as a

1 Watson, 668 F.3d at 1012–13.
2 Watson, 668 F.3d at 1013.
3 Watson, 668 F.3d at 1018.

precedent for any other case."1 It is included here for one reason: it shows, step by step, how a court applied an hourly government wage rate to an owner who wore several hats.

Sean McAlary was the president, secretary, treasurer, sole director, and sole shareholder of a Southern California real estate brokerage S corporation. In 2006 the corporation had gross receipts of $518,189 and net income of $231,454, and it transferred $240,000 to McAlary. It filed no Forms 941 or W-2. At trial, McAlary produced 2004 corporate minutes setting his remuneration at $24,000. The court was unpersuaded: the agreement "clearly was not the product of an arm's-length negotiation," meaning a bargain between independent parties each pursuing its own interest.2

The IRS's expert used the 2006 California wage survey for real estate brokers, which showed hourly rates of $32.99 at the 25th percentile, $48.44 at the median, and $64.28 at the 75th percentile. He multiplied the median by the standard full-time convention of 2,080 hours to reach $100,755. The court accepted the hourly architecture but not the median. McAlary performed a mix of tasks **(sales, recruiting, advertising, bookkeeping, and management)**, had limited experience as a broker, and ran a modest, commission-dependent operation. On those facts the court selected $40.00 an hour, between the 25th percentile and the median, and determined reasonable compensation of $83,200.3 The court described the exercise candidly: "Determining an employee's reasonable compensation is dependent upon a number of factors and is far from an exact science."4

Workpaper 3. McAlary's Hourly Arithmetic

```
IRS expert:   $48.44 (median) x 2,080 hours ............ $100,755.20
Court:        $40.00 (selected) x 2,080 hours .......... $ 83,200.00
Survey range: $32.99 x 2,080 = $68,619.20  to  $64.28 x 2,080 = $133,702.40
Payments received by McAlary in 2006 ................... $240,000.00
Remaining non-wage amount   $240,000 - $83,200 ......... $156,800.00

Conclusion: the court picked a point inside the survey range based
on documented facts about the owner's duties and experience.
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Warning: McAlary Is Not Precedent
When *McAlary* comes up in a file, a letter, or a presentation, say that it is a summary opinion that is not precedent under § 7463(b). Use it to illustrate method.

G. When a Low or Zero Wage Can Hold Up

The cases do not say every shareholder needs a large salary. They say that wages must follow services and remuneration, and some fact patterns legitimately support little or nothing.

The clearest is the shareholder who performs no services or only minor services and receives no remuneration, the regulatory exception in Part II.C. An often-cited district court decision, *Davis v. United States*, applied it in a two-owner corporation. One owner who did essentially nothing was held not to be an employee. The other, who worked roughly twelve hours a month, was an employee, although the court rejected the IRS's salary figure for that owner.5 The case is unpublished and fact-bound, and the practitioner should read the decision before relying on it.

Consider a composite contrast. Harold Pruitt owns 100 percent of two S corporations, each earning $200,000. The first is his solo law practice; every dollar of its revenue comes from his own legal work. He needs a substantial market wage from that corporation. The second owns a restaurant that employs a full-time general manager and a full-time chef on W-2 payroll, and Harold performs no services for it. Measured by services, his wage from the restaurant corporation can be zero, and its distributions are a return on capital. The same person, the same dollars of profit, and opposite answers, because the source of the receipts differs.

A second pattern is the year with no money out. Reclassified compensation will not exceed what the shareholder received directly or indirectly.6 Assume the shareholder received no actual or constructive payment **(compensation made available to draw, even if not withdrawn)** of cash or property, had no personal

1 I.R.C. § 7463(b).
2 Sean McAlary Ltd., Inc. v. Commissioner, T.C. Summ. Op. 2013-62, slip op. at 14.
3 McAlary, slip op. at 9 & n.6, 16.
4 McAlary, slip op. at 16.
5 Davis v. United States, 1994 U.S. Dist. LEXIS 10725 (D. Colo. July 15, 1994).
6 FS-2008-25, supra.

expenses paid, and had no compensation made available to draw. On those facts there is no payment to recharacterize. A corporate loss alone does not prevent wage treatment, and the example does not mean a working officer stops being an employee.

A third is the genuinely part-time owner. The IRS's valuation training material states that "[a]n employee is entitled to part-time compensation for part-time work."1 A semi-retired owner who works 500 documented hours a year while staff performs the rest is valued on 500 hours, not on a 2,080-hour convention. The operative word is documented.

V. SETTING AND DOCUMENTING A DEFENSIBLE WAGE

A. Three Valuation Approaches and the IRS Job Aid

In 2014 the IRS released a training document for its own valuation staff, the Reasonable Compensation Job Aid for IRS Valuation Professionals. Its status is stated on its face: "This Job Aid is not an official pronouncement of law, and cannot be used, cited, or relied upon as such."2 It is not authority for a return position. It is, however, a window into how an IRS valuation engineer will read the practitioner's file, and it describes three approaches.

The market approach compares the owner's pay with what comparable businesses pay a non-owner for the same position. It is the approach used in *JD & Associates* and *Watson*, and the Job Aid indicates that reconciliation across methods will generally rest heavily on it. It fits best when the owner performs one primary role. The income approach, often called the independent investor test, asks whether a hypothetical investor would be satisfied with the return left after the owner's compensation. It requires a reliable value for the business and carries the inversion problem described in Part IV.B, so it rarely fits a small service S corporation. The cost approach asks what it would cost to replace the owner's services by hiring people to perform each of the owner's distinct functions for the hours the owner actually spends on them. Practitioners call it the "Many Hats" approach. The Job Aid describes it as the least used by IRS valuators, but it is the most natural fit for the small business in which the owner does a little of everything.

Two sentences from the Job Aid govern every Many Hats calculation. The first: "It is inappropriate to add up market salaries of multiple positions on a full-time basis as this would distort the amount of total time actually worked."3 The second: "Reasonable Compensation is generally determined as a range rather than a specific number."4 The first forbids hat-stacking: adding together the full-time salaries of every role the owner touches. The second tells the practitioner what the workpaper should produce: a supportable range and a documented point within it.

B. Anatomy of a Many Hats Breakdown

My 2024 seminar materials walked through a sample breakdown for a small-business owner in Orange County, New York, working 2,080 hours a year. It produced annual reasonable compensation of $80,943, a blended rate of about $38.91 an hour. It is presented here as an illustration of structure only; the wage rates in it are from the report's own vintage and location and should not be reused.

Table 5. Sample Owner Time Allocation (Illustrative, 2,080 Hours)

Duty category	Share of hours	Share of pay (where reported)
Advertising, sales, and marketing	51%	32%
Management and supervision	25%	not reported
Accounting, finance, and bookkeeping	12% (250 hours)	12.31% ($9,961)
Computer and information technology	6% (125 hours)	7.42% ($6,010)
Human resources, compensation, and training	3%	not reported
Administrative, secretarial, and clerical	2%	not reported

1 IRS, Reasonable Compensation Job Aid for IRS Valuation Professionals § IV.2 (Oct. 29, 2014).

2 Reasonable Compensation Job Aid, supra (disclaimer). But cf. Mellencamp, J.C., *Authority Song*, on *Uh-Huh* (1983) ("I fight authority, authority always wins"), https://youtu.be/wsEwK69LXjQ.

3 Reasonable Compensation Job Aid, supra, § III.

4 Id. § V.

Duty category	Share of hours	Share of pay (where reported)
Janitorial, landscape, and maintenance	1%	not reported

Table 6. Drill-Down: Accounting, Finance, and Bookkeeping (250 Hours)

Task	Share of category	Hours	Hourly wage	Annual wages
Bookkeeper	37%	92.4	$26.70	$2,467
Payroll clerk	6%	15.0	$31.23	$468
Billing and invoice clerk	6%	15.0	$24.80	$372
Accountant	51%	127.3	$52.27	$6,654
Category total	100%	249.7	n/a	$9,961

Table 7. Drill-Down: Computer and Information Technology (125 Hours)

Task	Share of category	Hours	Hourly wage	Annual wages
Computer user support specialist	61%	76.1	$43.74	$3,329
Network technician	10%	12.5	$43.47	$543
Database administrator	29%	36.2	$59.05	$2,138
Category total	100%	124.8	n/a	$6,010

Tables 5 through 7 reproduce an illustrative 2024 practitioner report breakdown for teaching structure. Annual wages are rounded to the dollar from hours times rate. Hours are the controlling input; percentages are rounded. Category totals are sums of rounded rows. Remaining categories are omitted, so $80,943 is the report's total, not a figure reproducible from these tables. Do not reuse these rates; pull current data for the client's own area (Part V.C).

Look at what the structure does. An accountant's hourly rate applies only to the 127 hours the owner spends on accountant-level work, and a bookkeeper's lower rate applies to the 92 hours of bookkeeping. The total hours never exceed the hours the owner works.

The second rule is that the hours come from the client. The 2,080-hour figure is a convention **(40 hours times 52 weeks)** that government wage surveys use to convert hourly rates to annual figures. It is not a legal standard for how many hours an owner works. Use supported hours as an input. Explain any full-time convention, part-time adjustment, or overtime treatment. Hours times rate is a valuation method, not a statutory formula. In each case the hours need support: calendars, logs, appointment books, job tickets, or, in Travis's case, electronic logging device records that his truck already generates under federal hours-of-service rules.1 Courts can estimate in appropriate cases, but an estimate bears "heavily if it chooses upon the taxpayer whose inexactitude is of his own making."2

C. Free Government Wage Data: One Survey Behind Many Websites

The free wage data a storefront practitioner can use all traces to a single source: the Occupational Employment and Wage Statistics **(OEWS)** program of the U.S. Bureau of Labor Statistics **(BLS)**. OEWS is a federal-state survey of employers that publishes wage estimates for roughly 830 occupations, including the mean and the 10th, 25th, 50th **(median)**, 75th, and 90th percentiles, in hourly and annual terms. The current vintage at this writing is May 2025, released May 15, 2026.3

Three popular websites republish OEWS wages. O*NET OnLine **(onetonline.org)** is the most useful for matching duties to occupations because it publishes detailed task lists, and it displays the current OEWS wages by area. The Occupational Outlook Handbook **(OOH)** and the CareerOneStop salary finder also republish OEWS,

1 49 C.F.R. § 395.8(a)(1) (records of duty status kept by electronic logging device, subject to listed exceptions).

2 Cohan v. Commissioner, 39 F.2d 540, 544 (2d Cir. 1930) (opinion reads "bearing heavily").

3 U.S. Bureau of Labor Statistics, Occupational Employment and Wages—May 2025, News Release USDL-26-0725 (May 15, 2026), https://www.bls.gov/news.release/archives/ocwage_05152026.htm.

sometimes on an older vintage. Citing all three in a workpaper is citing the same survey three times. Cite OEWS, state the vintage, and use the other sites as tools.

OEWS fits the S corporation officer for a specific reason. Its employment counts include "salaried officers, executives, and staff members of incorporated firms" and exclude "the self-employed, owners and partners in unincorporated firms, household workers, or unpaid family workers."1 An S corporation officer on W-2 payroll is inside the surveyed population. OEWS wages are straight-time gross pay, which excludes overtime, non-production bonuses, and employer-paid benefits. Do not add a benefits percentage automatically. Compare cash to cash and benefits to benefits, and document the comparison.2

The data has four operating limits. Federal OEWS tables are published for the nation, the states, metropolitan statistical areas **(MSAs)**, and nonmetropolitan areas, not for counties. Industry-specific tables are national only, while area tables cover all industries, so no single federal table is both industry-specific and local; pick one and say why. Percentiles should not be averaged. BLS says so directly: "BLS does not recommend calculating averages of percentile wages."3 Finally, when a local cell is suppressed **("estimate not released")**, save a dated copy of the suppressed table, step up one geographic level **(area to state to nation)**, and say so in the workpaper.

D. Matching Duties to Occupations: The 2018 SOC

OEWS organizes wages by the 2018 Standard Occupational Classification **(SOC)**. Codes follow duties, not titles. An owner who calls himself "chief executive officer" **(CEO)** is coded by what he does. Federal statistical agencies assign each worker to a single code. The SOC manual expressly frees other users from that convention: it was "designed solely for statistical purposes," and "users may develop their own policies concerning workers that meet the definition of two or more occupations."4 That latitude belongs to the user; it is not IRS approval of any multi-code method. Under Coding Guideline 2, a worker in two or more occupations is coded in the occupation requiring the highest level of skill. If there is no difference in skill, the worker is coded in the occupation where the most time is spent.5 A sound workpaper records a primary code first and then shows the multi-code Many Hats split, citing frequently asked question **(FAQ)** 12.

Two coding rules matter for small businesses. Supervisors in Major Groups 13-0000 through 29-0000 generally share the code of the workers they supervise. Office and administrative support is Major Group 43-0000 and falls within the separate first-line-supervisor rules for Major Groups 33-0000 through 53-0000.6 The trade groups include construction, installation and repair, production, and transportation. For them, "[w]orkers in Major Groups 33-0000 through 53-0000 who spend 80 percent or more of their time performing supervisory activities are coded in the appropriate first-line supervisor category." Those below 80 percent "are coded with the workers they supervise."7 A working owner in a trade who spends most of the day on the tools is coded with the trade, not as a supervisor and certainly not as an executive.

The second rule follows from the first. The catch-all occupation 11-1021, General and Operations Managers, carries a national median hourly wage of $50.85, well above most trade and first-line supervisor codes, and it excludes first-line supervisors.8 Dropping a working trade owner into 11-1021 for all of his hours is title inflation. It produces a number the client cannot afford and the facts do not support.

E. A Five-Step Free Lookup Protocol

The steps below are presented in order because each depends on the one before it.

1 BLS, News Release USDL-26-0725, supra, Technical Note (Concepts), https://www.bls.gov/news.release/archives/ocwage_05152026.htm.

2 See U.S. Bureau of Labor Statistics, OEWS Frequently Asked Questions, https://www.bls.gov/oes/oes_ques.htm.

3 U.S. Bureau of Labor Statistics, OEWS Percentile Wages, https://www.bls.gov/oes/oes_perc.htm.

4 U.S. Office of Mgmt. & Budget, Standard Occupational Classification Manual, FAQ 12 (2018), https://www.bls.gov/soc/2018/soc_2018_manual.pdf.

5 SOC Manual, supra, Coding Guideline 2.

6 SOC Manual, supra, Classification Principle 4; id., Coding Guideline 5.

7 SOC Manual, supra, Coding Guideline 5.

8 O*NET OnLine, National Wages, 11-1021.00 (BLS May 2025 OEWS data), https://www.onetonline.org/link/localwages/11-1021.00.

The first step is to collect duties and hours from the client, in the client's words, with whatever records exist. If the corporation filed Form 1125-E, compare the stated time with the percentage of time devoted to the business reported there for the officer, and resolve any inconsistency before going further. Form 1125-E is required when total receipts are $500,000 or more.1 The second step is to match duties, not titles, to 2018 SOC codes using O*NET's task lists, identifying the primary code first and then any secondary codes, and applying the supervisory rules in Part V.D. The third step is to pull the OEWS wage table for the client's MSA **(or nonmetropolitan area)** for each code. Save a dated copy showing the vintage, area, and percentiles, and document any step-up for suppressed cells. The fourth step is to select a percentile for each duty, ordinarily within the 25th-to-75th band **(a practice convention, not a rule)**. Use the three *Dahl* groupings: what the owner brings **(performance)**, what the market pays **(comparisons)**, and what the business can support **(company conditions)**. Write down why each percentile was chosen. The fifth step is to compute hourly rate times documented hours for each duty in a spreadsheet and produce the range and the selected point. Compare the result with the wages actually reported on Form W-2, and preserve the whole package in the file.

Recordkeeping is not optional. Taxpayers must keep records sufficient to establish the amounts shown on any return.2 In an employment tax case the corporation generally bears the burden of proof. **Section** 7491(a) shifts the burden only for taxes imposed by subtitles A and B; employment taxes are in subtitle C.3 The workpaper is the evidence that carries that burden. It is a substantiation workpaper supporting the return, not an expert report, and it should not pretend to be one.

F. Worked Example: Travis's Many Hats Workpaper

Travis's interview, his electronic logs, his load-board history, and his kitchen-table books produced the following picture of 2025. He was on duty driving, loading, and unloading about 1,900 hours. He spent about 260 hours finding and booking loads and negotiating rates. He did his own routine maintenance **(oil changes, brake adjustments, tires, inspections)** for about 180 hours, sending major repairs to a shop. Bookkeeping, invoicing, and fuel-tax reporting under the International Fuel Tax Agreement **(IFTA)** took about 120 hours. General management **(insurance renewals, the lease with the carrier, permits, and compliance paperwork)** took about 80 hours. Total: 2,540 hours.

Because Travis has no employees, Coding Guideline 5 never comes into play. A statistical coder applying Guideline 2 would ask which of his occupations requires the highest skill, a judgment that could point to the mechanic or management code. For this workpaper, the code that governs most of his hours is 53-3032, Heavy and Tractor-Trailer Truck Drivers, and FAQ 12 permits the multi-code split. The other duties map to 43-5032 **(Dispatchers, Except Police, Fire, and Ambulance)**, 49-3031 **(Bus and Truck Mechanics and Diesel Engine Specialists)**, 43-3031 **(Bookkeeping, Accounting, and Auditing Clerks)**, and, for the small management slice, 11-1021. The rates below are national May 2025 OEWS figures used for classroom illustration; an actual file would use the client's MSA or nonmetropolitan area table, which may be higher or lower. Workpaper 4 is a classroom reconstruction prepared after the May 2025 OEWS release. A practitioner setting Travis's wage in February 2026 would use the most recent OEWS release then available and update it when the new data came out.4

Table 8. National May 2025 OEWS Hourly Wages Used in the Travis Example

SOC code and title	25th pct.	Median	75th pct.	Median annual
53-3032 Heavy and Tractor-Trailer Truck Drivers	$23.06	$28.19	$33.23	$58,640
43-5032 Dispatchers, Except Police, Fire, and Ambulance	$20.56	$24.20	$30.02	$50,340

1 Instructions for Form 1120-S (2025), supra, Line 7.

2 I.R.C. § 6001; Treas. Reg. § 1.6001-1(a).

3 I.R.C. § 7491(a)(1); see Blossom Day Care Ctrs., T.C. Memo. 2021-86 (sustaining IRS wage figures for failure of proof).

4 O*NET OnLine, National Wages for SOC 53-3032.00, 43-5032.00, 49-3031.00, 43-3031.00, and 11-1021.00 (BLS May 2025 OEWS data), https://www.onetonline.org (accessed Oct. 23, 2026).

SOC code and title	25th pct.	Median	75th pct.	Median annual
49-3031 Bus and Truck Mechanics and Diesel Engine Specialists	$24.30	$29.70	$36.29	$61,770
43-3031 Bookkeeping, Accounting, and Auditing Clerks	$20.92	$24.36	$29.55	$50,670
11-1021 General and Operations Managers	$34.77	$50.85	$80.42	$105,770

*Source: O*NET OnLine national wage pages republishing BLS OEWS May 2025 estimates. National figures are for illustration only.*

Percentile selection follows the *Dahl* groupings. For driving, Travis's fifteen years and clean record argue upward, while the one-truck scale of the business argues down; the median is a defensible midpoint. Booking loads on public freight boards is routine dispatch work, so the dispatcher median fits. His maintenance is routine preventive work by an uncertified mechanic, which supports the 25th percentile. The kitchen-table bookkeeping and fuel-tax reporting support the 25th percentile for bookkeeping clerks. The management slice is valued at the 25th percentile of 11-1021 because a one-person company with no staff sits at the bottom of the range that code covers. That is a judgment, and a practitioner could reasonably substitute a lower-paid code for some of those hours. The management rate is used here as an analogy for the identified management functions, not as a claim that Travis's one-person business literally matches the full statistical occupation.

Workpaper 4. Boudreaux Hauling, Inc.: Officer Compensation, 2025 (Illustrative)

```
Duty (SOC)                  Hours   Pct.    Rate      Amount
Driving (53-3032)           1,900   50th   $28.19   $53,561.00
Load booking (43-5032)        260   50th   $24.20   $ 6,292.00
Maintenance (49-3031)         180   25th   $24.30   $ 4,374.00
Bookkeeping/IFTA (43-3031)    120   25th   $20.92   $ 2,510.40
Management (11-1021)           80   25th   $34.77   $ 2,781.60
                            -----                   ----------
Total                       2,540                   $69,519.00

Sensitivity scenarios (same hours; every duty at one
single-occupation percentile):
  Low    (all at 25th percentile) ..................... $58,825.60
  Middle (all at median) ............................... $72,190.20
  High   (all at 75th percentile) ..................... $87,454.00

Selected point $69,519 falls between the low and high scenarios.
Blended rate  $69,519 / 2,540 hours ..................... $27.37/hr
Compare: Form W-2 Box 5 wages actually paid for 2025 ..... $0.00

Conclusion: low and high scenarios of about $58,800 and $87,500,
with a supported point near $69,500.
```

The low, middle, and high scenarios in Workpaper 4 apply a single occupation-level percentile to every duty. They are not averages of percentiles, which BLS cautions against, and they are not a statistical percentile for Travis or a safe harbor. The 25th-to-75th band is a practice convention.

G. Review It, Don't Trust It: Five Wrong Answers for Travis

Before Travis came in, he had heard five different answers. Each one is wrong, and each one fails for a reason worth naming.

Workpaper 5. Five Flawed Answers and What Is Wrong With Each

```
2025 ordinary income before any payment to Travis: $142,600

1. Cousin's AI app: "40% of profit is safe"
     $142,600 x 40% = $57,040
     Flaw: no authority for any ratio; the number has no source and
     cannot be explained to an examiner. That it lands near the
     bottom of the documented range is coincidence, not support.

2. Truck-stop folklore: "60/40 split"
     $142,600 x 60% = $85,560
     Flaw: no authority; it would change every year with profit
     rather than with the work Travis performed.

3. "Pay the Social Security wage base"
     2025 base $176,100 (2026: $184,500)
     Flaw: exceeds the entire $142,600 of profit; not a legal
     floor or ceiling.

4. Title inflation: "He's the president, use the executive code"
     2,540 hours x $50.85 (11-1021 median) = $129,159.00
     Flaw: Travis drives a truck most of the time; codes follow
     duties, and 11-1021 excludes first-line supervisors.

5. Hat-stacking: add the full-time median salaries of each role
     Driver $58,640 + Dispatcher $50,340 + Mechanic $61,770
       + Bookkeeper $50,670 = $221,420
     Flaw: assumes 8,320 hours of work (4 x 2,080); the Job Aid
     calls this "inappropriate."

Corrected answer (Workpaper 4): 2,540 documented hours,
duty-by-duty rates, low/high scenarios $58,825.60 and $87,454.00,
selected point $69,519.00.
```

H. Worked Example: A Low W-2 at a Storefront Tax Office

A second composite shows the partial-salary pattern from *Dahl* and *Watson*. Marisol Vega owns 100 percent of Vega Tax Service, Inc., a storefront tax office taxed as an S corporation, with four seasonal preparers on W-2 payroll. For 2025 she paid herself a W-2 salary of $15,000, took $85,000 in distributions, and the corporation reported $96,000 of ordinary income after her salary. She works about 1,450 hours a year: 950 hours preparing returns, 250 hours reviewing and supervising her preparers' work, 150 hours on the office's books, and 100 hours on office administration and marketing.

Her primary code is 13-2082, Tax Preparers. Because she supervises workers in a professional group, her review and supervision hours are coded with the preparers she supervises, but her responsibility as the reviewer and signer supports the 75th percentile for those hours.1 Her own preparation hours are valued at the median.

Workpaper 6. Vega Tax Service, Inc.: Officer Compensation, 2025 (Illustrative)

Duty (SOC)	Hours	Pct.	Rate	Amount
Return preparation (13-2082)	950	50th	$26.40	$25,080.00
Review/supervision (13-2082)	250	75th	$36.68	$ 9,170.00
Bookkeeping (43-3031)	150	50th	$24.36	$ 3,654.00
Office admin (43-6014)	100	50th	$22.86	$ 2,286.00
Total	1,450			$40,190.00

W-2 wages actually paid	$15,000.00
Shortfall exposed to recharacterization	$25,190.00
Total cash to Marisol $15,000 + $85,000	$100,000.00
Documented wage as share of cash $40,190 / $100,000	40.2%

Conclusion: the $15,000 salary is well below a documented $40,190, but roughly 60% of her cash remains distributions.

1 See SOC Manual, supra (classification of supervisors in Major Groups 13-0000 through 29-0000 with the workers they supervise).

Rates in Workpaper 6 are national May 2025 OEWS figures: 13-2082 median $26.40 and 75th percentile $36.68; 43-3031 median $24.36; and 43-6014 **(Secretaries and Administrative Assistants, Except Legal, Medical, and Executive)** median $22.86.1 Marisol has a different problem from Travis. She issued a Form W-2. Her examination, if one comes, is a wage-amount case, and Part VII explains why that changes the rates.

I. A Detail That Distorts the Comparison: Shareholder Health Insurance

When the corporation pays health insurance premiums for a more-than-2-percent shareholder, the premiums are treated as wages for income tax purposes but are not FICA wages if the statutory requirements are met.2 In practice that means the premiums are included in Form W-2, Box 1, but not in Boxes 3 and 5. The Form 1120-S instructions also direct that the amount be reported as an information item in Box 14.3 When comparing an officer's actual wages with an OEWS benchmark for FICA purposes, compare Box 5 **(Medicare wages)**, not Box 1. Otherwise the health insurance makes the officer's FICA wages look larger than they are. A more-than-2-percent shareholder includes stock attributed under § 318 on any day of the year. The premiums escape FICA only if paid under a plan or system for employees generally or a class of employees.4

J. Where AI Fits, and Where It Does Not

Generative AI tools can help with parts of this workflow. They can organize a client's rambling interview notes into a list of functional duties without titles. They can suggest candidate SOC codes for the practitioner to verify on O*NET. And they can play the role of a skeptical examiner reading a draft workpaper for gaps. Each of those uses keeps the facts and the numbers in the practitioner's hands.

Four boundaries are not negotiable. The first is that an AI tool should not be asked for a wage figure, a salary ratio, or an hours estimate. Language models generate plausible numbers by the same process that has produced fabricated case citations in court filings. In *Clinco v. Commissioner*, the Tax Court found that cited cases appeared to be hallucinations of an AI model and warned that "[s]ubmitting a brief with fictitious caselaw is a recipe for sanctions."5 A fabricated wage figure is harder to spot than a fabricated case name. Travis's cousin's "40 percent" is a small, illustrative example. The practitioner pulls the OEWS rate and types it in.

The second is confidentiality. Tax return preparers face criminal and civil exposure for unauthorized disclosure or use of tax return information. "Disclosure" is defined as "the act of making tax return information known to any person in any manner whatever."6 Existing § 7216 rules apply to AI tools, and no exception addresses them specifically. Removing names does not by itself make the information safe to disclose, because the rules also reach information derived from a return. Before disclosing real client information, identify the permitted use and disclosure, recipient, location, retention, and access. Rely on a specific regulatory exception or obtain valid, purpose-specific consent where required. A secure system or removal of names alone is not authorization. The IRS Office of Professional Responsibility **(OPR)** Alert 2026-19 reinforces these rules; it does not create a new exception.7

The third is arithmetic. Conversational AI output is not a calculator. Run every hours-times-rate extension in a spreadsheet and keep the spreadsheet.

The fourth is verification. OPR has told practitioners to "recognize that technology serves as a powerful tool, not a substitute for professional judgment," and has tied AI use to the diligence, competence, and written-advice

1 O*NET OnLine, National Wages for SOC 13-2082.00, 43-3031.00, and 43-6014.00 (BLS May 2025 OEWS data), https://www.onetonline.org.

2 I.R.C. § 1372(a); Notice 2008-1, 2008-2 I.R.B. 251.

3 IRS, S Corporation Compensation and Medical Insurance Issues, supra; Instructions for Form 1120-S (2025), supra.

4 I.R.C. §§ 1372(b), 318, 3121(a)(2)(B).

5 Clinco v. Commissioner, T.C. Memo. 2026-16 (Feb. 9, 2026). The court admonished counsel but imposed no monetary sanction.

6 I.R.C. §§ 7216(a), 6713(a); Treas. Reg. § 301.7216-1(b)(5).

7 Treas. Reg. §§ 301.7216-1(b)(3), 301.7216-2, 301.7216-3(a); Rev. Proc. 2013-14 (consent format for Form 1040 series filers).

provisions of Circular 230.1 Every code, rate, and citation an AI tool suggests is a lead to check, not a fact to file.

VI. PRACTITIONER EXPOSURE: TIGTA, CIRCULAR 230 § 10.21, AND § 6694

A. "Nobody Gets Audited" Is the Wrong Lesson

Clients who have taken distributions without payroll for years without hearing from the IRS conclude that the risk is theoretical. Overall examination rates for S corporation returns have been low and falling. In fiscal year 2012, according to IRS Data Book figures, S corporation examinations closed equaled about 0.48 percent of the Forms 1120-S filed in the preceding calendar year. By fiscal year 2018 the figure had fallen to about 0.22 percent.2

Table 9. Form 1120-S Examination Rates (Selected Years)

Fiscal year	Forms 1120-S filed in preceding calendar year	Examinations closed	Coverage ratio
2012	4,469,329	21,658	0.48%
2014	4,518,765	16,317	0.36%
2016	4,688,683	15,869	0.34%
2018	4,848,921	10,575	0.22%
2021	not computed	7,091 (6,605 field; 486 correspondence)	not computed

Table 9 compares examinations closed during selected fiscal years with S corporation returns filed in the preceding calendar year. These are administrative coverage ratios, not the probability that a particular return will be examined. Ratios are calculated from the Data Book counts to two decimal places. No comparable denominator was obtained for fiscal year 2021, so no ratio is shown. Sources: IRS Data Book, FY 2012, FY 2014, FY 2016, FY 2018, tbl. 9a; Data Book 2021, tbl. 18, at 46.

The aggregate rate is the wrong number to watch. In August 2021 the Treasury Inspector General for Tax Administration **(TIGTA)** reported on exactly the population this program is about. For tax years 2015 through 2017, about 4.4 million returns, roughly 30 percent of S corporation returns, had a single shareholder and reported no officer compensation. TIGTA also reviewed 3,172 IRS examinations closed in fiscal years 2016 through 2019 of single-shareholder S corporations with no officer compensation and gross receipts of at least $250,000. Of those, 1,406 **(44.3 percent)** showed no evidence that the examiner considered officer compensation. For processing years 2016 through 2018, TIGTA identified 266,095 single-shareholder returns, not selected for a field examination, that each reported profits over $100,000 and no officer compensation. Together they reported $108 billion in profits and $69 billion in distributions. TIGTA estimated nearly $25 billion of unreported officer compensation. TIGTA also reported that the IRS began a compliance initiative project **(CIP)** on officer compensation in August 2020. These are 2015–2018 data, not current filing statistics.3

Read together, the numbers say that the filter for this issue is simple and the IRS knows where the returns are. A single-shareholder S corporation with six-figure profit and nothing on Line 7 is the textbook profile. Travis's 2023 and 2024 returns fit it.

B. When a Prior Preparer Created the Problem: Circular 230 § 10.21

The new preparer's first obligation runs to the client and concerns the years the new preparer did not touch. Circular 230 § 10.21 provides in full:

"A practitioner who, having been retained by a client with respect to a matter administered by the Internal Revenue Service, knows that the client has not complied with the revenue laws of the United States or has

1 IRS Off. of Pro. Resp., OPR Alert Issue No. 2026-19, Introductory Guidelines for Responsible AI Use in Federal Tax Practice (June 24, 2026).

2 IRS, Data Book (Pub. 55-B), FY 2012, FY 2014, FY 2016, and FY 2018, tbl. 9a; IRS, Data Book (Pub. 55-B), 2021, tbl. 18, at 46.

3 Treasury Inspector Gen. for Tax Admin., Efforts to Address the Compliance Risk of Underreporting of S Corporation Officers' Compensation Are Increasing, but More Action Can Be Taken, Rep. No. 2021-30-042 (Aug. 11, 2021).

made an error in or omission from any return, document, affidavit, or other paper which the client submitted or executed under the revenue laws of the United States, must advise the client promptly of the fact of such noncompliance, error, or omission. The practitioner must advise the client of the consequences as provided under the Code and regulations of such noncompliance, error, or omission."1

Two duties sit in that text: tell the client promptly about the noncompliance, and tell the client the consequences under the Code and regulations. The rule binds practitioners as Circular 230 defines them and, for unenrolled preparers who participate in the Annual Filing Season Program, it applies through the consent to Circular 230 duties that program requires.2 **Section** 10.21 applies to any noncompliance you learn of, including in the years you are working on. It requires prompt advice of the problem and its consequences. A written letter with acknowledgment is good practice, not a rule requirement.

What **§** 10.21 does not say matters as much. It does not require the new preparer to amend the prior preparer's returns, to file delinquent employment tax returns for prior years, or to involve himself or herself in fixing another practitioner's work. My long-standing view, stated in my 2023 course text, is that **§** 10.21 does not itself require the preparer to amend a $0-compensation Form 1120-S the preparer did not prepare. It does require prompt advice about the error and its consequences. Other duties depend on the engagement and the preparer's conduct.

Practice Pointer: The § 10.21 Letter

Put the § 10.21 advice in writing, have the client sign an acknowledgment, and keep both in the file. The letter should identify the years and returns involved. It should describe the noncompliance in plain words: a working officer paid through distributions and a Form 1099, with no wages reported. And it should describe the consequences: possible reclassification of payments as wages, employment taxes on the corporation, and the officer's own share of FICA. Penalties and interest belong on that list, along with state payroll consequences the client should discuss with a qualified advisor. State what you have been engaged to do and what you have not.

C. Why Not Just Amend the Prior Years?

Voluntarily filing prior-year payroll returns sounds like the responsible thing to do. It often is not the practitioner's call to make, and it is rarely simple. A corporation that never ran payroll has no employment tax returns on file. Catching up means four quarterly Forms 941 per year, an annual Form 940, Forms W-2 and W-3, and the penalty notices each late return can generate. Ordinary prior-year income tax withholding corrections are limited, and a separate procedure applies where the officer was treated as a non-employee **(Part VII.F)**. Any voluntary filing has to be analyzed tax by tax, and coordination with an EA, CPA, or attorney is recommended. And a corporation with no payroll history is usually unregistered with its state as an employer, which opens a separate set of state obligations outside this text's scope.

That does not mean prior-year exposure should be ignored. It means the decision to come forward belongs to the client, made with full advice. Because the correction raises employment-tax and controversy issues, coordination with an EA, CPA, or attorney is recommended. That is a risk-management recommendation, not a rule that only those practitioners may prepare the returns; the representation limits in Part VII.G apply if the IRS has questions.

D. The Year You Sign: § 6694

Section 10.21 requires prompt advice about known noncompliance, including returns the practitioner prepared. **Section** 6694 can apply to signing and nonsigning preparers responsible for an understatement.3 It applies to any tax return preparer, defined as a person who prepares for compensation all or a substantial portion of a return or claim for refund, whether or not the preparer holds any credential.4 **Section** 6694(a) applies to an understatement due to an unreasonable position the preparer knew or reasonably should have known about. Its penalty is the greater of $1,000 or 50 percent of the income derived by the preparer with respect to the return. **Section** 6694(b) applies to an understatement due to a willful attempt to understate the liability, or to "a reckless

1 31 C.F.R. § 10.21.
2 Rev. Proc. 2014-42, § 4.05(4).
3 31 C.F.R. § 10.21; Treas. Reg. § 1.6694-1(b).
4 I.R.C. § 7701(a)(36)(A).

or intentional disregard of rules or regulations." Its penalty is the greater of $5,000 or 75 percent of the income derived, reduced by any § 6694(a) penalty paid.1

A Form 1120-S with $0 on Line 7 does not itself report an employment tax liability, so the practitioner should think carefully about where the understatement in a $0-salary engagement shows up. One place is the shareholder's Form 1040, often prepared by the same office. Reasonable compensation paid to the shareholder is excluded from QBI, so a § 199A deduction computed on QBI that includes amounts that are really wages is overstated.2 Whatever the precise theory in a given case, the practical point holds: knowingly signing returns that rest on a $0-salary position for a working officer invites a § 6694 inquiry.

My 2024 materials include an unverified account, relayed second-hand by a tax attorney and offered here only as a cautionary story. A preparer who described himself as "just a tax guy" **(no bookkeeping, no payroll)** sent every S corporation client an annual letter saying they needed to take reasonable compensation. When clients ignored the letter, he prepared and filed their $0-salary returns anyway. After one client was examined, the IRS reviewed his other S corporation clients and asserted $1,000 under § 6694(a) and $5,000 under § 6694(b) per client. The matter reportedly settled for $15,000 in penalties plus about $20,000 in legal fees.3 The lesson is uncomfortable. A warning letter is not a shield; it can be evidence that you knew. **Section** 6694(a) generally requires substantial authority for an undisclosed position, or reasonable basis with adequate disclosure, subject to the special tax-shelter and reportable-transaction rules. Its exception requires reasonable cause and good faith. **Section** 6694(b) separately addresses willful, reckless, or intentional conduct.4

⊗ **Warning: A Warning Letter Is Evidence Against You, Not a Shield**
A letter telling the client to take reasonable compensation, followed by your signature on a return that ignores it, documents that you knew the requirement. Under § 6694(b), reckless or intentional disregard of rules or regulations carries the larger penalty. If the client will not fix the problem, the protective step is not a second letter. It is declining to sign.

E. The Intake Rule

My office rule, stated in my 2023 course text and 2024 materials, is straightforward. Do not accept or file a return for a profitable S corporation whose working officers take distributions with no wages. The exception is officers who commit to registering as an employer and getting onto payroll immediately. It is a business rule, not a legal standard, and it does not cure anything about a completed tax year. What it does is draw the line at the point the practitioner controls: the current and future returns that carry the practitioner's signature.

F. The Rest of the Circular 230 Frame

Four other Circular 230 provisions frame this work for practitioners subject to them. **Section** 10.22 requires due diligence as to accuracy, including in determining the correctness of representations made to clients. **Section** 10.34 sets the standards for return positions and requires advising the client of penalties reasonably likely to apply. **Section** 10.35 requires competence, which for this topic means knowing enough about employment tax to recognize the issue even when the engagement is "just the 1120-S." **Section** 10.37 governs written advice, which includes the § 10.21 letter and any memo supporting a wage figure.5 Responsibility follows the preparer's work. Whether a workpaper was built by hand, by a vendor tool, or with AI assistance, the preparer who relies on it owns it.

VII. ONCE AN EXAMINATION IS UNDERWAY

A. How the Examination Proceeds

Reasonable-compensation cases are employment tax examinations of the corporation, focused on Forms 941 and 940. The procedural path depends on whether a Form W-2 was issued. Where none was issued, treating the officer as an employee is a worker-classification determination. The corporation can petition the Tax

1 I.R.C. § 6694(a)(1), (b)(1)–(3).
2 I.R.C. § 199A(c)(4)(A).
3 Account from author's 2024 seminar materials (second-hand report from a tax attorney). Unverified; present as an anecdote, not as a reported decision.
4 I.R.C. § 6694(a)(2)–(3), (b)(2); Treas. Reg. § 1.6694-1(b), (e).
5 31 C.F.R. §§ 10.22, 10.34, 10.35, 10.37.

Court under § 7436 for review of both status and the amount of employment tax.1 Where a W-2 was issued, the dispute is usually only about amount, unless the corporation raises Section 530 or claims the payments were for non-employee services.2 If a notice of determination is mailed, the Tax Court petition must be filed before the 91st day after mailing. Refer before that clock runs.3 The IRS's Classification Settlement Program, which offers reduced settlements in some worker-classification cases, does not include "[c]ases which involve only recharacterizing officer/shareholder distributions" and similar payments.4 But where a Form 1099 was timely filed for the officer, the case may be CSP-eligible even if distributions or personal expenses are also recharacterized. Eligibility is not automatic. The offer is generally computed for the latest examination year, and earlier-year treatment depends on the program conditions; in the Manual's consistent-reporting examples, an agreement for the offer year can affect examination of earlier years.5

B. Section 3509 and the Two-Track Rule

Section 3509 changes the employer's liability when an employer fails to withhold income tax and the employee's share of FICA "by reason of treating such employee as not being an employee." In that case the employer's liability for income tax withholding is 1.5 percent of wages, and its liability for the employee's share of FICA is 20 percent of the normal employee tax.6 If the employer also failed to file required information returns for the worker, the figures become 3 percent and 40 percent, unless the failure was due to reasonable cause and not willful neglect.7 The employer still owes the full employer share of FICA. The reduced rates are unavailable if the employer's liability is due to intentional disregard of the withholding requirements.8 When the criteria are met, the Manual treats application of § 3509 as mandatory.9

For corporate officers, the Manual divides the cases into two tracks.10 In the first track, the corporation issued the officer no Form W-2 and paid the officer only through a Form 1099, Schedule K-1 distributions, loans, or personal expenses. Converting the officer to an employee is a worker reclassification, and § 3509 applies. The Manual then sorts the payments by whether an information return was filed. It treats the Schedule K-1 as the information return: "For distributions reported on Schedule K-1 **(Form 1120S)** ... IRC 3509(a) rates are applicable because the Schedule K-1 is considered the information return required to be filed consistent with the taxpayer's position that the officer was a 'non-employee.'" Shareholder loans and personal expenses paid by the corporation, which appear on no information return, take the higher § 3509(b) rates.11

In the second track, the corporation issued a Form W-2 for some wages, and the IRS recharacterizes distributions, loans, or personal expenses as additional wages. The Manual is direct: "If the taxpayer filed and furnished Form W-2 for some wages, and distributions, loans, or personal expenses are being recharacterized to additional wages, reduced rates under IRC 3509 are not applicable. Generally, this is a reasonable compensation issue and not a worker classification issue. Full rates should be used for FICA and FITW."12

Table 10. Employer Rates Under the Two-Track Rule (Wages up to the OASDI Base)

Situation	Employer FICA	Employee FICA (employer liability)	FITW (employer liability)	Total
Track 1, § 3509(a): paid via K-1 or Form 1099, no W-2	7.65%	1.53% (20% of 7.65%)	1.50%	10.68%

1 I.R.C. § 7436(a); IRM 4.23.5.7.3.1 (Nov. 22, 2017).
2 IRM 4.23.5.7.3.1(5) (Nov. 22, 2017).
3 I.R.C. § 7436(b)(2).
4 IRM 4.23.6.8(8) (Dec. 21, 2017).
5 IRM 4.23.6.9(1)–(3) (Feb. 13, 2024).
6 I.R.C. § 3509(a)(1)–(2).
7 I.R.C. § 3509(b)(1).
8 I.R.C. § 3509(c).
9 IRM 4.23.8.5 (May 17, 2018); IRM 4.23.8.5.2.
10 IRM 4.23.8.5.2.1 (Apr. 17, 2024).
11 IRM 4.23.8.5.2.1(3) (Apr. 17, 2024).
12 IRM 4.23.8.5.2.1(4) (Apr. 17, 2024).

Situation	Employer FICA	Employee FICA (employer liability)	FITW (employer liability)	Total
Track 1, § 3509(b): unreported loans or personal expenses, no W-2	7.65%	3.06% (40% of 7.65%)	3.00%	13.71%
Track 2: some W-2 wages filed (Dahl / Watson pattern)	7.65%	7.65%	Full withholding (relief possible under § 3402(d))	Full rates
Either track: intentional disregard (§ 3509(c))	7.65%	7.65%	Full withholding	Full rates

Source: I.R.C. § 3509; IRM 4.23.8.5.1 and 4.23.8.5.2.1 (Apr. 17, 2024). Section 3509 does not apply if income tax was withheld but FICA was not, or to certain statutory employees (§ 3509(d)(2)–(3)). For wages above $200,000, the Manual adds 0.18% (§ 3509(a)) or 0.36% (§ 3509(b)) for Additional Medicare Tax. For wages above the OASDI base, compute the OASDI and Medicare pieces separately. FUTA is computed separately.

The intentional-disregard bar deserves respect in this area specifically. The Manual notes that courts have found intentional disregard in officer cases in light of the established law. It cites *Fred R. Esser, P.C.*, a district court decision denying reduced rates to a corporation whose officers took no wages.1 Consider a corporation that kept a CP-261 in its files, ignored a prior preparer's warning letter, or kept paying an officer through a Form 1099 after being told otherwise. It has handed the examiner the facts for that argument.

C. What Else Changes When § 3509 Applies

Several collateral rules follow from § 3509 and are worth knowing before the first meeting with the examiner. The statute itself provides three rules. The employee's own liability for tax is not affected by the employer's assessment. The employer may not recover the § 3509 tax from the employee. And §§ 3402(d) and 6521 do not apply.2 Practically, the officer still owes the employee share of FICA personally; the Manual addresses this in its discussion of the effect of § 3509 on employee liability. The corporation cannot claim relief for income tax the officer already paid. And the mitigation provision that coordinates SECA and FICA is unavailable.3

On the penalty side, when all assessments in the examination are made under § 3509, the examiner inputs a reference code that prints "3509" on the transcript. That code tells Collection that the Trust Fund Recovery Penalty does not apply.4 And in a reclassification in which nothing was actually withheld from the worker, the failure-to-deposit penalty is typically computed only on the employer's share of FICA.5

In Track 2, where § 3509 does not apply, different relief exists. Section 3402(d) can relieve the employer of liability for income tax it failed to withhold if the employee reported the income and paid the tax, though penalties and FICA remain.6 A parallel rule relieves the employer of uncollected Additional Medicare Tax that the employee paid.7 And FUTA is modest: the statutory rate is 6 percent on the first $7,000 of wages, reduced by credits for state unemployment contributions. An officer whose original W-2 already exceeded $7,000 generates no additional FUTA. The state credit is capped and can be reduced for late state payments or in credit-reduction states, so the net rate is not automatically 0.6 percent.8

Section 530 relief is the statutory safe harbor for employers that consistently treated workers as non-employees with a reasonable basis. The IRM requires examiners to consider Section 530 in officer classification cases, while predicting that taxpayers "will have difficulty satisfying the reasonable basis requirement." *Grey* also held,

1 IRM 4.23.8.5.2.1(5) (Apr. 17, 2024) (citing Fred R. Esser, P.C. v. United States, 750 F. Supp. 421 (D. Ariz. 1990)).
2 I.R.C. § 3509(d)(1)(A)–(C).
3 IRM 4.23.8.5.3 (citing Rev. Rul. 86-111); see Form 8919 (uncollected employee FICA).
4 IRM 4.23.8.5.2(4).
5 IRM 4.23.8.5.1(3)(b) (citing Rev. Rul. 75-191).
6 I.R.C. § 3402(d).
7 I.R.C. § 3102(f)(3).
8 I.R.C. §§ 3301, 3302(a)–(b), 3306(b)(1); IRM 4.23.8.5.2.1(4).

as an alternative ground, that **Section** 530 relief was unavailable for statutory employees. The cited officer cases do not support promising relief.1

D. The Penalty Stack, Sorted by Return

Penalties in a reasonable-compensation case come from two different returns, and treating them as one stack produces errors in both directions.

Table 11. Penalties by Return

Return and taxpayer	Penalty	Notes
Forms 941 and 940 (corporation)	§ 6651(a)(1) failure to file, 5% per month up to 25%; § 6651(a)(2) failure to pay, 0.5% per month up to 25%	Apply to unfiled quarterly and annual employment tax returns. Subject to reasonable-cause relief and the applicable tax base. For months in which both additions apply, reduce the failure-to-file addition by the failure-to-pay addition under § 6651(c)(1). Analyze unfiled-return and substitute-return cases separately.
Forms 941 and 940 (corporation)	**§ 6656 failure to deposit:** 2%, 5%, 10%, or 15%	Tiered by lateness; under § 3509 typically computed on the employer share only.
Forms 941 (responsible persons)	§ 6672 Trust Fund Recovery Penalty, 100% of trust fund taxes not collected or paid over	Applies only to a responsible person who willfully fails to collect, account for, or pay over the tax; it is not imposed merely because the person is an officer. Not applied when all assessments are made under § 3509.
Forms W-2 and W-3 (corporation)	§§ 6721 and 6722 information return penalties	Per-return amounts adjusted for inflation; reasonable-cause relief under § 6724.
Forms 941 and 940 actually filed (corporation)	§ 6662 negligence, 20%	Applies to the underpayment on a filed return; sustained against the corporation in *Blossom Day Care*. Where no return was filed, the Manual states the accuracy-related penalty does not apply.
Form 1040 (shareholder)	§ 6662 accuracy-related penalty, 20%	Substantial understatement (5% / $5,000 floor if § 199A claimed) and negligence.

Sources: I.R.C. §§ 6651(a), (c)(1), 6656(a)–(b), 6662(a)–(d), 6664(a), (c), 6672(a), 6721, 6722, 6724; Blossom Day Care Ctrs., T.C. Memo. 2021-86; IRM 4.23.8.5.1(3), 4.23.8.5.2(4).

The accuracy-related penalty is the one most often misplaced. It applies to underpayments of any tax imposed by Title 26, including employment tax on a filed Form 941, and the Tax Court sustained it against the corporation in *Blossom Day Care*.2 The Manual says that "[i]f a taxpayer has not filed a return, the accuracy-related penalty does not apply," because a substitute for return is not the taxpayer's return for this purpose.3 **Section** 6664(b) limits these penalties to cases in which a taxpayer return was filed; a section 6020(b) substitute return does not qualify.4 The other common home for **§** 6662 in these cases is the shareholder's Form 1040.

1 IRM 4.23.5.7.3(5) (Nov. 22, 2017); Joseph M. Grey Public Accountant, P.C. v. Commissioner, 119 T.C. 121, 134 (2002); Revenue Act of 1978, Pub. L. No. 95-600, § 530, 92 Stat. 2763, 2885–86, as amended.

2 I.R.C. § 6664(a); Blossom Day Care Ctrs., T.C. Memo. 2021-86.

3 IRM 4.23.8.5.1(3)(c).

4 I.R.C. § 6664(b).

E. The § 199A Connection and the 5 Percent Trap

Reasonable compensation affects the shareholder's § 199A deduction in two directions. Wages paid to the shareholder, including amounts recharacterized as wages on examination, are excluded from qualified business income. A recharacterization therefore reduces QBI dollar for dollar and reduces the deduction by up to 20 percent of the adjustment.1 Above the threshold, timely reported W-2 wages can help the wage limit. Wages recharacterized on examination or reported late generally will not, and corrected Forms W-2 count only under the 60-day rules. A specified service business above the threshold may lose the deduction regardless.2 The ordinary deduction generally cannot exceed 20 percent of taxable income after subtracting net capital gain. Once fully applicable, the business-level wage/property limit is the greater of 50 percent of qualifying W-2 wages or 25 percent of those wages plus 2.5 percent of qualified property's unadjusted basis immediately after acquisition. The specified-service-business limitation phases in above the threshold and reaches full effect at the upper end of the range. The new minimum deduction is a separate exception for qualifying active business income.3

Section 199A is now permanent. The 2025 reconciliation act removed its scheduled expiration and widened the phase-in range above the threshold to $75,000 **($150,000 for joint returns)**. It also added a minimum deduction of $400 for taxpayers with at least $1,000 of active QBI. These changes are effective for taxable years beginning after December 31, 2025. The minimum applies only if the taxpayer's aggregate QBI from qualified businesses in which the taxpayer materially participates is at least $1,000; both amounts are indexed after 2026.4 For 2026 the threshold is $201,750 for most filers, $201,775 for married individuals filing separately, and $403,500 for joint returns, with the limitations fully phased in at $276,750, $276,775, and $553,500.5 Some IRS web pages still describe § 199A as expiring after 2025; they are out of date.

The trap is in § 6662. Ordinarily a substantial understatement of income tax is one exceeding the greater of 10 percent of the tax required to be shown or $5,000. For any taxpayer who claims a § 199A deduction, "5 percent" is substituted for "10 percent."6 For a taxpayer claiming § 199A, the threshold is the greater of 5 percent of the tax required to be shown or $5,000. Below about $100,000 of required tax the $5,000 floor usually controls. Substantial authority, adequate disclosure, and reasonable cause can still prevent the penalty.7

F. The Form 941-X Prior-Year Trap

Clients who learn the rule often want to fix last year by paying extra salary this year. It does not work. Wages are reported for the year they are paid, and the IRS computes officer compensation adjustments year by year.8 Correction of prior-year payroll returns is also constrained. The Form 941-X instructions state that "you may correct federal income tax withholding errors only if you discovered the errors in the same calendar year you paid the wages." Prior-year withholding corrections are limited to administrative errors and errors for which section 3509 rates apply. Where the corporation treated the officer as a non-employee and filed no Forms 941, the instructions provide for delinquent Forms 941 marked "Misclassified Employees" with Form 941-X attached, at § 3509 rates.910 FICA, Additional Medicare Tax, and Form W-2c corrections follow their own rules for open years. Any prior-year correction has to be analyzed tax by tax, which is one more reason to coordinate with an EA, CPA, or attorney.

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1 I.R.C. § 199A(a), (c)(4)(A).
2 I.R.C. § 199A(b)(2)–(4), (d); Treas. Reg. § 1.199A-2(b)(2).
3 I.R.C. § 199A(a), (b)(2)–(4), (d)(3), (i).
4 Pub. L. No. 119-21, § 70105, 139 Stat. 72, 162 (2025) (amending I.R.C. § 199A(b)(3)(B) and (i)); I.R.C. § 199A(i).
5 Rev. Proc. 2025-32, § 4.26, 2025-45 I.R.B. 695.
6 I.R.C. § 6662(d)(1)(A), (C).
7 I.R.C. §§ 6662(d)(2)(B), 6664(c)(1).
8 See IRM 4.23.6.9 (Feb. 13, 2024) (examples computing reasonable compensation separately for each year).
9 Instructions for Form 941-X (Rev. Apr. 2026), Line 42; id., Lines 19–22.
10 Instructions for Form 941-X (Rev. Apr. 2026).

G. The Representation Line for Preparers Who Are Not EAs, CPAs, or Attorneys

Attorneys, CPAs, and enrolled agents may represent taxpayers before all offices of the IRS, including in employment tax examinations, Appeals, and Collection. Apart from the limited categories in Circular 230 § 10.7 **(family, bona fide officers, full-time employees, special appearances)**, an unenrolled preparer without an AFSP Record has no representation rights. That preparer may receive and inspect information under a Form 8821 authorization but may not advocate or negotiate.1 AFSP rights require a Record for the year the return was prepared and the year of representation. For returns prepared and signed after December 31, 2015, the AFSP requirements apply. The Form 2848 instructions preserve a limited grandfather rule for earlier returns and require a valid, active preparer tax identification number **(PTIN)**.2

An unenrolled preparer who holds a valid AFSP Record of Completion has limited representation rights, listed on Form 2848 as designation "h" **(Unenrolled Return Preparer)**. Those rights cover examinations of returns the preparer prepared and signed, before revenue agents and customer service representatives, and they exclude appeals officers, revenue officers, Counsel, and similar IRS employees.3 Apply that to a $0-salary S corporation. The examination is of the corporation's employment tax returns, and the corporation never filed Forms 941. No one prepared and signed them, so no AFSP holder's limited rights attach. Even where a payroll service filed Forms 941, the income tax preparer usually did not prepare and sign them.

The practitioner's best move at that point is not advocacy. It is a clean handoff. The handoff file should contain the returns, the § 10.21 letter, and a Many Hats workpaper with dated OEWS printouts. It should also carry a note that the case appears to be a Track 1 § 3509(a) case at 10.68 percent for the K-1 and Form 1099 amounts. A storefront preparer who hands an EA, CPA, or attorney that file has protected the client and the relationship.

H. Worked Example: Track 1 and Track 2 Side by Side

Suppose the IRS opens an employment tax examination of Boudreaux Hauling for 2024, a year the prior preparer handled, and determines reasonable compensation of $64,000. Assume, for illustration, that the examiner treats the $36,000 Form 1099-NEC amount and $17,800 of the Schedule K-1 distributions as § 3509(a) wages, and the $10,200 of pickup-truck payments as § 3509(b) wages. The allocation among payment types is an assumption for teaching; in an actual examination, how the determined wage is matched to specific payments is a point for the representative to address.

1 31 C.F.R. § 10.7(c)–(d).

2 Instructions for Form 2848 (Rev. Sept. 2021).

3 Rev. Proc. 2014-42, § 6.01; Instructions for Form 2848 (Rev. Sept. 2021).

Workpaper 7. Boudreaux Hauling, 2024 Examination (Track 1, Hypothetical)

```
Determined reasonable compensation ......................... $64,000.00
Total received by Travis in 2024
  ($36,000 + $78,000 + $10,200) ............................ $124,200.00
  (Cap check: $64,000 does not exceed amounts received.)

Section 3509(a) base: 1099-NEC $36,000 + K-1 $17,800 = $53,800
  Employer FICA       $53,800 x 7.65% ....................... $4,115.70
  Employee FICA       $53,800 x 1.53% ....................... $  823.14
  FITW                $53,800 x 1.50% ....................... $  807.00
  Subtotal            $53,800 x 10.68% ...................... $5,745.84

Section 3509(b) base: personal pickup payments $10,200
  Employer FICA       $10,200 x 7.65% ....................... $  780.30
  Employee FICA       $10,200 x 3.06% ....................... $  312.12
  FITW                $10,200 x 3.00% ....................... $  306.00
  Subtotal            $10,200 x 13.71% ...................... $1,398.42

Corporation's employment tax under section 3509 ............. $7,144.26
  Plus FUTA (up to $420 gross before any state credit), penalties,
  and interest.
Illustrative section 6656 at 10% on employer share only
  $64,000 x 7.65% = $4,896.00 x 10% ......................... $  489.60

Travis personally: employee share of FICA not extinguished
  $64,000 x 7.65% ........................................... $4,896.00

Comparison: full rates on the same $64,000 (no section 3509)
  FICA $64,000 x 15.3% ...................................... $9,792.00
  plus full income tax withholding liability.

Conclusion: the Track 1 rates are materially lower than full rates,
but section 3509 does not erase Travis's personal FICA share.
```

One complication in Travis's file deserves a flag rather than an answer. Travis reported the $36,000 Form 1099-NEC on a 2024 Schedule C and paid self-employment tax on it, roughly $5,086.64 before considering any Schedule C expenses **($36,000 × 92.35% × 15.3%)**. If that amount becomes wages, the self-employment tax was paid on income that was not self-employment income. Because § 3509(d)(1)(C) makes the § 6521 mitigation provision unavailable when § 3509 applies, recovering that tax depends on the ordinary refund-claim rules and statute of limitations on Travis's own Form 1040. That coordination belongs to the representative, and the preparer's job is to make sure the representative knows it is there.

Now consider Marisol in Track 2. Suppose an examination of 2025 accepts the $40,190 documented in Workpaper 6. Because she issued a Form W-2, § 3509 does not apply.

Workpaper 8. Vega Tax Service, 2025 (Track 2, Hypothetical)

```
Determined reasonable compensation ......................... $40,190.00
W-2 wages already reported ................................. $15,000.00
Recharacterized distributions .............................. $25,190.00

Employer FICA       $25,190 x 7.65% ....................... $1,927.04
Employee FICA       $25,190 x 7.65% ....................... $1,927.04
Total FICA (sum of components) ............................. $3,854.08
  ($0.01 rounding vs. $25,190 x 15.3% = $3,854.07)
FITW: full liability, but section 3402(d) relief available to the
  extent Marisol reported the income and paid the tax on Form 1040.
FUTA: original W-2 of $15,000 already exceeded the $7,000 base,
  so no additional FUTA.

Collateral effect on Marisol's Form 1040 (simplified):
  QBI reduced by recharacterized wages + employer FICA deduction
    $25,190.00 + $1,927.04 ................................... $27,117.04
  Section 199A deduction reduced by up to 20% ................ $5,423.41

Conclusion: full rates, no section 3509, and a Form 1040 ripple
through section 199A.
```

Workpaper 8 is an illustrative annual allocation using separately rounded employer and employee amounts. Actual quarterly return amounts must be computed using the applicable Social Security and Medicare lines and payroll rounding adjustments. The § 199A figure in Workpaper 8 is a directional maximum assuming taxable income below the threshold, no losses, the taxable-income limit not binding, and the employer FICA deducted in the same year.

Table 12. Track 1 vs. Track 2 at a Glance (From Workpapers 7 and 8)

Item	Travis (Track 1, 2024)	Marisol (Track 2, 2025)
Form W-2 issued to officer?	No	Yes ($15,000)
Recharacterized amount	$64,000	$25,190
Rate regime	§ 3509(a) 10.68% / § 3509(b) 13.71%	Full FICA 15.3% plus FITW
Corporation's FICA and FITW computed above	$7,144.26	$3,854.08 FICA plus FITW (subject to § 3402(d))
Officer's personal FICA exposure	$4,896.00 (§ 3509(d)(1)(A))	Included in full-rate FICA
TFRP	Not applied if all assessments under § 3509	Possible

Simplified directional deltas for teaching; not final Form 941, 940, or 1040 results. Omitted: penalties other than the illustrative § 6656 figure, interest, FUTA credit computations, Additional Medicare Tax, and state taxes. Also omitted: the income tax effect of the employer FICA deduction at the corporate level, and refund coordination for self-employment tax previously paid.

Travis's Case, Resolved

Return to the second Tuesday of February 2026 and Travis's two questions: does he have to run payroll on himself, and how much?

The first answer is yes. Travis is the president and performs essentially all of the corporation's services, so the officer rule in Part II.B makes him an employee, and he fails both elements of the minor-services exception. The Form 1099-NEC does not change that; *Grey* and its companion cases, including a trucking company, rejected the structure. His buddy at the truck stop is wrong, and the IRS told Travis so on his own S election acceptance notice.

The second answer is a documented method, not a ratio. The figure below is a retrospective classroom calculation. In February 2026, the practitioner would use the latest release then available to set a provisional wage and revisit it after the new data became available. Workpaper 4 values Travis's 2,540 documented hours, duty by duty, at a supported point of $69,519, between low and high scenarios of about $58,800 and $87,500, using national OEWS data for illustration. Before the number goes into a payroll system, the practitioner replaces the national rates with the OEWS table for Travis's own metropolitan or nonmetropolitan area, prints and dates each table, and recomputes. The cousin's AI "40 percent" figure is discarded for the reasons in Workpaper 5. If the local data support roughly the same figure, Travis's 2026 wage is set at about $69,500, paid through a payroll service starting in March: ten monthly payrolls of $6,950. Paying the year's wage over ten months rather than twelve is a timing choice within the same calendar year, and the file should say why.

Table 13. What a Defensible Wage Costs Travis (2026, Assuming 2025-Level Profit)

Item	Defensible wage ($69,500)	Schedule C comparison
Wages	$69,500.00	n/a
Employer FICA (7.65%)	$5,316.75	n/a
Employee FICA (7.65%)	$5,316.75	n/a
Total FICA or SE tax	$10,633.50	$20,148.74 (on $142,600 × 92.35% × 15.3%)
Apparent payroll-tax saving vs. Schedule C	$9,515.24	n/a
QBI after wages and employer FICA ($142,600 – $69,500 – $5,316.75)	$67,783.25	n/a
Tentative § 199A deduction at 20% of QBI	$13,556.65	n/a

Payroll-tax comparison only; not overall tax savings. The § 199A line is a directional maximum assuming taxable income below the threshold, no losses, the taxable-income limit not binding, and the employer FICA deducted in the same year. Simplified directional deltas; not final Form 1120-S, 941, or 1040 results. Omitted: income tax on wages and pass-through income, the deduction for one-half of SE tax in the Schedule C comparison, and the § 199A taxable-income limitation. Also omitted: FUTA and state payroll taxes, payroll service fees, and Additional Medicare Tax. Assumes 2026 profit equal to 2025.

Table 13 is the slide that usually ends the argument at the desk. With a defensible wage, the S corporation still produces a payroll-tax saving against a Schedule C on these assumptions. Roughly half of Travis's profit still passes through as a non-wage return on his truck and his business. The structure works when it is used honestly. It fails when the wage is zero.

The prior years are handled under § 10.21, with the letter described in Part VI.B. For Travis it covers the 2023 and 2024 returns, the likely § 3509 regime, and the self-employment tax he paid on the Forms 1099-NEC. It recommends that he consult an EA, CPA, or attorney about coming forward, and it states that the practitioner has not been engaged to amend. Travis signs an acknowledgment, and both go in the file.

The 2025 return is the hard call, and it belongs to the practitioner who will sign it. A new payment made in 2026 is not a 2025 payment. Payments Travis actually received in 2025 can still be reported or corrected for 2025, using the misclassified-employee procedure in Part VII.F if § 3509 applies. As Part VI.C explains, coordination with an EA, CPA, or attorney is recommended; that is risk management, not a rule about who may prepare the returns.1

A promise to run payroll in 2026 does not fix the 2025 return. Before signing, the practitioner needs a supported treatment of the 2025 payments, coordinated across the Form 1120-S, Travis's Form 1040, and any payroll and information returns, ideally with a competent payroll or controversy provider. If that support is not there, the practitioner declines the 2025 return. **Section** 6694 requires an actual understatement on a return the preparer prepared; a $0 on Line 7 does not by itself trigger the penalty.2 Either way, the § 10.21 letter covers 2025 as well, and the practitioner does not prepare another Form 1099-NEC to Travis from his own corporation.

If the IRS opens an employment tax examination of 2023 or 2024, the practitioner does not represent the corporation; Part VII.G explains why AFSP rights do not reach it. The practitioner refers Travis to an EA, CPA, or attorney. The file contains the returns, the CP-261, the § 10.21 letter, and the Many Hats workpaper with dated wage tables and electronic logs. A cover note flags both timely Forms 1099-NEC for Classification Settlement Program evaluation across all relevant years **(IRM 4.23.6.9)**. It also flags Track 1 treatment under IRM 4.23.8.5.2.1 at the rates in Table 10, the intentional-disregard risk under § 3509(c), and the self-employment tax refund question.

Three habits carry over from Travis's file to every S corporation client. At intake, screen every Form 1120-S for a working officer with distributions and nothing on Line 7. Deliver and document the § 10.21 advice on any prior preparer's $0-salary returns without volunteering to amend them, and decline to sign a current-year $0-salary return. In the file, keep a contemporaneous Many Hats workpaper built on client-stated, supported hours and dated OEWS printouts, with AI kept within the limits in Part V.J. At examination, refer the matter early to an EA, CPA, or attorney, and send the file with the § 3509 track already identified.

Reasonable compensation has no safe harbor. It has a method, and the method is what makes a wage defensible.

1 Instructions for Form 941-X (Rev. Apr. 2026), Line 42; I.R.C. § 3509(a)–(d).

2 I.R.C. § 6694(a), (e); Treas. Reg. § 1.6694-1(b); 31 C.F.R. § 10.34(a), (d).

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Name of the CE Provider	AmData
Program name	Get Your WISP Together! A Hands-On Tax Office Security Workshop
IRS program number	A5BAX-T-00141-26-I
CE	2
Prerequisite	Basic understanding of individual income tax principles and joint tax filing. **Field of Study:** Taxes
Advanced Preparation	None
Program Level	Intermediate
Delivery Method:	Live in-person
Program Category:	Federal Tax Law Topics/Federal Tax Related Matters - A program designed to enhance professional knowledge in Federal Tax related matters.



ABSTRACT

This student text accompanies a two-hour live workshop on the written information security plan **(WISP)** that federal law requires of tax preparation businesses. It explains the three separate legal layers that govern client data in a tax office. They are the Federal Trade Commission's Safeguards Rule, the Internal Revenue Code's confidentiality rules for tax return information, and the IRS e-file program's incident-reporting requirement. It then walks the reader through drafting, implementing, and maintaining a plan sized for a seasonal practice. The text traces the analysis through two composite practices introduced in the opening narrative. One is a one-person Gulfport, Mississippi, office with a seasonal helper; the other is a two-office firm serving Louisiana, Mississippi, and Alabama clients. It resolves both of their cases at the end. Mississippi, Alabama, and Louisiana breach-notice statutes serve as the state illustrations. After completing the program, participants should be able to do six things. First, determine whether a tax practice is covered and identify the effect of the fewer-than-5,000-consumer exception. Second, inventory taxpayer-information locations and document a practical risk assessment. Third, select and document safeguards, responsibilities, access controls, and service-provider oversight. Fourth, distinguish security controls from legal authorization to disclose or use tax return information. Fifth, apply IRS and FTC incident-reporting triggers and identify when state-law analysis is

necessary. Sixth, prepare an implementation, testing, and maintenance action plan. The worksheets in Exhibits A through I are original Tax Practice Pro forms intended to be completed during and after the session.

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Definitions:

- **Fact-Driven Education:** This program is focused on providing accurate, up-todate information about tax laws, regulations, and administrative updates as they stand today.
- **Non-Political Content:** All discussions are strictly factual and are not intended to express or imply any political opinions or preferences.
- **Commitment to Professionalism:** Our shared responsibility as tax professionals is to understand and apply the law, ensuring compliance and effective client representation.
- **Focus on Practice:** This program prioritizes practical, actionable knowledge to support your work, free from bias or interpretation beyond what the law provides.

The First Calls

Earl Dubose has prepared returns out of the front room of his house in Gulfport, Mississippi, for nineteen seasons. He opens the doors in mid-January, closes them after the April deadline, and spends the rest of the year fishing and fielding the occasional notice. He files about 450 individual returns a season through a cloud-based professional tax program. His niece Kendra works the front desk from February through April, scanning documents and booking appointments. His nephew Marcus, who works in information technology **(IT)** for a hospital system, handles "the computer stuff" on weekends. Earl has an Electronic Filing Identification Number **(EFIN)**, a Preparer Tax Identification Number **(PTIN)**, and an Annual Filing Season Program **(AFSP)** record of completion. He also has a three-ring binder labeled WISP that he bought at a seminar in 2023 and has not opened since.

On Monday, February 2, 2026, Earl received an email from a man who said he had just moved to the coast. He needed a return done. The message had a link to "my W-2 and last year's return." Earl clicked it, saw what looked like his email login screen, typed his password, and got a blank page. He assumed the link was broken and went back to work. Nine days later, on Wednesday, February 11, a long-time client called to ask why Earl had emailed her a request to "confirm her direct-deposit account." Earl had sent no such email. That evening Marcus logged into Earl's mailbox and found a rule, created February 3, that silently forwarded every incoming message to an outside address. The rule's settings and the mailbox log confirmed that it had been forwarding mail for more than a week. The mailbox held years of client attachments: W-2s, 1099s, driver's license images, and prior-year returns.

Earl's question to the conference hotline was short: "What do I have to do, who do I have to tell, and by when? And was I supposed to have something in place that would have stopped this?"

About an hour west on Interstate 10 sits the second practice. Renée Fontenot owns Bayou Tax & Bookkeeping, LLC, with storefronts in Slidell, Louisiana, and Picayune, Mississippi. She files about 1,400 returns a season with four seasonal preparers and keeps a year-round bookkeeping clientele. She pays an outside IT contractor to maintain her network and client portal. Her clients live in Louisiana, Mississippi, and Alabama. On Monday, June 22, 2026, her IT contractor reported a problem. The client-portal account of Dana, a seasonal preparer who left on April 30, had been used in June to download several hundred client files. Renée's question was more sophisticated than Earl's, but it was the same question.

This text answers both. It begins with the law that requires a WISP and explains what the plan must contain and how to scale it. It then turns to the problem every reader hopes to avoid: what to do, and whom to tell, when something goes wrong. Earl and Renée reappear throughout, and their cases are resolved at the end.

Caution: Composite practices

Earl Dubose, Renée Fontenot, their staff, and their firms are composites created for teaching. They are not clients, and the facts are simplified. The worked examples omit facts that would matter in a real engagement, including the specific terms of a firm's insurance policy and vendor contracts. They are not a substitute for counsel when an actual incident occurs.

I. WHY A TAX OFFICE MUST HAVE A WISP

A. The Short Answer: Tax Preparers Are "Financial Institutions"

Most seasonal practitioners hear "financial institution" and think of banks. Federal privacy law uses a much broader definition. The Gramm-Leach-Bliley Act of 1999 **(GLBA)** imposes on every financial institution "an affirmative and continuing obligation to respect the privacy of its customers and to protect the security and confidentiality of those customers' nonpublic personal information."1 The statute directs the federal regulators to set standards for "administrative, technical, and physical safeguards."2 It defines "financial institution" by reference to activities that are financial in nature, not by charter or license.3

The Federal Trade Commission enforces the statute for financial institutions within its jurisdiction that are not subject to another regulator's enforcement authority under GLBA section 505.4 Its implementing standards are the Standards for Safeguarding Customer Information, universally called the Safeguards Rule.5 The rule does not leave tax practitioners to argue about coverage. Its scope paragraph names "tax preparation firms" among the businesses to which it applies.6 Its definition of financial institution includes, as an express example, "[a]n accountant or other tax preparation service that is in the business of completing income tax returns."7

The operative command follows. A covered business "shall develop, implement, and maintain a comprehensive information security program" that is written and "appropriate to your size and complexity."8 That program, reduced to writing, is the WISP. The IRS and its Security Summit partners have been saying the same thing in plain English for years. In August 2026 the IRS reminded practitioners that "[f]ederal law requires tax and accounting professionals to create and maintain a Written Information Security Plan."9

Coverage follows the activity, not the credential. An unenrolled seasonal preparer, an AFSP participant, an enrolled agent, and a CPA firm are all covered. The test is whether they are in the business of completing income tax returns. A practitioner who prepares only a handful of returns for family members, without charge, presents a harder question. This text does not attempt to resolve it. Attorneys and certain CPA firms raise coverage questions of their own that are beyond this text. Everyone in the room who prepares returns for paying clients should assume the rule applies.

⊗ **Warning: The binder is not the program**
The rule requires a program that is developed, implemented, and maintained. A purchased template that has never been tailored, adopted, or followed does not satisfy that standard. If it describes safeguards the office does not use, it can be worse than nothing. It documents the gap between what the firm promised and what it did. Earl's 2023 binder is the cautionary example.

B. Three Legal Layers, Not One

The most common conceptual error in WISP seminars is to treat "data security" as a single obligation. A tax office actually sits under three overlapping regimes. Each answers a different question, and compliance with one does not discharge the others.

The three layers answer different questions

Layer	Central question	Principal authority
Information security	How must the practice protect the customer information it holds?	GLBA, 15 U.S.C. § 6801(b); FTC Safeguards Rule, 16 C.F.R. pt. 314

1 15 U.S.C. § 6801(a).
2 15 U.S.C. § 6801(b).
3 15 U.S.C. § 6809(3)(A) (incorporating activities described in 12 U.S.C. § 1843(k)).
4 15 U.S.C. § 6805(a)(7); 16 C.F.R. § 314.1(b) (2026).
5 16 C.F.R. pt. 314 (2026); see 15 U.S.C. § 6805(b)(2) (rulemaking authority).
6 16 C.F.R. § 314.1(b) (2026).
7 16 C.F.R. § 314.2(h)(2)(viii) (2026).
8 16 C.F.R. § 314.3(a) (2026).
9 IRS News Release IR-2026-92 (Aug. 18, 2026).

Layer	Central question	Principal authority
Confidentiality and authorized use	May the preparer disclose or use this tax return information, for this purpose, to this recipient?	I.R.C. §§ 7216, 6713; Treas. Reg. §§ 301.7216-1 through -3
E-file participation	What additional conditions apply because the office is an Authorized IRS e-file Provider?	IRS Pub. 1345 (Rev. Dec. 2025)

Source: authorities cited in the table. State breach-notice and data-security statutes add a fourth layer, covered in Section V.

The Treasury regulations under section 7216 say expressly that the two federal regimes are cumulative. GLBA requirements "do not supersede, alter, or affect the requirements of section 7216," and section 7216 does "not override any requirements or restrictions of the Gramm-Leach-Bliley Act, which are in addition to" the section 7216 rules.1 The practical consequence runs in both directions. An encrypted client portal protects a transmission, but it does not make an otherwise impermissible disclosure lawful. A disclosure that section 7216 permits must still be made through appropriate safeguards.

The e-file layer matters because nearly every practitioner in this room is an Electronic Return Originator **(ERO)**. An ERO is the e-file role that originates the electronic submission of returns prepared or collected for clients. Publication 1345 tells providers that those subject to GLBA "must follow the FTC's Financial Privacy and Safeguard Rules." It also warns that failures that lead to an unauthorized disclosure "may subject you to penalties under sections 7216 and/or 6713."2 It also imposes what is typically the shortest reporting deadline a practitioner will face after an incident, discussed in **Section** V.

C. Where IRS Publications Fit in the Authority Hierarchy

Practitioners are accustomed to sorting authority, and that habit is useful here. The statute and the FTC's regulation are binding. The section 7216 regulations are binding. IRS publications, including Publication 5708 **(the IRS sample WISP)**, Publication 4557, and the one-page Publication 5709, are guidance. They are helpful, often excellent, and not themselves the law. Publication 5708 says as much: "It is not an exhaustive discussion of everything related to WISPs."3

That distinction has teeth in at least three places. First, Publication 5708 summarizes the FTC reporting duty as reporting a security event "affecting 500 or more people." The regulation's actual trigger is narrower and more technical, as **Section** V explains.4 Second, Publication 4557's password guidance **(a minimum of eight characters)** predates the current federal technical standard.5 Third, several commercial WISP templates circulating at tax seminars contain policies that are sensible office choices but are not legal requirements. Others contain statements that are simply wrong. Where a template and the regulation disagree, the regulation controls, and practitioners who argue otherwise tend to learn that lesson the hard way.6

Practice Pointer: Read the rule itself

The core of the Safeguards Rule, sections 314.3 and 314.4, runs about four printed pages. Every practitioner who signs a WISP should read those sections at least once. Doing so takes less time than a single amended return and is the fastest cure for template-induced confusion.

1 Treas. Reg. § 301.7216-1(c).

2 IRS Pub. 1345, Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns, "Safeguarding IRS e-file" (Rev. Dec. 2025).

3 IRS Pub. 5708, Creating a Written Information Security Plan for Your Tax & Accounting Practice 2 (Rev. 8-2024).

4 Compare IRS Pub. 5708, supra, at 2, with 16 C.F.R. §§ 314.2(m), 314.4(j)(1) (2026).

5 IRS Pub. 4557, Safeguarding Taxpayer Data 6 (Rev. 6-2024); NIST SP 800-63B-4 § 3.1.1.2 (July 2025).

6 But cf. Mellencamp, J.C., *Authority Song*, on *Uh-Huh* (1983) ("I fight authority, authority always wins"), https://youtu.be/wsEwK69LXjQ.

D. The Small-Practice Exception and How to Count

Section 314.6 is the most misunderstood paragraph in the rule. It provides that four specified requirements "do not apply to financial institutions that maintain customer information concerning fewer than five thousand consumers."1 The four requirements are the written risk-assessment specifications in section 314.4(b)(1), the continuous-monitoring or penetration-testing and vulnerability-assessment regime in section 314.4(d)(2), the written incident response plan in section 314.4(h), and the annual written report to the board or equivalent in section 314.4(i).2

Read the exception for what it does not do. It does not eliminate the WISP. It does not eliminate the underlying risk assessment, which section 314.4(b) still requires; only the prescribed written contents in paragraph **(b)**(1) fall away. It does not touch access controls, encryption, multi-factor authentication, disposal, change management, logging, testing, training, vendor oversight, program adjustment, or the duty to notify the FTC of a qualifying event.3 Seminar handouts that describe small firms as "exempt from the Safeguards Rule" are wrong.

The threshold is measured in consumers about whom the firm maintains customer information. It is not returns filed this season, active clients, or employees. A "consumer" is "an individual who obtains or has obtained a financial product or service from you."4 "Customer information" means "any record containing nonpublic personal information about a customer."5 Because the definition reaches individuals who "ha[ve] obtained" service, archived files for former clients count while the firm still holds them. The rule does not spell out how to count spouses on joint returns, dependents, or individuals who appear only as payers or employers. Until the FTC addresses those questions, the defensible approach is to count conservatively and document the method used.

Workpaper: Worked Example 1, Counting consumers for § 314.6

```
Count method: the Rule defines a consumer as an individual (16 C.F.R. section 314.2(b)), and a person who
becomes your client for tax preparation has a customer relationship with you (16 C.F.R. section 314.2(e)
(2)(i)(H)), making that client a customer under 16 C.F.R. section 314.2(c). So when both spouses are your
clients on a joint return, count each spouse separately. A dependent or other person whose information
merely appears in the file is not automatically a consumer. This text uses a conservative, documented
filer-plus-spouse method because the Rule does not prescribe a tax-preparer counting worksheet.
Assumptions for both counts below: each person is counted once across all years, offices, and changes in
marital status. The archive counts are pre-2026 illustrations. A current count is required before relying
on the exception.
EARL DUBOSE (sole practitioner, Gulfport, MS)
  Distinct filing units in retained files, 2019-2025 seasons     820
  Share filing jointly (from software report)                    40%
  Spouses on joint returns: 820 x 0.40                           328
  Individuals counted (filers + spouses): 820 + 328            1,148
  Threshold                                                    5,000
  Result: 1,148 < 5,000. Exception available.

RENEE FONTENOT (two offices, LA/MS)
  Distinct filing units in retained files, 2016-2025 seasons   3,900
  Share filing jointly                                           45%
  Spouses on joint returns: 3,900 x 0.45                       1,755
  Individuals counted (filers + spouses): 3,900 + 1,755        5,655
  Result: 5,655 >= 5,000. Exception NOT available.
  Note: counting filing units alone (3,900) would put Renee
  under the line. The counting method decides the answer,
  so she documents the conservative count and complies with
  §§ 314.4(b)(1), (d)(2), (h), and (i).
```

Caution: Counting method is practitioner judgment

The regulation does not prescribe how to treat spouses, dependents, bookkeeping clients' employees, or duplicate records. The method shown above, counting each filer and spouse once, is a conservative judgment rather than a rule. A firm near the threshold should either comply with the four additional requirements or obtain advice. Either way, it should record in the WISP the counting method it used.

1 16 C.F.R. § 314.6 (2026).1 Id. (listing §§ 314.4(b)(1), (d)(2), (h), and (i)).

3 See 16 C.F.R. §§ 314.4(a), (b)(2), (c), (d)(1), (e)–(g), (j) (2026) (requirements not listed in § 314.6).

4 16 C.F.R. § 314.2(b)(1) (2026).

5 16 C.F.R. § 314.2(d) (2026).

Destroying old files to get under the line is a legitimate strategy only if the destruction complies with the retention rules discussed in Section III.F.

E. What Is at Stake

The Safeguards Rule is enforced by the FTC, and Publication 1345 warns that "[n]ot taking necessary steps to implement or correct your security program may result in sanctions from the FTC."1 This text does not quantify FTC civil penalties. That analysis turns on enforcement authorities and orders outside the scope of a two-hour program, and the figures quoted in seminar handouts are frequently unsupported. Three consequences closer to home deserve more attention.

The first is the section 7216 and 6713 regime, which governs disclosures and uses of tax return information by preparers. The two sections do not share a mental-state test. **Section** 7216 makes a knowing or reckless disclosure or use a misdemeanor. **Section** 7216 states fines of $1,000, or $100,000 for conduct meeting the identity-theft condition incorporated from section 6713(b), imprisonment for up to one year, or both, plus prosecution costs.2 The general federal fine statute can authorize higher fines, so these are not absolute monetary ceilings.3 **Section** 6713, which contains no knowing-or-reckless requirement, imposes a civil penalty of $250 per disclosure or use, capped at $10,000 per calendar year. The enhanced amounts in identity-theft cases are $1,000 and $50,000.4 The enhancement requires a disclosure or use made in connection with a crime relating to the misappropriation of another person's taxpayer identity. Exposure of a Social Security number alone does not establish that condition.5 A breach caused by an outside criminal is not automatically a "disclosure" by the preparer for these purposes. **Section** 7216 requires knowing or reckless conduct, and this text does not suggest that every victimized office has committed a crime.

The second is professional discipline. The IRS Office of Professional Responsibility has stated that failure to maintain a WISP could, "in circumstances of willfulness," expose a practitioner to discipline under Circular 230, citing the competence and compliance-procedure provisions.6 Competence under Circular 230 "requires the appropriate level of knowledge, skill, thoroughness, and preparation necessary for the matter."7 A practitioner who handles client data without understanding the rules that govern it has a competence problem as well as a security problem. Ordinary return preparation alone does not make an unenrolled preparer a Circular 230 practitioner. An unenrolled preparer who represents a taxpayer under the limited-practice rules is subject, to the extent of that authority, to the conduct rules the IRS prescribes.8 Annual Filing Season Program **(AFSP)** participants consent to the duties and restrictions in subpart B and section 10.51 of Circular 230 for the period covered by the record of completion.9 Other preparer, security, and confidentiality duties apply independently. Every preparer in the room is subject to the Safeguards Rule, to sections 7216 and 6713, and to state breach law.

The third is the client relationship. Breach notices, state attorney general filings, and identity-theft clean-up can disrupt a practice at any time, including the middle of filing season. The rest of this text is about preventing that disruption.

II. THE VOCABULARY AND THE MAP

A. Ten Terms the Rule Uses Precisely

Practitioners are experts in tax and, for the most part, beginners in information security. The Safeguards Rule uses ordinary-sounding words with defined meanings, and the definitions drive the outcomes. The ten that matter most for a seasonal office follow.

1 IRS Pub. 1345, supra, "IRS e-file Security, Privacy and Business Standards."
2 I.R.C. § 7216(a); Taxpayer First Act, Pub. L. No. 116-25, § 2009(b), 133 Stat. 1007 (2019).
3 18 U.S.C. §§ 3559(a)(6), 3571(b), (d), (e).
4 I.R.C. § 6713(a), (b)(1); Pub. L. No. 116-25, § 2009(a).
5 I.R.C. § 6713(b)(1).
6 IRS Off. of Prof'l Resp., Tax Pro Newsletter No. 2026-22, How to Be a Careful WISP(er) (July 22, 2026) (citing 31 C.F.R. §§ 10.35, 10.36).
7 31 C.F.R. § 10.35(a) (2026).
8 31 C.F.R. § 10.7(c)(2)(iii) (2026).
9 Rev. Proc. 2014-42, § 4.05(4).

An **authorized user** is "any employee, contractor, agent, customer, or other person that is authorized to access" the firm's information systems or customer information.1 Kendra is an authorized user. So is Marcus. Dana stopped being one on April 30. **Customer information** is any record of nonpublic personal information about a customer, in paper, electronic, or other form.2 An **information system** is "a discrete set of electronic information resources organized for the collection, processing, maintenance, use, sharing, dissemination or disposition of electronic information containing customer information or connected to a system containing customer information." A system that holds no client files itself can still be an information system because it is connected to one that does. Examples include the office router and an administrator account used to manage the portal. It includes the email account, the tax software, the scanner that stores images, and the cloud drive.3

Encryption means "the transformation of data into a form that results in a low probability of assigning meaning without the use of a protective process or key, consistent with current cryptographic standards and accompanied by appropriate safeguards for cryptographic key material."4 **Multi-factor authentication (MFA)** means authentication through verification of at least two of three factor types: knowledge factors, "such as a password"; possession factors, "such as a token"; and inherence factors, "such as biometric characteristics." In plain terms, something you know, something you have **(a phone app or security key)**, and something you are.5 A **service provider** is anyone who "receives, maintains, processes, or otherwise is permitted access to customer information" through providing services to the firm. That includes the tax software company, the cloud storage vendor, and Marcus.6

A **security event** is "an event resulting in unauthorized access to, or disruption or misuse of, an information system, information stored on such information system, or customer information held in physical form."7 A **notification event** is narrower. It means acquisition of unencrypted customer information without the authorization of the individual to whom it pertains.8 Every notification event is a security event, but many security events are not notification events. A ransomware lockout with no data taken may be one example, though that conclusion depends on facts. The **Qualified Individual** is the person designated to oversee and implement the program. The term is not defined in section 314.2; it comes from the designation requirement in section 314.4(a). Finally, **tax return information** is a section 7216 term rather than an FTC term. It means "any information, including, but not limited to, a taxpayer's name, address, or identifying number, which is furnished in any form or manner for, or in connection with, the preparation of a tax return of the taxpayer".9 The definition reaches far more than the completed return. Practitioners should read the full paragraph rather than substitute a narrower state-law definition of personal information.

B. Follow One W-2 Through the Office

The most effective exercise in this workshop takes ten minutes. Pick a single client document and trace every place it lands between the day it arrives and the day it is destroyed. Most practitioners discover three or four storage locations they had never thought of as part of their "system."

1 16 C.F.R. § 314.2(a) (2026).
2 16 C.F.R. § 314.2(d) (2026).
3 16 C.F.R. § 314.2(j) (2026).
4 16 C.F.R. § 314.2(f) (2026).
5 16 C.F.R. § 314.2(k) (2026).
6 16 C.F.R. § 314.2(r) (2026).
7 16 C.F.R. § 314.2(q) (2026).
8 16 C.F.R. § 314.2(m) (2026).
9 Treas. Reg. § 301.7216-1(b)(3)(i).

Workpaper: Worked Example 2, Earl's data map for one W-2

Step	Where the W-2 goes	Copy?	Who can reach it
1	Emailed PDF in Earl's inbox	Yes	Earl; anyone with his password
2	Downloaded to laptop	Yes	Anyone using the laptop
3	Kendra re-scans paper copy	Yes	Kendra; scanner memory
4	Imported into cloud tax software	Yes	Earl, Kendra, vendor staff
5	Photo texted to Marcus	Yes	Earl, Marcus, phone backups
6	Paper original in cabinet	Orig.	Anyone in the front room
7	Nightly laptop backup to USB	Yes	Anyone holding the drive
8	Phone photos sync to cloud	Yes	Earl's personal cloud account

Count: one document, seven copies plus one paper original, in eight locations, three of which (steps 2, 5, 8) Earl never listed in his binder. Step 1 is the copy the attacker reached in February.

Section 314.4(c)(2) requires the firm to "[i]dentify and manage the data, personnel, devices, systems, and facilities" that enable it to achieve business purposes, in accordance with their relative importance to business objectives and the firm's risk strategy.1 The data map is how a small office meets that requirement honestly. Notice that a hardware inventory, the familiar list of computers and serial numbers, answers a different question. A hardware list tells you what you own. A data map tells you where taxpayer information lives. That includes places you do not own, such as the email provider, the phone's photo cloud, and the nephew's phone. Exhibit C combines both on two pages.

Practice Pointer: The email inbox is a filing cabinet

For most small offices, the single largest unmanaged store of client data is the email account. Every attachment ever received is still there unless someone deleted it. Moving clients to a secure upload portal reduces both the chance and the size of an incident like Earl's. So does periodically purging attachments from email after import.

III. BUILDING THE CORE PLAN

This section moves through the elements of section 314.4 in the order a small office should draft them. Each subsection identifies what the rule requires, how a one-person office satisfies it, and how a larger office's answer differs. The finished product is Exhibit B, a six-page core WISP. Exhibits C through I hold the records that show the plan is actually operating.

A. Name the Qualified Individual

The firm must "[d]esignate a qualified individual responsible for overseeing and implementing" the program.2 In a one-person practice, that person is almost always the owner. The rule permits the role to be filled by an employee of an affiliate or a service provider. If the firm does that, the firm must "[r]etain responsibility for compliance." It must also designate a senior member of its own personnel to direct and oversee the outsourced Qualified Individual, and require the service provider to maintain an appropriate program of its own.3

The rule does not require a separate "Public Information Officer," a signature page for every employee, or a certification. Those are documentation choices some templates make, and some are useful, but none is the legal test. The legal test is whether a person with appropriate responsibility and authority is actually overseeing an operating program.

Caution: Outsourcing the role is not outsourcing the duty

Renée's IT contractor offered to "be her Qualified Individual." That is permissible, but section 314.4(a)(1) leaves compliance responsibility with Bayou Tax. If Renée accepts, her WISP must name a senior person inside her firm, almost certainly Renée herself, who directs and oversees the contractor. The contract must also require the contractor to maintain an appropriate information security program.

B. Assess the Risks

The program must be based on "a risk assessment that identifies reasonably foreseeable internal and external risks to the security, confidentiality, and integrity of customer information." The assessment must evaluate the

1 16 C.F.R. § 314.4(c)(2) (2026).
2 16 C.F.R. § 314.4(a) (2026).
3 16 C.F.R. § 314.4(a)(1)–(3) (2026).

sufficiency of the safeguards in place to control those risks.1 The firm must also "periodically perform additional risk assessments" that reexamine those risks and safeguards.2 Those obligations apply to every covered firm. A firm outside the section 314.6 exception, like Renée's, must also put the assessment in writing. The written assessment must contain criteria for evaluating and categorizing risks; criteria for assessing the confidentiality, integrity, and availability of systems and information; and a description of how identified risks will be mitigated or accepted.3

A risk assessment sounds formidable. For a seasonal office, it is a table. Each row names a plausible bad event and the control currently in place. It also records the evidence that the control works, a likelihood and impact score, and the corrective action. The scoring method below is a common practitioner convention, not a regulatory formula. Whatever method the firm uses must identify reasonably foreseeable risks and assess whether the safeguards in place are sufficient. The score only sets priorities.

Worked Example 3, Earl's risk table, as he should have written it in January

Risk	Control today	L	I	Score	Action / owner / due
Phishing steals email password	Password only	3	3	9	Turn on MFA for email; Earl; Jan. 10
Laptop stolen from car	Unknown if encrypted	2	3	6	Verify full-disk encryption; Marcus; Jan. 10
Kendra keeps access after season	None	2	2	4	Offboarding checklist (Exh. E); Earl; Apr. 30
Ransomware on laptop	USB backup, untested	2	3	6	Test a restore; Marcus; Jan. 15
Paper files seen by visitors	Cabinet, unlocked	2	2	4	Lock cabinet; Earl; Jan. 5
Client W-2s texted to Marcus	None	3	2	6	Stop practice; use portal; Earl; now

Scale: Likelihood (L) 1 = unlikely, 2 = possible, 3 = likely; Impact (I) 1 = minor, 2 = serious, 3 = severe. Score = L x I (range 1–9); 6 or more is fixed before the season. A row that describes a missing express requirement, such as MFA, encryption, or removing a departed user's access, is fixed now, regardless of its score. The preseason target does not authorize continued noncompliance; the cutoff only ranks everything else. Rows scoring 6 or more: phishing (9), laptop (6), ransomware (6), texting (6), so four items must be fixed before opening day. The scoring convention is practitioner judgment, not a regulatory formula.

The first row is the one that hurt Earl. A two-factor prompt on his email account would very likely have stopped an attacker who had only the password typed into the fake login page. Some sophisticated phishing kits can relay MFA codes, so MFA is a strong control rather than a perfect one. The table also shows what the rule means by "evaluating the sufficiency" of controls. "Unknown if encrypted" is not a control. It is a question someone must answer.

⚠ Caution: "Accept" is not a waiver

A risk table may record a decision to accept residual risk. It cannot record a decision to skip an express requirement. A note reading "MFA not needed, small office, accepted" does not satisfy section 314.4(c)(5). The only alternative that section allows is the Qualified Individual's written approval of "reasonably equivalent or more secure access controls."

C. Control Access and Require MFA

The firm must implement and periodically review access controls. Those controls must authenticate users and permit access only by authorized users. They must also limit each authorized user to the customer information needed to perform that user's duties.4 In a two-person office this means separate logins for Earl and Kendra, never a shared password. Kendra's account should not have administrative rights to the tax software or the router. Every account should be reviewed at season's end.

1 16 C.F.R. § 314.4(b) (2026).
2 16 C.F.R. § 314.4(b)(2) (2026).
3 16 C.F.R. § 314.4(b)(1) (2026).
4 16 C.F.R. § 314.4(c)(1) (2026).

The MFA requirement is broader than many practitioners realize. The rule requires MFA "for any individual accessing any information system," unless the Qualified Individual has "approved in writing the use of reasonably equivalent or more secure access controls."1 Several widely circulated templates describe MFA as a remote-access requirement only. That is too narrow. The rule's text reaches any individual and any information system.

Workpaper: Worked Example 4, Flawed vs. corrected MFA policy

```
FLAWED (common template language):
  "Multi-factor authentication is required for all remote
   access to the firm's network."
  Problem: Earl has no "network" and no "remote access."
  Under this wording he complied while his email, tax
  software, cloud drive, and portal admin all ran on
  password alone.

CORRECTED (Exhibit B, § 5), as Earl should have adopted it:
  "MFA is required for every individual, including the owner,
   accessing an information system covered by this plan.
   Covered systems include systems containing customer
   information and systems connected to them. As of [date]
   they include: email (app prompt), tax software (vendor
   MFA), cloud drive (app prompt), client portal admin
   (security key), and laptop login (password plus app
   prompt). Any alternative requires the Qualified
   Individual's written approval of reasonably equivalent
   or more secure access controls under 16 C.F.R.
   § 314.4(c)(5), listed here."
```

D. Encrypt, and Know What That Means

The rule requires the firm to "[p]rotect by encryption all customer information held or transmitted by you both in transit over external networks and at rest." Where encryption is infeasible, the alternative is "effective alternative compensating controls reviewed and approved by your Qualified Individual."2 For a seasonal office, "at rest" means at least full-disk encryption on every laptop and desktop and encryption on any external backup drive. It also means encrypted storage at the cloud vendor, which the firm confirms rather than assumes. "In transit" means encrypting customer information as it crosses external networks, which the tax software's own encrypted channels and a secure portal accomplish. The rule does not prohibit email or prescribe attachment-level encryption. Assess the actual transmission, storage, recipients, and keys. This sample firm uses a reviewed portal instead of ordinary email attachments. Encryption settings on most modern operating systems are a configuration choice, not a purchase. Marcus can verify them in an afternoon.

Encryption has a limit that the Earl case illustrates. It protects data from someone who steals the disk. It does not protect data from someone who logs in as you. When the attacker reached Earl's mailbox with Earl's password, the email provider's encryption at rest did nothing to stop him. To the system, he was Earl. The FTC definition of notification event reflects this point in a related way. Information is treated as unencrypted if "the encryption key was accessed by an unauthorized person."3

E. Passwords: Update the Policy to the Current Standard

Many WISP templates still require eight-character passwords containing uppercase letters, numbers, and symbols, changed every 60, 90, or 180 days. One commercial example plan in circulation contains both a 90-day and a 180-day rotation rule in different sections. Those rules reflect advice the federal standards community has since abandoned. The National Institute of Standards and Technology's current authentication guideline was finalized in July 2025. It provides that password verifiers require "a minimum of 15 characters in length" for passwords used as a single factor, and "a minimum of eight characters" when the password is used as part of MFA. It also provides that verifiers "SHALL NOT impose other composition rules." They "SHALL NOT require subscribers to change passwords periodically," but they "SHALL force a change if there is evidence

1 16 C.F.R. § 314.4(c)(5) (2026).
2 16 C.F.R. § 314.4(c)(3) (2026).
3 16 C.F.R. § 314.2(m) (2026).

that the authenticator has been compromised." And they must compare new passwords "against a blocklist" of known-compromised values.1

NIST guidance is a technical standard written primarily for federal systems. It is not itself a regulation binding on tax offices, and the FTC rule does not prescribe password length. It is, however, the most defensible reference point for a firm's chosen policy, and it is more current than the password advice in Publication 4557.2

Workpaper: Worked Example 5, Rewriting a password clause

```
TEMPLATE CLAUSE:
  "Passwords must be at least 8 characters, include upper and
   lower case, a number and a symbol, and be changed every
   90 days. Passwords must not be written down."
  Result in practice: Summer2026! -> Fall2026! -> Winter2026!

CORRECTED CLAUSE (firm policy, modeled on NIST SP 800-63B-4):
  "Every account uses a unique passphrase of at least 15
   characters (at least 8 where MFA is also required), stored
   in the firm's approved password manager. No composition
   rules. No scheduled changes; a password is changed
   immediately on any sign of compromise, including any
   phishing click. Staff do not reuse firm passwords anywhere
   else."
```

F. Retain What the Law Requires and Dispose of the Rest

The disposal requirement is one of the rule's most concrete provisions, and one of the most often misstated. The firm must develop procedures for "secure disposal of customer information in any format no later than two years after the last date the information is used in connection with the provision of a product or service" to the customer. Three exceptions apply: where the information is "necessary for business operations or for other legitimate business purposes," where it "is otherwise required to be retained by law or regulation," or where "targeted disposal is not reasonably feasible due to the manner in which the information is maintained." The firm must also "[p]eriodically review [its] data retention policy to minimize the unnecessary retention of data."3

Tax practitioners have a federal retention rule of their own that interacts with the two-year rule. A preparer must, "for the period ending 3 years after the close of the return period," retain either a completed copy of each return or a record of each taxpayer's name, taxpayer identification number, taxable year, and type of return.4 The regulation also requires a record of the individual preparer required to sign each return. When a return becomes due in a later return period than the one in which it was presented for signature, the three years run from the close of that later period.5 The "return period" is "the 12-month period beginning on July 1 of each year."6 Separately, the ERO instructions to Form 8879 direct the ERO to "[r]etain the completed Form 8879 for 3 years from the return due date or IRS received date, whichever is later."7

1 NIST SP 800-63B-4, Digital Identity Guidelines: Authentication and Authenticator Management § 3.1.1.2 (July 2025).

2 Compare IRS Pub. 4557, supra, at 6 ("Use a minimum of eight characters"), with NIST SP 800-63B-4, supra, § 3.1.1.2.

3 16 C.F.R. § 314.4(c)(6)(i)–(ii) (2026).

4 I.R.C. § 6107(b).

5 Treas. Reg. § 1.6107-1(b)(1)–(2).

6 I.R.C. §§ 6107(d), 6060(c).

7 Form 8879, IRS e-file Signature Authorization, Important Notes for EROs (Rev. Jan. 2021).

Workpaper: Worked Example 6, When may Earl shred a departed client's file?

```
Facts: Client last served for her 2023 Form 1040, signed and
e-filed February 20, 2024. She did not return in 2025 or 2026.

Two-year rule, 16 C.F.R. § 314.4(c)(6)(i):
  Last use                          February 20, 2024
  Two years later                   February 20, 2026
  ...but "required to be retained by law" exception applies:

I.R.C. § 6107(b) copy-or-list:
  Return period containing 2/20/2024: July 1, 2023 - June 30, 2024
  Close of return period            June 30, 2024
  + 3 years                         June 30, 2027

Form 8879 (ERO instructions):
  Return due date                   April 15, 2024
  IRS received date                 February 20, 2024
  Later of the two                  April 15, 2024
  + 3 years                         April 15, 2027

Legal dates: return copy or list through June 30, 2027;
Form 8879 through April 15, 2027. Keeping both through
June 30, 2027 is a simplified firm policy. Other rules
or holds can require longer retention.

FLAWED POLICY: "Shred all client files two years after last
service" -> would destroy the § 6107(b) copy and the 8879 in
February 2026, more than a year early.

CORRECTED POLICY: Keep the return copy (or list) and the 8879
through June 30, 2027. Source documents (W-2 images, license
copies) are kept for any period another rule requires,
then only for a documented business purpose; after that
they are securely disposed of on the firm's schedule.
If the return claimed EIC, CTC/ACTC, AOTC, or HOH status:
  Form 8867, worksheets, and copies of documents relied on
  are kept 3 years from the latest of due date or e-file
  date: April 15, 2024 + 3 years = April 15, 2027
  (Treas. Reg. § 1.6695-2(b)(4)).
```

Caution: Business-purpose retention is a judgment

Section 6107(b) can be satisfied with a record of each taxpayer's name, identifying number, taxable year, and return type, together with the signing-preparer record. Other rules can require keeping source documents. If the preparer determined eligibility for the earned income credit, the child tax credit or additional child tax credit, the American opportunity tax credit, or head of household status, Treas. Reg. § 1.6695-2(b)(4) requires keeping Form 8867, the worksheets, and copies of documents the preparer relied on. Those records are kept for three years from the latest applicable date. The retained file also records how and when the information was obtained and who furnished it (Treas. Reg. § 1.6695-2(b)(4)(i)(C)). Separately, the knowledge requirement calls for contemporaneous documentation of any inquiries made and the responses (Treas. Reg. § 1.6695-2(b)(3)(i)); keep that documentation with the retained records. Retaining W-2 images and driver's license copies beyond that period rests on the "legitimate business purposes" exception. Defending a later examination or answering a client's question can be a legitimate purpose. The firm should state the purpose and the period in its retention schedule (Exhibit G) rather than keep everything indefinitely by default. Additional archive years increase the records retained. They increase the section 314.6 consumer count only when they add distinct individuals not already counted.

Disposal must actually work. Reformatting a drive or deleting files does not reliably remove data. The current NIST media-sanitization guideline describes three outcomes. "Clear" applies logical techniques to all user-addressable storage. "Purge" makes recovery of the target data "infeasible." "Destroy" renders recovery "infeasible using state-of-the-art laboratory techniques." The guideline also calls for verification: "[t]he sanitization results should be inspected to verify that the sanitization technique was completed successfully."1 For a seasonal office, the practical answer is usually a reputable shredding vendor for paper. For old drives,

1 NIST SP 800-88 Rev. 2, Guidelines for Media Sanitization §§ 3.1.1–3.1.3, 4.5.1 (Sept. 2025).

copiers, and phones, use a vendor that provides a certificate of destruction. Exhibit G records the method and the evidence. Remember the copier. Many office copiers and multifunction scanners store images internally.

G. Protect the Equipment, the Room, and the Backup

The program must include physical safeguards appropriate to the firm.1 For a home office, the realistic risks are household members, visitors, burglary, and weather. On the Gulf Coast, a hurricane is a reasonably foreseeable hazard to "the security or integrity" of records, which is one of the three objectives the program must address.2 A locked cabinet and a laptop that stays encrypted and logged out when unattended cover much of it. Add a backup stored somewhere other than the room that floods, and a tested restoration process.

The rule does not prescribe a backup interval. Backups belong in the plan because ransomware and storms are foreseeable risks. A backup that has never been restored is a hope rather than a control. The rule's testing requirement applies here: the firm must "[r]egularly test or otherwise monitor the effectiveness of the safeguards' key controls."3

Workpaper: Worked Example 7, Earl's restore test, as it should have been run in January (Exhibit I entry)

Date of test:	January 15, 2026
Tested by:	Marcus (QI approval: Earl)
Backup tested:	USB drive, nightly image of laptop
Procedure:	Restored 3 client folders from the 1/14 image to a spare laptop
Result:	2 of 3 folders opened. Folder 3 (the 2024 archive) failed. The archive had been deleted from the laptop by mistake, and the drive kept only 14 days of images, so no surviving backup still held it.
Finding:	Backup retention too short; drive kept in same room as laptop.
Corrective action:	Second encrypted drive, rotated weekly to Earl's safe-deposit box; retention extended to 90 days. 2024 returns recovered from the tax software vendor archive and added back to the backup job.
Retest:	January 22, 2026 - the failed folder and two others restored, 3 of 3.

H. Train People and Plan for Their Departure

The firm must provide "security awareness training that is updated as necessary to reflect risks identified by the risk assessment." It must use qualified information security personnel, whether employed, affiliated, or contracted. It must provide those personnel with security updates and training, and verify that they keep their knowledge of changing threats current.4 The rule sets no annual date and no minimum number of hours. For a seasonal office, the sensible time to train is the first day of the season, before the first client document arrives. The training should be concrete. Staff should learn what a phishing email asking for a password reset looks like, why client documents never travel by text message, and whom to call when something seems wrong.

Departures are where small offices most often fail. Renée's incident began not with a sophisticated attack but with an account that nobody turned off. The access-control requirement in section 314.4(c)(1) is a continuing obligation. When an authorized user stops being authorized, every credential must be revoked: tax software, portal, email, cloud drive, building keys, and any personal device that synchronized firm data. Exhibit E is a one-page access and offboarding record built for that purpose.

1 15 U.S.C. § 6801(b); 16 C.F.R. § 314.3(a) (2026).
2 16 C.F.R. § 314.3(b)(2) (2026).
3 16 C.F.R. § 314.4(d)(1) (2026).
4 16 C.F.R. § 314.4(e)(1)–(4) (2026).

Warning: Seasonal staff leave every April

A seasonal practice offboards its entire staff once a year. The offboarding checklist should be scheduled on the calendar for the last day of the season. The owner completes it and records the date each account was disabled. "We'll get to it after the extension rush" is how a June incident happens.

I. Monitor, Log, Manage Change, and Review

Four remaining requirements are short but important. The firm must "[i]mplement policies, procedures, and controls designed to monitor and log the activity of authorized users and detect unauthorized access or use of, or tampering with, customer information by such users."1 For small offices, this usually means turning on the login-alert and audit-log features that the email provider, tax software, and portal already offer. Someone must also read them. In Earl's case, an alert on a new forwarding rule would have flagged the attack on February 3. The firm must also "[a]dopt procedures for change management." In plain terms, the WISP is reviewed whenever the office adds a new system, vendor, or way of working.2 The firm must also adopt "secure development practices for in-house developed applications" and "procedures for evaluating, assessing, or testing the security of externally developed applications you utilize to transmit, access, or store customer information."3 Few seasonal offices write their own software, so the practical duty is the second one. Before relying on the tax software, portal, or cloud drive, and again when it changes, the firm records how it evaluated that application's security. It also records what it found and what it did about any gap. This requirement applies below the 5,000-consumer line. Finally, the firm must "[e]valuate and adjust" the program in light of testing results, material changes to operations, and other circumstances that may materially affect it.4

Renée's firm, being over the 5,000-consumer line, has two further obligations. First, its testing must include continuous monitoring or periodic penetration testing and vulnerability assessments. Absent effective continuous monitoring or "other systems to detect, on an ongoing basis, changes in information systems that may create vulnerabilities," it must conduct "[a]nnual penetration testing" and vulnerability assessments "at least every six months." Vulnerability assessments are also required whenever there are material changes to operations or business arrangements, or other circumstances that may have a material impact on the information security program. Ordinary login alerts should not be assumed to meet the continuous-monitoring standard.5 Second, its Qualified Individual must "report in writing, regularly and at least annually," to the board or equivalent governing body, or to a senior officer if there is none, on the program's overall status and material matters.6 For a single-member LLC whose owner is also the Qualified Individual, the report is in substance a written annual self-review. It should be kept with the WISP.

Practice Pointer: Schedule the annual review

Even a firm under the 5,000-consumer threshold should put an annual review on the calendar, ideally in early December, before the season. Walk the data map, update the risk table, confirm the vendor list, test a restore, and re-sign the plan. The rule requires periodic and event-driven evaluation. A fixed annual date simply makes sure it happens.

IV. VENDORS, CONTRACTORS, AND THE RIGHT TO DISCLOSE

A. Overseeing Service Providers

The firm must oversee service providers. It does so by taking reasonable steps "to select and retain service providers that are capable of maintaining appropriate safeguards," "[r]equiring your service providers by contract to implement and maintain such safeguards," and "[p]eriodically assessing your service providers based on the risk they present and the continued adequacy of their safeguards."7 Selection, contract, and periodic review are the three steps, and the WISP should show all three for each vendor.

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1 16 C.F.R. § 314.4(c)(8) (2026).
2 16 C.F.R. § 314.4(c)(7) (2026).
3 16 C.F.R. § 314.4(c)(4) (2026).
4 16 C.F.R. § 314.4(g) (2026).
5 16 C.F.R. § 314.4(d)(2), (d)(2)(i)–(ii) (2026).
6 16 C.F.R. § 314.4(i) (2026).
7 16 C.F.R. § 314.4(f)(1)–(3) (2026).

One sample plan widely distributed to tax offices excludes tax software companies and e-file transmitters from part of its vendor-oversight discussion. The apparent theory is that the IRS already regulates them. **Section** 314.4(f) contains no such exception. Tax software vendors are among the most important service providers a practice has, because they hold every return. The firm cannot audit a national software company. It can document why it selected the vendor, what security commitments the vendor's agreement contains **(MFA availability, encryption, incident notice to the firm)**, and when it last reviewed them. Exhibit F provides one page per vendor.

B. Security Is Not Permission: Section 7216

A WISP answers the question "is this information protected?" **Section** 7216 answers a different question: "may I disclose or use it at all?" The default rule is consent. Unless section 7216 or the regulations specifically authorize a disclosure or use, a preparer "may not disclose or use a taxpayer's tax return information prior to obtaining a written consent from the taxpayer."1 Consent must come first: "[a] taxpayer must provide written consent before a tax return preparer discloses or uses the taxpayer's tax return information."2 For Form 1040-series filers, consents must follow the format and mandatory language prescribed in Rev. Proc. 2013-14.3

The definition of "tax return preparer" for these purposes is broad. It reaches "[a]ny person who is engaged in the business of providing auxiliary services in connection with the preparation of tax returns, including a person who develops software that is used to prepare or file a tax return and any Authorized IRS e-file Provider."4 "Disclosure" means "the act of making tax return information known to any person in any manner whatever."5 Several exceptions matter in everyday operations, and each has conditions.

Common tax-office disclosures and the authority that permits them

Situation	Authority and condition	WISP implication
Kendra and Earl share a client file inside the office	**Treas. Reg. § 301.7216-2(c)(2):** disclosure among officers, employees, or members of the same U.S. preparer to assist in preparation	Role-based access; no consent needed for this purpose
Return sent to another U.S. preparer for review or processing	**Treas. Reg. § 301.7216-2(d)(1):** permitted for preparation or auxiliary services, but only if the services are not "substantive determinations or advice affecting the tax liability"	**Classify the actual service; substantive outside advice generally requires consent. A separate exception covers qualifying quality or peer review, § 301.7216-2(p)(1):** only attorneys, CPAs, enrolled agents, and enrolled actuaries eligible to practice may review; information is used only for the review; no taxpayer-identifying information in reports; the preparer keeps a record of the review; reviewers keep no identifying documents afterward
Marcus, the IT contractor, repairs the laptop	**Treas. Reg. § 301.7216-2(d)(2):** only "to the extent necessary," and only if each individual receives a written notice of §§ 6713 and 7216	Keep the signed notice in the vendor file (Exhibit F)

1 Treas. Reg. § 301.7216-3(a)(1).
2 Treas. Reg. § 301.7216-3(b)(1).
3 Rev. Proc. 2013-14, 2013-3 I.R.B. 283.
4 Treas. Reg. § 301.7216-1(b)(2)(i)(B).
5 Treas. Reg. § 301.7216-1(b)(5).

Situation	Authority and condition	WISP implication
Offshore preparer or offshore staff viewing files	**Treas. Reg. § 301.7216-3:** written consent required before disclosure; 1040-series SSNs may not be disclosed offshore by consent and must be redacted or masked, § 301.7216-3(b)(4)(i), unless, under (b)(4)(ii), the SSN is disclosed through an adequate data protection safeguard defined in IRS guidance and the U.S. preparer verifies that safeguard in the consent request	Determine where every person with access sits, not just where the server sits
Cloud portal, AI tool, or document service	No blanket exception for "cloud," "enterprise," or "secure" services	Analyze purpose, recipient, location, retention, and secondary use

Sources: regulations cited. The table summarizes; the regulation text controls each condition.

Warning: The nephew needs a notice

Marcus is a person "under contract with the tax return preparer in connection with the programming, maintenance, repair, testing, or procurement of equipment or software." Earl may disclose tax return information to him "only to the extent necessary" for the services and "only if the tax return preparer ensures that all individuals who are to receive disclosures of tax return information receive a written notice that informs them of the applicability of sections 6713 and 7216 to them."1 Family relationship does not change the rule. Earl had never given Marcus that notice, and the texted W-2 photos in Worked Example 2 went beyond what any repair required.

C. Artificial Intelligence Tools

Generative AI tools have arrived in tax offices faster than anyone's policy. A preparer who pastes a client's W-2 into a consumer chatbot to "check box 12" has made a disclosure to the provider of that tool. The question is whether any exception covers it. No regulation creates an AI-specific safe harbor. A setting that tells the provider not to train on the data addresses one possible secondary use. It does not itself supply section 7216 authority or taxpayer consent. Whether a particular enterprise arrangement fits an existing exception, such as an auxiliary-services relationship under section 301.7216-2(d), depends on the facts. They include the contract, the provider's actual access and retention, the location of its personnel and subprocessors, and the service performed. It must be analyzed rather than assumed.

The security layer applies at the same time. An AI service that receives customer information is a service provider under section 314.4(f). Adding it is a change that section 314.4(c)(7) expects the firm to manage. The workable office policy is short. No client information goes into any AI tool that has not been reviewed and approved in writing. Approved tools are listed in the WISP with their permitted uses. Client data is minimized or removed before use wherever the task permits. Removing names or SSNs does not automatically take information outside section 7216. Tax return information includes information the preparer derives or generates from it, and even statistical compilations that cannot identify a taxpayer.2 Data minimization is a safeguard, not disclosure authority. Use generic questions without client-specific facts unless a documented exception or valid consent applies.

The same discipline applies to the output. An AI tool can draft, summarize, and calculate, but the preparer who signs the return or the advice remains responsible for it. That responsibility runs through the preparer-penalty regime and, for anyone subject to Circular 230, its diligence standard. Neither depends on how the work was produced.3 A machine helps only when the person directing it understands the work well enough to check it.4

1 Treas. Reg. § 301.7216-2(d)(2).

2 Treas. Reg. § 301.7216-1(b)(3)(i), (i)(B).

3 31 C.F.R. § 10.22(a) (2026) (due diligence in preparing returns and in representations to clients); I.R.C. § 6694(a)–(b).

4 See also Jay Williams & Raymond Abrashkin, *Danny Dunn and the Homework Machine* (Whittlesey House 1958) (a boy builds a machine to do his homework, an early fictional version of the same

Workpaper: Worked Example 8, Flawed vs. corrected AI use

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FLAWED: Kendra photographs a client's brokerage 1099 and asks
a free chatbot, "What goes on Schedule D?" The image includes
name, address, SSN (last 4 visible), and account number.
  Disclosure?          Yes - to the tool provider.
  Exception?           None identified; no consent on file.
  Safeguards?          Unreviewed provider; retention unknown.
  WISP status?         Tool not on approved list.

CORRECTED: Earl's policy lists one approved, contracted AI
service, reviewed for retention, training, access location,
and §7216 basis. Kendra asks the general question
("How are wash-sale adjustments reported on Form 8949?") with
no client data, then applies the answer herself in the tax
software. Earl reviews the result before signing.
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V. WHEN SOMETHING GOES WRONG

A. The Incident Response Plan

A firm outside the section 314.6 exception must have a "written incident response plan designed to promptly respond to, and recover from, any security event materially affecting the confidentiality, integrity, or availability of customer information." The plan must address seven areas: goals; internal processes for responding; "clear roles, responsibilities, and levels of decision-making authority"; external and internal communications; remediation of identified weaknesses; documentation and reporting; and post-event evaluation and revision of the plan.1 Earl is not required to have that written plan. He still has every reporting obligation discussed below, and Exhibit H is designed so that a one-person office can adopt a three-page version anyway. Earl needed one in February.

Begin containment and evidence preservation immediately, with responder guidance. Change the compromised password, revoke active sessions, and remove the forwarding rule, preserving logs and a record of what was changed. Contact the insurer or breach-response contact and evaluate reporting duties at the same time; many cyber policies require panel vendors, so call before hiring anyone. Do not delay stopping active exposure while waiting for insurer approval or collecting screenshots. Record the time of discovery and the time of confirmation, because each reporting clock below runs from one or the other. Work through the reporting decisions in order of deadline. The IRS deadline usually comes first.

B. The IRS: Next Business Day

Publication 1345 establishes six security, privacy, and business standards for e-file providers. The first five apply to Online Providers, which are businesses that let taxpayers prepare and file their own returns through a website. They include requirements such as extended-validation certificates and external vulnerability scans. They do not apply to an ordinary ERO. The sixth standard, "Reporting of Security Incidents," "is now mandated for all Providers."2 The rule is direct: Authorized IRS e-file Providers "must report security incidents to the IRS as soon as possible but not later than the next business day after confirmation of the incident."3

A reportable incident is defined broadly as "an event that can result in an unauthorized disclosure, misuse, modification, or destruction of taxpayer information."4 There is no 500-person threshold and no harm threshold. Providers that are EROs only "must contact their local stakeholder liaison."5 The IRS data-theft page for tax professionals repeats the instruction to report client data theft to the local Stakeholder Liaison. It adds two words worth posting by the phone: "Speed is critical."6 That page also directs practitioners to report to the

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delegation problem; the machine helps only once the children understand the work well enough to direct and check it).

1 16 C.F.R. § 314.4(h)(1)–(7) (2026).

2 IRS Pub. 1345, supra, "IRS e-file Security, Privacy and Business Standards."

3 Id., "Reporting of Security Incidents."

4 Id.

5 Id.

6 IRS, Data Theft Information for Tax Professionals (last reviewed Mar. 26, 2026), https://www.irs.gov/individuals/data-theft-information-for-tax-professionals.

states through the Federation of Tax Administrators' breach-reporting page. It also says to consider the FBI, local police, and the credit bureaus.1

Warning: Thirty days is not the IRS deadline

The FTC's 30-day deadline (Section V.C) is frequently repeated at seminars. It does not displace the IRS next-business-day rule. An ERO that waits for a forensic report or for the FTC analysis before calling the Stakeholder Liaison is late. Look up the local Stakeholder Liaison's contact information now and record it in Exhibit H-3 before the season begins.

C. The FTC: Notification Events Involving 500 or More Consumers

Since May 13, 2024, covered firms have had a federal duty to notify the FTC of certain events.2 The trigger is a "notification event," which means "acquisition of unencrypted customer information without the authorization of the individual to which that information pertains." Two refinements follow in the same definition. First, "[u]nauthorized acquisition will be presumed to include unauthorized access to unencrypted customer information" unless the firm has reliable evidence that no unauthorized acquisition occurred or could reasonably have occurred. Second, customer information is treated as unencrypted "if the encryption key was accessed by an unauthorized person."3

If the notification event "involves the information of at least 500 consumers," the firm "must notify the Federal Trade Commission as soon as possible, and no later than 30 days after discovery of the event."4 The 30 days are an outer limit, not a waiting period. The same is true of the state deadlines below, each of which also requires notice without unreasonable delay. Notice is made electronically on the FTC's online form.5 It must include the firm's name and contact information, the types of information involved, the date or date range if determinable, and the number of consumers affected or potentially affected. It must also include a general description of the event and whether a law-enforcement official has provided a written determination that public disclosure would impede a criminal investigation or damage national security.6 A law-enforcement request delays the FTC's public disclosure of the notice. It is not an extension of the firm's 30-day filing deadline.7

The discovery rule is the trap. An event "shall be treated as discovered as of the first day on which such event is known to you." The firm is deemed to know of it "if such event is known to any person, other than the person committing the breach, who is your employee, officer, or other agent."8 If a seasonal employee notices something wrong and tells no one, the clock may already be running.

The FTC duty applies to every covered firm, including firms under the section 314.6 exception. **Section** 314.6 does not list paragraph **(j)**.9

Three decisions, three triggers

Question	IRS (Pub. 1345)	FTC (16 C.F.R. § 314.4(j))	State (MS, AL, LA)
What triggers it?	Security incident that can result in unauthorized disclosure, misuse, modification, or destruction	Acquisition (presumed from access) of unencrypted customer information	Defined "breach" of defined "personal information" of a state resident

1 Id.
2 16 C.F.R. § 314.5 (2026); Standards for Safeguarding Customer Information, 88 Fed. Reg. 77,499 (Nov. 13, 2023).
3 16 C.F.R. § 314.2(m) (2026).
4 16 C.F.R. § 314.4(j)(1) (2026).
5 Id.; FTC, Safeguards Rule Security Event Reporting Form, https://www.ftc.gov/business-guidance/privacy-security/gramm-leach-bliley-act/safeguards-rule-form.
6 16 C.F.R. § 314.4(j)(1)(i)–(vi) (2026).
7 16 C.F.R. § 314.4(j)(1)(vi) (2026).
8 16 C.F.R. § 314.4(j)(2) (2026).
9 16 C.F.R. § 314.6 (2026).

Question	IRS (Pub. 1345)	FTC (16 C.F.R. § 314.4(j))	State (MS, AL, LA)
Threshold?	None	At least 500 consumers	No numeric threshold for resident notice (MS and AL have harm-based exceptions; LA a documented no-harm exception); AG thresholds vary
Clock starts	Confirmation	Discovery (knowledge of any employee or agent)	Discovery or determination (varies)
Deadline	Next business day	As soon as possible; no later than 30 days	**MS:** without unreasonable delay; AL: 45 days; LA: 60 days
To whom	Stakeholder Liaison (EROs)	FTC online form	Affected residents; AG in AL (over 1,000) and LA (all)

Sources: IRS Pub. 1345 (Rev. Dec. 2025); 16 C.F.R. §§ 314.2(m), 314.4(j) (2026); Miss. Code Ann. § 75-24-29; Ala. Code §§ 8-38-5, -6; La. R.S. 51:3074; La. Admin. Code tit. 16, pt. III, § 701. Simplified; see Section V.D for conditions.

D. The States: Mississippi, Alabama, and Louisiana

State Data Breach Notice Laws: Mississippi, Alabama, and Louisiana

Federal reporting does not replace state breach-notice law. The duty to notify individuals generally runs under the law of each state where an affected individual resides. That duty is in addition to any obligations under the law of the state where the office sits. A Gulfport office with clients who moved to Mobile or Slidell has three statutes to read. The three Gulf states illustrate how much they differ.

TOPIC	MISSISSIPPI	ALABAMA	LOUISIANA
Who is covered	Any person who conducts business in this state and who owns, licenses, or maintains personal information of Mississippi residents.	Covered entity (broadly); also imposes an affirmative security duty.	Agency or person that maintains computerized data of Louisiana residents.
Definition of breach	Unauthorized acquisition of electronic files, media, databases or computerized data containing personal information, where access has not been secured by encryption or by any other method or technology that renders the information unreadable or unusable.	Breach of security of the system compromising personal information (law focuses on substantial harm standard).	Compromise of the security, confidentiality, or integrity of computerized data that results in, or there is a reasonable likelihood to result in, the unauthorized acquisition of and access to personal information.
Personal information includes	Name + Social Security number, driver's license or state or tribal ID number, or financial account or card number + required security code	Expressly includes a non-truncated Social Security number or tax identification number.	First name or first initial and last name + Social Security number, driver's license or state ID, passport number, biometric data, or account/card number + required security code, access code, or password (only when not encrypted or redacted).
Affirmative security duty	No (statute does not impose a general security duty).	**Yes.** Must implement and maintain reasonable security measures (coordinator, risk identification, safeguards, vendor oversight, evaluation and adjustment).	**Yes.** Must implement and maintain reasonable security procedures and practices.
When to notify individuals	Without unreasonable delay (no fixed deadline).	As expeditiously as possible and without unreasonable delay, and within **45 days** after determining a breach is reasonably likely to cause substantial harm.	In the most expedient time possible and without unreasonable delay, and no later than **60 days** from discovery.
No-notice safe harbor	No notice if, after an investigation, the business reasonably determines the breach will not likely result in harm to the affected individuals.	Notice required only if the breach is reasonably likely to cause substantial harm. If no notice, must document determination in writing and keep records for at least five years.	If no reasonable likelihood of harm, must document determination in writing and retain for five years; provide to AG within 30 days of a written request.
Third-party / service provider duties	If only maintaining information for another, must notify the owner or licensee as soon as practicable if information was, or is reasonably believed to have been, acquired for fraudulent purposes.	Third-party agent must notify the covered entity as expeditiously as possible and no later than **10 days** after determining a breach occurred or having reason to believe it did.	Not specifically detailed in statute.
Attorney general notice	No AG notice requirement (as codified in 2025).	Required if more than **1,000** Alabama residents are notified, within **45 days**.	Required. Written notice to the Consumer Protection Section within **10 days** of distribution of notice to Louisiana citizens (no numerical threshold).
Consumer reporting agencies (CRAs)	No requirement.	Must notify nationwide CRAs if more than **1,000** individuals are notified, without unreasonable delay.	No requirement.
Federal law exemption	Compliant if it follows the notification procedures of its primary or federal functional regulator (15 USCS 6809(2)); applicability to tax preparers is doubtful.	Exempt only if subject to federal breach-notice regimes and actually give notice to individuals pursuant to those federal rules. Must still send AG a copy when more than 1,000 are notified.	Financial-institution safe harbor limited to institutions following the federal banking agencies' interagency guidance. Does not cover tax preparers generally.
Enforcement / private right of action	Unfair trade practices enforced by the Attorney General. No private right of action.	Enforced by the Attorney General (statute does not provide a private right of action).	Attorney General may impose fines up to $5,000 per day of delay. Allows a civil action for actual damages resulting from untimely disclosure.

Caution: State law moves | State breach statutes are amended frequently, and the summaries above reflect statutory text reviewed in October 2026. Before relying on any deadline in an actual incident, read the current statute of every state where an affected individual resides, or engage counsel to do so. The IRS data-theft page notes that "[m]ost states require that the attorney general be notified of data breaches." The 2025 Mississippi codification reviewed for this text contains no attorney general notice requirement in section 75-24-29; confirm the current official text before relying on that.

Mississippi. The statute applies to "any person who conducts business in this state" and who owns, licenses, or maintains personal information of Mississippi residents.1 A "breach of security" is the "unauthorized acquisition of electronic files, media, databases or computerized data containing personal information" where access "has not been secured by encryption or by any other method or technology that renders the personal information unreadable or unusable."2 Personal information means a name combined with a Social Security number, a driver's license or state or tribal identification number, or a financial account or card number together with any required security code.3 A business that owns or licenses the personal information "shall disclose any breach of security to all affected individuals" "without unreasonable delay." A business that only maintains personal information for another must notify the owner or licensee "as soon as practicable following its discovery," if the information was, or is reasonably believed to have been, acquired by an unauthorized person for fraudulent purposes. The owner or licensee then carries the resident-notice duty.4 A tax office usually sits in the owner-or-licensee role, but the distinction matters when the office merely holds another firm's data. Notification is not required if, after an investigation, the business "reasonably determines that the breach will not likely result in harm to the affected individuals."5 As codified in the 2025 Mississippi Code, the most recent codification reviewed for this text, Mississippi imposes no attorney general notice requirement. The statute treats a business as compliant if it follows the notification procedures of its "primary or federal functional regulator, as defined in 15 USCS 6809(2)."6 Whether a tax preparer has such a regulator with breach-notice procedures is doubtful, and preparers should not rely on that provision without advice. Violations are unfair trade practices enforced by the Attorney General, and the statute creates no private right of action.7

Alabama. The Data Breach Notification Act of 2018 is more demanding in three ways. First, it imposes an affirmative security duty: a covered entity "shall implement and maintain reasonable security measures." It lists elements that closely track the Safeguards Rule, including a designated coordinator, risk identification, safeguards, vendor oversight, and evaluation and adjustment.8 Second, its personal-information definition expressly includes "[a] non-truncated Social Security number or tax identification number," and an encryption safe harbor that is lost if the key or credential "has been breached together with the information."9 Third, it sets a firm outer deadline. After a prompt good-faith investigation,10 notice is due to affected residents if the breach "is reasonably likely to cause substantial harm," "as expeditiously as possible and without unreasonable delay," and within 45 days.11 The 45 days run from the earlier of the entity's receipt of notice from a third-party agent that a breach occurred or its own determination that a breach occurred and is reasonably likely to cause substantial harm. If the entity determines that notice is not required, it must document that determination in writing and keep the records for at least five years.12 If more than 1,000 Alabama residents must be notified, the Attorney General must also be notified within 45 days.13 When more than 1,000 individuals must be notified at a single time, the entity must also notify the nationwide consumer reporting agencies **(CRAs)**, without unreasonable delay, of the timing, distribution, and content of the notices.14 A third-party agent must notify the covered entity "as expeditiously as possible and without unreasonable delay," and no later than 10 days after determining that a breach occurred or having reason to believe it did.15 Entities subject to federal breach-notice regimes are exempt only if they maintain procedures under, and actually give notice pursuant to, those federal

1 Miss. Code Ann. § 75-24-29(1).
2 Miss. Code Ann. § 75-24-29(2)(a).
3 Miss. Code Ann. § 75-24-29(2)(b).
4 Miss. Code Ann. § 75-24-29(4).
5 Miss. Code Ann. § 75-24-29(3).
6 Miss. Code Ann. § 75-24-29(7).
7 Miss. Code Ann. § 75-24-29(8).
8 Ala. Code § 8-38-3(a)–(b).
9 Ala. Code § 8-38-2(6).
10 Ala. Code § 8-38-4(a).
11 Ala. Code § 8-38-5(a)–(b).
12 Ala. Code § 8-38-5(f).
13 Ala. Code § 8-38-6(a).
14 Ala. Code § 8-38-7.
15 Ala. Code § 8-38-8.

rules. Even then, they must send the Attorney General a copy when more than 1,000 are notified.1 The FTC Safeguards Rule requires notice to the FTC, not to affected individuals, so an FTC filing alone does not meet the exemption's individual-notice condition.

Louisiana. Louisiana defines a breach as "the compromise of the security, confidentiality, or integrity of computerized data that results in, or there is a reasonable likelihood to result in, the unauthorized acquisition of and access to personal information maintained by an agency or person."2 Personal information means a resident's first name or first initial and last name "in combination with" a Social Security number, a driver's license or state identification card number, a passport number, biometric data used to authenticate the individual's identity, or an account or card number "in combination with any required security code, access code, or password that would permit access to an individual's financial account," and only "when the name or the data element is not encrypted or redacted."3 A business must "implement and maintain reasonable security procedures and practices."4 Resident notice is due "in the most expedient time possible and without unreasonable delay," and no later than 60 days from discovery. If notice is delayed for law-enforcement needs or to determine the scope of the breach, the business must give the Attorney General written reasons within that period. The Attorney General then "shall allow a reasonable extension of time to provide the notification."5 A business that concludes there is "no reasonable likelihood of harm" must document that determination in writing. It must retain the determination and supporting documentation for five years from the date of discovery, and provide it to the Attorney General within 30 days of receiving a written request.6 The Attorney General's rule then adds a requirement with no numerical threshold. Written notice to the Consumer Protection Section, including "the names of all Louisiana citizens affected," is timely only "if received within 10 days of distribution of notice to Louisiana citizens." Each day of delay is a separate violation, punishable by a fine of up to $5,000.7 Louisiana also allows a civil action for actual damages resulting from untimely disclosure,8 and its financial-institution safe harbor is limited to institutions following the federal banking agencies' interagency guidance. It does not cover tax preparers generally.9

Caution: State law moves

State breach statutes are amended frequently, and the summaries above reflect statutory text reviewed in October 2026. Before relying on any deadline in an actual incident, read the current statute of every state where an affected individual resides, or engage counsel to do so. The IRS data-theft page notes that "[m]ost states require that the attorney general be notified of data breaches." The 2025 Mississippi codification reviewed for this text contains no attorney general notice requirement in section 75-24-29; confirm the current official text before relying on that.

E. Credentials and Clients After the Breach

A tax-office breach carries two risks that other businesses do not face. The first is misuse of the practitioner's own credentials: the EFIN, the PTIN, and the e-Services and CAF **(Centralized Authorization File)** authorizations. Publication 4557 advises checking "e-File Applications and PTIN accounts weekly for total returns filed using EFINs and PTINs."10 The IRS "Returns per PTIN" tile reports, weekly, the number of Form 1040-series returns processed under a PTIN. The current IRS page states that "[d]ata is available for all PTIN holders that have federal tax returns processed under their PTIN in the calendar year."11 Publication 4557 **(Rev. 6-2024)** still states that "[o]nly those preparers who are attorneys, CPAs, enrolled agents or Annual Filing Season

1 Ala. Code § 8-38-11.
2 La. R.S. 51:3073(2).
3 La. R.S. 51:3073(4)(a).
4 La. R.S. 51:3074(A).
5 La. R.S. 51:3074(E).
6 La. R.S. 51:3074(I).
7 La. Admin. Code tit. 16, pt. III, § 701(A)–(B).
8 La. R.S. 51:3075.
9 La. R.S. 51:3076.
10 IRS Pub. 4557, supra, at 4.
11 IRS, Returns per PTIN (page last reviewed Oct. 9, 2026; FAQ heading marked "updated Oct. 15, 2026"), https://www.irs.gov/tax-professionals/returns-per-ptin.

Program participants and who file 50 or more returns may obtain PTIN information."1 The current IRS page does not repeat that restriction, so practitioners should check the page rather than rely on the publication. If the count is "substantially higher than the number of tax returns you've prepared" and the practitioner suspects misuse, the IRS directs filing Form 14157.2 The Stakeholder Liaison will direct any EFIN or account action. There is no universal rule that a breached practitioner must obtain a new EFIN or PTIN. Practitioners should follow the instructions they receive rather than assumptions.

The second is identity theft against clients. The current IRS guidance is more restrained than many practitioners expect. According to the IRS, clients should complete Form 14039 only if they receive an IRS notice or letter directing them to do so, or if their e-filed return is rejected because of a duplicate Social Security number.3 Advising every affected client to file Form 14039 immediately creates unnecessary work for clients and the IRS. The better advice is to watch for IRS correspondence, consider the IRS Identity Protection PIN program, and follow the IRS instructions if a return is rejected.

VI. PUTTING THE PLAN TO WORK

A WISP is finished when the office is operating under it, not when it is printed. The final step is an action plan with a short list of corrective items. Each item has an owner, a date, and evidence when it is done. Exhibit A serves as the checklist. Exhibit I records reviews and tests.

The order of operations for a seasonal office that is starting from nothing in November is straightforward. First, name the Qualified Individual and count consumers **(Exhibit A)**. Second, map the data **(Exhibit C)**. Third, fill in the risk table **(Exhibit D)** and fix every missing required safeguard now and every other row scoring six or more before opening day. The preseason target does not authorize continued noncompliance. MFA on email and tax software, verified laptop encryption, and a tested backup will be on almost every office's list. Fourth, write or adapt the core plan **(Exhibit B)** so it describes what the office actually does. Fifth, set up the vendor files and section 7216 notices **(Exhibit F)** and the retention schedule **(Exhibit G)**. Sixth, fill in the incident kit, especially the contact sheet **(Exhibit H)**, before an incident occurs. Seventh, put three dates on the calendar: staff training on the first day of the season, offboarding on the last day, and the annual review in December.

Practice Pointer: Keep the sensitive parts separate

The WISP should describe safeguards without serving as an attacker's manual. Passwords, recovery codes, network diagrams, and detailed configuration settings belong in a restricted file referenced by the plan, not in the copy handed to every seasonal employee.

Earl's and Renée's Cases, Resolved

A. Earl Dubose: What He Had to Do, Whom He Had to Tell, and By When

Earl's first question was what he had to do. That evening, Wednesday, February 11, Marcus documented the forwarding rule with screenshots and an export of the mailbox audit log. He then deleted the rule, changed Earl's password, signed out every active session, and turned on MFA. Marcus preserved the evidence and cut off the attacker's access in the same sitting, without waiting on anyone else. Earl called the cyber-liability carrier the next morning and was assigned a breach coach, who engaged a forensic firm from the carrier's panel. The forensic review established that the attacker had logged into the mailbox repeatedly between February 3 and February 11. The forwarding rule had sent incoming messages to the outside address throughout. Under the FTC presumption, unauthorized access to unencrypted customer information is presumed to be acquisition.4 Here acquisition was not merely presumed. The forwarded messages were actually taken.

1 IRS Pub. 4557, supra, at 8.
2 IRS, Returns per PTIN, supra.
3 IRS, Data Theft Information for Tax Professionals, supra.
4 16 C.F.R. § 314.2(m) (2026).

Workpaper: Earl's reporting workpaper

```
FACTS
  Phishing click                    Mon  Feb  2, 2026
  Forwarding rule created           Tue  Feb  3, 2026
  Discovery (client call)           Wed  Feb 11, 2026
  Confirmation (Marcus, evening)    Wed  Feb 11, 2026

WHO WAS EXPOSED (attachments in mailbox, per forensic review;
Before the incident, Earl had only guessed at the share. The
forensic review identified 212 retained filing units that had ever emailed documents)
  Client filing units                              212
  Joint returns (spouse added)                 +   85
  Filers and spouses                               297
  Dependents whose SSNs appeared               +  140
  Individuals whose personal information was exposed                  437
  By residence:  MS 394 + AL 25 + LA 18 =          437
  ASSUMPTION: the forensic review established that these
  437 people are the entire affected or potentially
  affected population.

1. IRS (Pub. 1345) - ERO, confirmed incident
   Confirmation Wed Feb 11 -> report by Thu Feb 12, 2026
   To: local Stakeholder Liaison.  DONE Thu Feb 12, a.m.

2. FTC (16 C.F.R. § 314.4(j))
   Notification event? Yes (acquisition via forwarding rule).
   Consumers: 297 (filers + spouses). Even counting
   dependents, 437. Threshold 500.  297 < 500; 437 < 500.
   FTC notice NOT required. Analysis documented in file.

3. MISSISSIPPI (§ 75-24-29) - 394 residents
   Name + SSN acquired, not encrypted -> breach.
   No-harm exception not reasonably available (SSNs + W-2s).
   Notice "without unreasonable delay." Letters mailed
   Fri Feb 27, 2026. No AG notice (2025 Code).

4. ALABAMA (§§ 8-38-4, -5, -6) - 25 residents
   Substantial-harm determination after investigation:
   Wed Feb 18, 2026.  Feb 18 + 45 days = Sat Apr 4, 2026.
   If Marcus's Feb 11 report counts as third-party-agent
   notice: Feb 11 + 45 = Sat Mar 28, 2026. Use the earlier
   date. Letters mailed Feb 27. Meeting the outer limit
   does not by itself show prompt notice; record why.
   AG notice: 25 <= 1,000 -> not required. Consumer reporting agencies: not required.

5. LOUISIANA (R.S. 51:3074; LAC 16:III.701) - 18 residents
   Outer limit: Feb 11 + 60 days = Sun Apr 12, 2026.
   Letters mailed Feb 27.
   AG notice with names of all 18 due within 10 days of
   distribution: Feb 27 + 10 = Mon Mar 9, 2026.
   Submitted on AG online form Mon Mar 2 (received Mar 2).

6. STATE TAX AGENCIES: reported through the Federation of
   Tax Administrators breach page per IRS instructions.
```

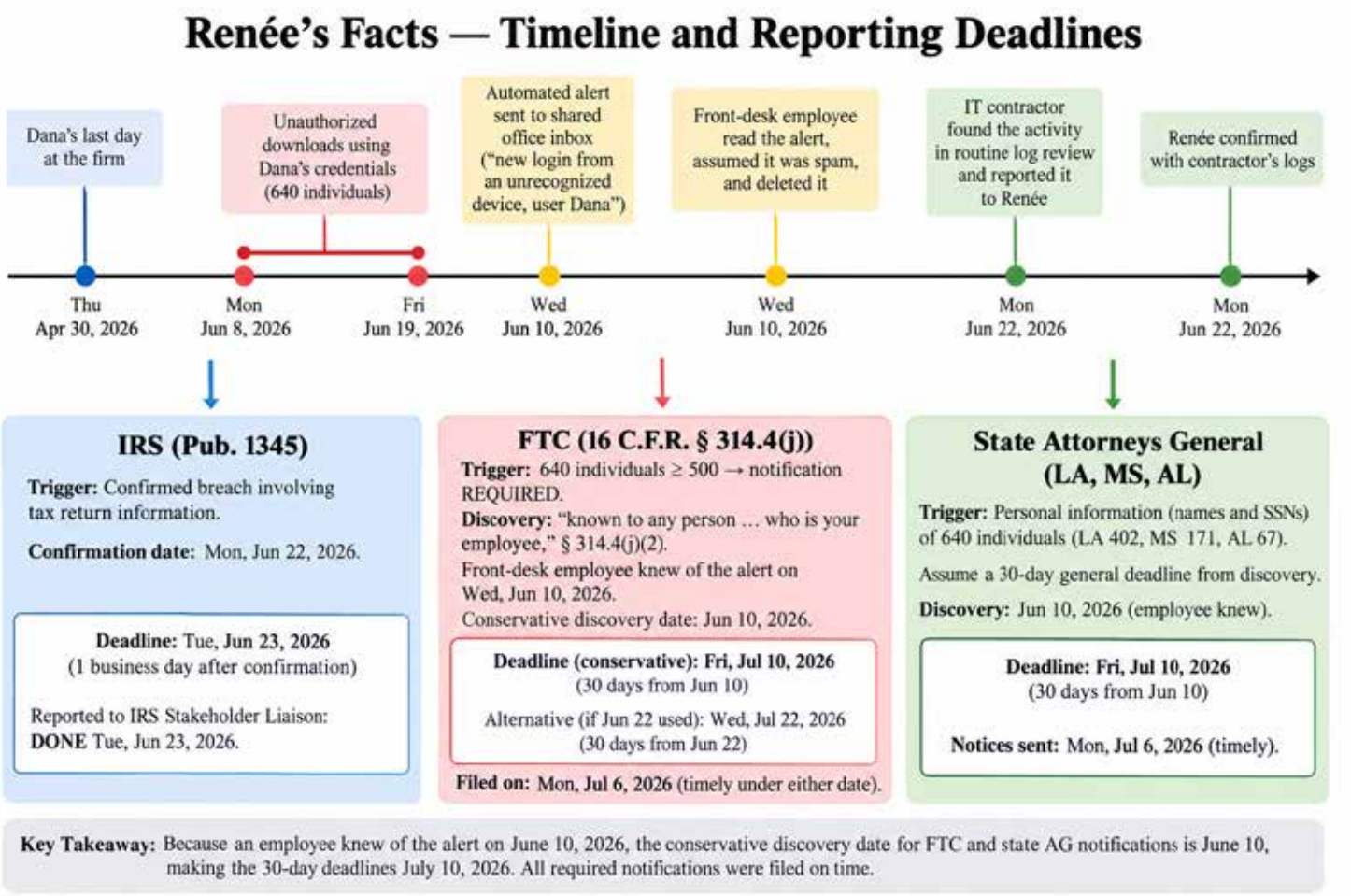
The second question was whom he had to tell. The workpaper answers it. One feature deserves emphasis. Earl's FTC analysis came out "no notice" only because his client count was under 500. It would have taken 203 more filers or spouses **(297 + 203 = 500)** to change the answer. If dependents were counted as consumers, it would have taken only 63 more **(437 + 63 = 500)**. More importantly, the IRS call and the state notices did not depend on any threshold at all. Earl's practice is in Mississippi, but two other states' laws applied because his clients had moved.

The third question was whether Earl was supposed to have something in place. The answer is yes. Assume Earl updated his count before the incident and still maintained customer information concerning fewer than 5,000 consumers. He therefore qualified for the section 314.6 exception, which excused him from a written incident response plan. It did not excuse him from a WISP, a risk assessment, MFA on every information system,

encryption, training, vendor oversight, or a section 7216 notice to his nephew.1 The single control most likely to have stopped this attack, MFA on his email account, was a setting he had not turned on. Earl's revised plan, built on Exhibits A through I, now lists MFA on five systems and routes all client documents through a secure upload portal instead of email. It also adds a 90-day purge of attachments from email after import, an alert on new forwarding rules, a signed section 7216 notice for Marcus, and a calendar with three dates on it.

B. Renée Fontenot: The Account Nobody Turned Off

Renée's facts turned on a different failure and produced a different answer. Dana's last day was Thursday, April 30, 2026. Nobody disabled her client-portal account. The portal's logs showed that her credentials were used between June 8 and June 19 to download files covering 640 individuals **(filers and spouses, counted as in Worked Example 1)**. The apparent purpose was to solicit them for a practice Dana was starting. On Wednesday, June 10, the portal sent an automated alert **("new login from an unrecognized device, user Dana")** to the shared office inbox in Picayune. A front-desk employee read it, assumed it was spam, and deleted it. The IT contractor found the activity in a routine log review and reported it to Renée on Monday, June 22



1 16 C.F.R. §§ 314.3(a), 314.4(b), (c)(3), (c)(5), (e), (f), 314.6 (2026); Treas. Reg. § 301.7216-2(d)(2).

Workpaper: Renée's reporting workpaper

```
FACTS
  Dana's last day                    Thu Apr 30, 2026
  Unauthorized downloads             Jun  8 - Jun 19, 2026
  Alert read by employee             Wed Jun 10, 2026
  Contractor reports to Renee        Mon Jun 22, 2026
  Confirmation (contractor's logs)   Mon Jun 22, 2026

EXPOSED INDIVIDUALS (filers + spouses, by residence)
  LA 402 + MS 171 + AL 67 =                          640
  ASSUMPTION: the downloaded files contain readable names
  and full Social Security numbers.

1. IRS (Pub. 1345) - confirmed Mon Jun 22
   Report by Tue Jun 23, 2026. To Stakeholder Liaison.
   DONE Tue Jun 23.

2. FTC (16 C.F.R. § 314.4(j)) - 640 >= 500 -> REQUIRED
   Discovery: "known to any person ... who is your employee,"
   § 314.4(j)(2). The front-desk employee knew of the
   alert on Jun 10. Conservative discovery date: Jun 10.
     Jun 10 + 30 days = Fri Jul 10, 2026  (conservative)
     Jun 22 + 30 days = Wed Jul 22, 2026  (if Jun 22 held)
   Filed on the FTC online form Thu Jul 9, 2026.
   Outer limit met; the file must still show why notice
   took until Jul 9 ("as soon as possible").

3. LOUISIANA - 402 residents
   Outer limit, using the same conservative Jun 10
   discovery date: Sun Aug 9, 2026 (Fri Aug 21 if Jun 22).
   Letters mailed Fri Jul 17, 2026.
   AG notice with all 402 names: Jul 17 + 10 = Mon Jul 27.

4. MISSISSIPPI - 171 residents
   Without unreasonable delay; mailed Jul 17. No AG notice (2025 Code).

5. ALABAMA - 67 residents
   Substantial-harm determination Mon Jun 29, 2026.
   IT contractor's Jun 22 report may be third-party-agent
   notice (§ 8-38-5(b)): Jun 22 + 45 = Thu Aug 6, 2026.
   Determination Jun 29 + 45 = Thu Aug 13, 2026.
   Use the earlier date, Aug 6. Mailed Jul 17.
   AG notice: 67 <= 1,000 -> not required.

6. WISP: Renee is over 5,000 consumers -> written incident
   response plan (§ 314.4(h)) applies; post-event review
   and plan revision required by § 314.4(h)(7).
```

The discovery question is the one a reviewing agency would ask first. The rule deems the firm to know of an event when it is "known to any person, other than the person committing the breach, who is your employee, officer, or other agent."1 Whether an employee who read an alert and misjudged it "knew" of a notification event is arguable. Renée's counsel treated June 10 as the discovery date and filed with the FTC by July 9, the day before the earlier deadline. Using the earlier date avoids relying on the later discovery date for the outer-deadline calculation. It does not establish that notice was made "as soon as possible," which the rule also requires. The file should record the investigation steps and the reason for each interval. The lesson for every reader is in the deleted alert. Training is not about frightening staff. It is about making sure the one person who sees the warning knows what it means and whom to tell.

Dana's conduct raises the section 7216 questions that Earl's case did not. Dana was a tax return preparer who used client tax return information to solicit business for herself, without consent. The regulations do permit a preparer to compile a restricted solicitation list of clients' names, contact information, entity classification, and return form number. Only the compiler may use it, and it may not be transferred except with a sale of the business.2 That restricted-list exception does not establish permission to download full client files. Whether

1 16 C.F.R. § 314.4(j)(2) (2026).

2 Treas. Reg. § 301.7216-2(n)(1).

section 7216 reaches information she obtained through access that was no longer authorized is a fair question. That theory is one of several, alongside federal and state computer-crime laws and Renée's civil claims, which are outside this text. If section 7216 applies and her conduct was knowing or reckless, the exposure is hers.1 Any section 6713 liability would likewise require analysis of the information, its connection to return preparation, the actual use or disclosure, and any applicable exception. The arithmetic below only illustrates the cap. If each of 640 uses were a separately prohibited act in one calendar year, $250 each would total $160,000, but the penalty is capped at $10,000 per calendar year. It does not compute Dana's liability.2 Renée's own exposure is different. Her offboarding failure was a failure of the access controls required by section 314.4(c)(1), and her post-event duties included revising her plan.3 Her revised WISP now ties offboarding to the payroll termination date and requires a second person to confirm every disabled account. It also routes portal alerts to the Qualified Individual's phone rather than a shared inbox.

Simplified penalty arithmetic (illustration only)

Computation (I.R.C. § 6713)	Per disclosure	Uncapped	Capped per calendar year
Standard penalty, 640 disclosures	$250	$160,000	$10,000
Identity-theft enhancement, if § 6713(b) applied	$1,000	$640,000	$50,000

Simplified directional figures for teaching; not a computation of any actual assessment. Omits whether each use is a separate "disclosure or use," the calendar-year allocation of uses, the § 7216(b) and regulatory exceptions applied through § 6713(c), and any criminal exposure under § 7216(a). If both ordinary and identity-theft disclosures occur, the annual caps apply separately to each category (§ 6713(b)(2)).

C. The Common Thread

Earl's office was small enough to be excused from four requirements and too small, in his mind, to be a target. Renée's office was large enough to have an IT contractor and still lost track of one account. Both incidents began with an ordinary control that was missing: a second factor on an email login in one case, an offboarding step in the other. Both firms then faced reporting deadlines measured in days, set by three different authorities and several state legislatures. The WISP exists to make those days uneventful. It is not a binder on a shelf. It is the written record of what the office actually does, sized to the office, reviewed every year, and opened before February.

1 I.R.C. § 7216(a).
2 I.R.C. § 6713(a).
3 16 C.F.R. § 314.4(c)(1), (g), (h)(7) (2026).

NOT A CPA OR EA YET? HERE'S HOW TO HELP YOUR CLIENTS ANYWAY



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(07) Program # A5BAX-T-00000-26-I

Course Details	
Name of the CE Provider	AmData
Program name	Not a CPA or EA Yet? Here's How to Help Your Clients Anyway
IRS program number	A5BAX-T-00000-26-I
CE	1
Prerequisite	None. **Field of Study:** Taxes
Advanced Preparation	None
Program Level	Basic
Delivery Method:	Live in-person
Program Ctegory	Federal Tax Law Topics/Federal Tax Related Matters - A program designed to enhance professional knowledge in Federal Tax related matters.



ABSTRACT

Most of the problems that walk into a storefront tax office are information problems: a refund that has not arrived, a missing W-2, one page of a multi-page notice, a balance the client cannot explain. An unenrolled preparer can solve most of them with the right authorization, completed correctly, and a Centralized Authorization File **(CAF)** number. This text distinguishes the three types of IRS authority **(the Third Party Designee check box, Form 8821, and Form 2848)** and the oral fallbacks; explains the limited Form 2848 representation available to Annual Filing Season Program **(AFSP)** Record of Completion holders and the three conditions that must all be met; walks through Form 8821 line by line for individuals, married filers, sole proprietors, single-member LLCs, and corporations; and covers CAF mechanics, submission and withdrawal, and practical use through Tax Pro Account, the Practitioner Priority Service, and the Transcript Delivery System.

Definitions:

- **Fact-Driven Education:** This program is focused on providing accurate, up-todate information about tax laws, regulations, and administrative updates as they stand today.
- **Non-Political Content:** All discussions are strictly factual and are not intended to express or imply any political opinions or preferences.
- **Commitment to Professionalism:** Our shared responsibility as tax professionals is to understand and apply the law, ensuring compliance and effective client representation.
- **Focus on Practice:** This program prioritizes practical, actionable knowledge to support your work, free from bias or interpretation beyond what the law provides.

The First Call

Lena Broussard has prepared returns from a strip-center storefront in Gulfport, Mississippi, for nine filing seasons. She is not a CPA, an enrolled agent, or an attorney. She works under the office owner's electronic filing identification number **(EFIN)**, and most of her clients are wage earners, Earned Income Tax Credit **(EITC)** and Additional Child Tax Credit **(ACTC)** claimants, and Schedule C filers. In the fall of 2025 she finished the continuing education for the IRS Annual Filing Season Program **(AFSP)**, and her first Record of Completion, for calendar year 2026, issued in early January 2026.

On a Tuesday afternoon in March 2026, Cherie Watts, a client of three seasons, walked in holding a single sheet of paper. It was page 3 of a multi-page IRS notice. It showed a "proposed" amount due, a response date, and an IRS phone number. Cherie did not know where the other pages were. Lena had prepared and signed Cherie's 2024 Form 1040 in February 2025.

Lena called the number on the page. The IRS assistor was polite and firm: without an authorization on file, the IRS could not discuss Cherie's account with her. Cherie had taken the afternoon off work to come in, and she did not have an IRS Online Account. She had never set one up, and the identity-verification step had failed when she tried two years earlier.

Lena's questions are the ones this text answers. What authorization lets her see Cherie's account, and how does she complete it so it is not returned? How does she get a Centralized Authorization File **(CAF)** number, and how fast can she put the authorization to work? Once she knows what the notice is, may she speak for Cherie, or only gather facts for her? Does Lena's brand-new AFSP Record of Completion change the answer? The text follows Lena and Cherie through each step and resolves the case in the final section, *Cherie's Case, Resolved*.

I. Introduction: Information Versus Advocacy

A. Most Storefront Problems Are Information Problems

Federal law treats returns and return information as confidential. The IRS may disclose a taxpayer's information to a person the taxpayer designates, in the manner the regulations prescribe.1 That designation is the whole game for a storefront practice. "Where is my refund?", "Why did they keep part of it?", "Which W-2 am I missing?", "What does this notice say?", and "How much do I owe?" are all information questions. Each one can usually be answered once the right authorization is on file.

The written-consent rules are specific. The consent must be a separate written document that pertains only to the authorized disclosure, signed and dated by the taxpayer, and it must identify the taxpayer, the designee, the type of return information, and the tax years involved.2 The regulation separately allows the IRS to act on a taxpayer's "nonwritten" request, to the extent necessary to respond to the taxpayer's request for information or assistance. That is a separate category from paragraph **(b)** written consents, and it underlies the oral authorizations discussed in Part II.D.3 Form 8821 is the IRS's standard written vehicle.

B. The Rule for the Whole Program

One sentence sets the boundary for everything that follows: **getting information is fine; arguing the client's position is not**, with one narrow exception for AFSP Record of Completion holders. Practice before the IRS

1 I.R.C. § 6103(a) (general confidentiality rule); I.R.C. § 6103(c) (disclosure to designee of taxpayer).
2 Treas. Reg. § 301.6103(c)-1(b)(1).
3 Treas. Reg. § 301.6103(c)-1(c).

covers "all matters connected with a presentation to the Internal Revenue Service or any of its officers or employees relating to a taxpayer's rights, privileges, or liabilities."1 The IRS states it plainly: attorneys, CPAs, and enrolled agents "continue to be the only tax professionals with unlimited representation rights."2

The published description for this program says that an unenrolled preparer cannot file Form 2848. As a general statement that is close, but it is incomplete. An unenrolled preparer who holds a valid AFSP Record of Completion may be named on Form 2848 under designation "h," with tight limits on what, when, and before whom **(Part III)**. This text addresses a person acting solely as an unenrolled return preparer. Other limited-practice capacities, such as a qualifying corporate officer, regular full-time employee, or immediate family member of the taxpayer, carry their own eligibility and scope rules and must be evaluated separately; a fiduciary acts as the taxpayer, not as a representative.3 Returns prepared and signed on or before December 31, 2015, remain under the older Rev. Proc. 81-38 rules.4 For returns signed after 2015, an unenrolled preparer without a qualifying record works through information authorizations, and that is still a great deal of help.

C. How to Read This Text

The sources here are the Internal Revenue Code, Treasury regulations, revenue procedures, the Internal Revenue Manual **(IRM)**, IRS forms and instructions, and IRS web pages. Each carries different weight. The IRM is the IRS's internal operating manual. Courts have held that it does not have the force of law and does not confer rights on taxpayers.5 For this topic, though, the IRM matters more than its legal weight suggests, because it tells the CAF unit what to accept and what to send back. A preparer who argues that an IRM procedure is not binding authority may be right in the abstract and still have the Form 2848 returned.6

Where this text draws an inference the IRS has not stated in so many words, it says so in a Caution box. Telephone numbers, fax numbers, processing times, and web screens were checked on October 22, 2026, and they change without notice; confirm them on IRS.gov before relying on them. The program is federal only. The one state-specific item is where Mississippi taxpayers send paper and faxed authorizations.

II. The Three Types of IRS Authority

Think of IRS authorizations as a ladder. The bottom rung is the Third Party Designee check box on the return itself. The middle rung is Form 8821, the Tax Information Authorization **(TIA)**. The top rung is Form 2848, the Power of Attorney and Declaration of Representative. Each rung reaches further, and each has its own rules about who may stand on it.

A. Third Party Designee: "Check-Box Authority"

The Third Party Designee section sits near the signature area of Form 1040. The client checks "Yes," names the designee, and enters the designee's phone number and a personal identification number the designee chooses. No separate form is filed. The authority covers that one return and no other.7

According to the 2025 Form 1040 instructions, the designee may "give the IRS any information that is missing from your return"; "call the IRS for information about the processing of your return or the status of your refund or payment(s)"; "receive copies of notices or transcripts related to your return, upon request"; and "respond to certain IRS notices about math errors, offsets, and return preparation."8 The same instructions draw the limits: the client is not authorizing the designee "to receive any refund check, bind you to anything **(including any additional tax liability)**, or otherwise represent you before the IRS."9

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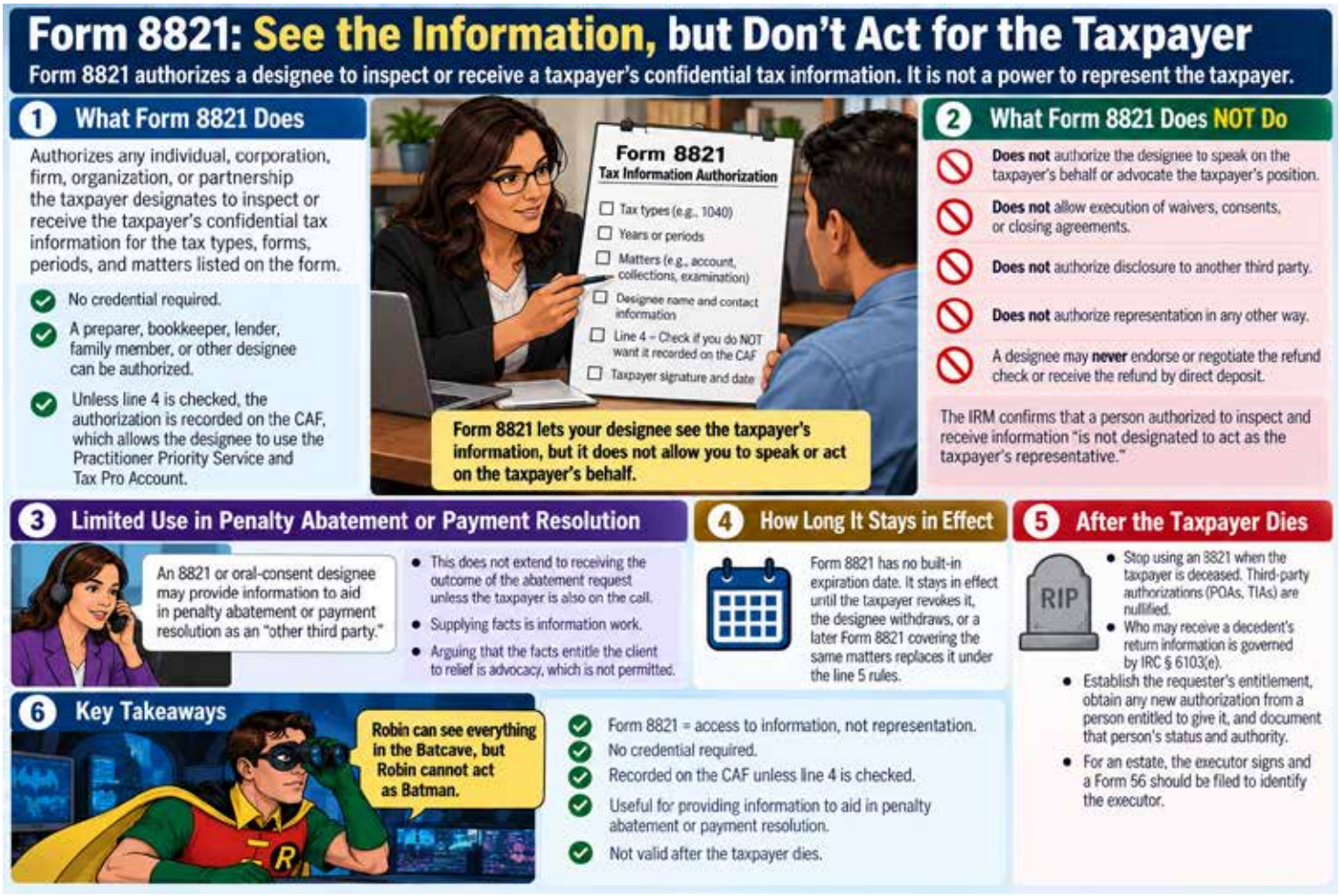
1 31 C.F.R. § 10.2(a)(4).
2 IRS, *Annual Filing Season Program*, irs.gov/tax-professionals/annual-filing-season-program.
3 31 C.F.R. § 10.7(c)(1)(i)–(iv), (e); Instr. for Form 2848 (Rev. Sept. 2021), Part II, designations d–f.
4 Rev. Proc. 2014-42, 2014-29 I.R.B. 192, § 6.02.
5 *Fargo v. Commissioner*, 447 F.3d 706, 713 (9th Cir. 2006).
6 But cf. Mellencamp, J.C., *Authority Song*, on *Uh-Huh* (1983) ("I fight authority, authority always wins"), https://youtu.be/wsEwK69LXjQ.
7 IRS, *Other Third-Party Authorization*, irs.gov/businesses/small-businesses-self-employed/other-third-party-authorization (rev. June 28, 2026).
8 2025 Instr. for Form 1040, *Third Party Designee*.
9 2025 Instr. for Form 1040, *Third Party Designee*.

The authority ends automatically no later than the due date, without regard to extensions, of the following year's return. For a 2025 return, that is generally April 15, 2027.1 It also stops at the door of compliance activity. The IRM states that the designation "does not give the designee the right to obtain information from the IRS in the context of an audit, collection or other compliance activity."2

PRACTICE POINTER: Use the check box, but do not stop there

Check-box authority is useful during the filing season and shortly after, for the one return you just prepared. It is free and requires nothing from the client beyond a "Yes." But it gives you nothing for any other year, and it gives you nothing once the matter turns into an audit or a collection case. For any client you expect to help after April, a Form 8821 is the better tool.

B. Form 8821: "Robin Authorization"



Form 8821 authorizes "any individual, corporation, firm, organization, or partnership" the taxpayer designates to inspect or receive the taxpayer's confidential information for the tax types, forms, periods, and matters listed on the form.3 No credential is required. A storefront preparer, a bookkeeper, a lender, or a family member can be a designee. Unless line 4 is checked, the authorization is recorded on the CAF, which is what lets the designee use the Practitioner Priority Service and Tax Pro Account.4

What Form 8821 does not do matters just as much. It does not authorize the designee to speak on the taxpayer's behalf, advocate the taxpayer's position, execute waivers, consents, or closing agreements, authorize disclosure to another third party, or represent the taxpayer in any other way. A designee may

1 2025 Instr. for Form 1040, *Third Party Designee*; see also IRS, *Other Third-Party Authorization* (one year from due date).
2 IRM 13.1.23.3.1.4(3) (June 8, 2022).
3 Instr. for Form 8821 (Rev. Sept. 2021), *Purpose of Form*.
4 Instr. for Form 8821 (Rev. Sept. 2021), *Line 4*.

never endorse or negotiate the refund check or receive the refund by direct deposit.1 The IRM confirms that the person authorized to inspect and receive information "is not designated to act as the taxpayer's representative."2

The memory aid from earlier presentations of this material still works: Robin can see everything in the Batcave, but Robin cannot act as Batman. There is one useful nuance. The IRM permits an 8821 or oral-consent designee to provide information to aid in penalty abatement or payment resolution as an "other third party," although that does not extend to receiving the outcome of the abatement request unless the taxpayer is also on the call.3 Supplying facts is information work. Arguing that the facts entitle the client to relief is advocacy.

Form 8821 has no built-in expiration date. It stays in effect until the taxpayer revokes it, the designee withdraws, or a later 8821 covering the same matters replaces it under the line 5 rules discussed in Part V.4 If the client dies, stop using the authorization the client signed: when the taxpayer is deceased, "the third-party authorizations **(POAs, TIAs)** are nullified."5 Who may receive a decedent's return information after death is governed by § 6103(e). Establish the requester's entitlement, obtain any new authorization from a person entitled to give it, and document that person's status and authority; for an estate, the executor signs and a Form 56 should be filed to identify the executor.6 Entitlement to the information is not the same thing as appointment as executor.

C. Form 2848: "Superhero Form"

Form 2848 authorizes an individual to represent the taxpayer before the IRS. A representative may receive information and may also advocate, negotiate, and perform the other acts the form authorizes. The representative must be eligible to practice, and Part II of the form lists the designations **(a)** through **(r)** under which a person may qualify.7 Attorneys, CPAs, and enrolled agents have unlimited representation rights.8 For an unenrolled preparer, there is one narrow door: designation "h," discussed in Part III.

D. Oral Authorization: A Fallback, Not a Plan

Two oral tools exist, and the difference between them matters. **Oral disclosure consent (ODC)** lets the taxpayer, on the call, consent to the IRS discussing a specific open issue or notice with the third party. Contrary to a common belief, the client does not have to stay on the line: once the taxpayer provides ODC, "the taxpayer does not need to remain on the call or be present during subsequent disclosures to that authorized designee."9 The consent is limited to the open account issue or notice and lasts until that issue is resolved. It does not authorize representation or binding agreements, and it does not trigger systemic mailing of notices or transcripts to the third party.10 It is not recorded on the CAF.11

An **oral TIA** is different. The IRS describes it as "the verbal equivalent of Form 8821," valid until revoked or withdrawn, and recorded on the CAF at the taxpayer's request by calling 800-829-1040.12 Neither oral tool authorizes representation.13

The practical verdict from prior versions of this program still holds. Oral consent works in a pinch when the client is sitting in your office and the hold time is tolerable. It is slow, it depends on getting through, and an ODC does not outlast the issue. For anything that will take more than one call, get a written Form 8821. If you do rely on oral consent, confirm before the client hangs up which issues and periods it covers and whether the client wants the IRS to keep talking with you until those issues are resolved; one discussion is not open-ended

1 Instr. for Form 8821 (Rev. Sept. 2021), *Purpose of Form*.
2 IRM 13.1.23.3.1.2(1) (Mar. 16, 2026).
3 IRM 21.1.3.3(21) (Oct. 1, 2026); IRM 21.1.3.3.2(13) (Mar. 16, 2026).
4 Instr. for Form 8821 (Rev. Sept. 2021), *Line 5*.
5 IRM 21.1.3.3(8) (IRM 21.1.3 eff. Oct. 1, 2026).
6 I.R.C. § 6103(e)(3), (7); Instr. for Form 8821 (Rev. Sept. 2021), *Line 6*, *Estate*, *All others*.
7 **Instr. for Form 2848 (Rev. Sept. 2021),** *Part II—Declaration of Representative*.
8 IRS, *Annual Filing Season Program*, irs.gov/tax-professionals/annual-filing-season-program.
9 IRM 21.1.3.3.2(1), reminder (Mar. 16, 2026).
10 IRM 21.1.3.3.2(1), (4), (10), (12) (Mar. 16, 2026).
11 IRS, *Other Third-Party Authorization* (ODC "is not recorded on the Centralized Authorization File").
12 IRS, *Other Third-Party Authorization*, irs.gov (rev. June 28, 2026).
13 IRM 13.1.23.3.1.3(2) (Mar. 16, 2026).

authority. The IRM directs the assistor to confirm, before recording the consent, that the taxpayer wants the IRS to communicate directly with the third party until the matter is resolved.1

E. The Three Rungs Side by Side



Table 1. Comparing the three types of IRS authority

	Third Party Designee	Form 8821 (TIA)	Form 2848 (POA)
Who can hold it	Anyone the client names on the return	Any individual or organization	A person eligible to practice; as preparer, an unenrolled person only under designation "h" (other limited capacities, e.g., officer, employee, family, apply separately)
What it allows	Information about that return; certain math-error, offset, and preparation notices	Inspect and receive information for listed taxes, forms, periods	Receive information and represent the client
Advocacy	No	No	Yes (limited for "h")
Scope	One return	Listed forms and periods	Listed forms and periods
How long it lasts	Ends by next year's due date (no extensions)	Until revoked, withdrawn, or replaced	Until revoked, withdrawn, or replaced

1 IRM 21.1.3.3.2(4) (Mar. 16, 2026).

	Third Party Designee	Form 8821 (TIA)	Form 2848 (POA)
Recorded on CAF	No (recorded on the tax module)	Yes, unless line 4 checked	Yes, unless line 4 checked
Who signs	Client, by signing the return	Client only	Client and representative

*Sources: 2025 Instr. for Form 1040; Instr. for Form 8821; Instr. for Form 2848; IRM 13.1.23. Designation "h" limits are in Part III.*1

III. The AFSP: A Limited Door to Form 2848

A. What the Record of Completion Adds

The Annual Filing Season Program rests on Rev. Proc. 2014-42. **Section** 6.01 "permits unenrolled tax return preparers who obtain a Record of Completion to represent taxpayers before the IRS," within limits.2 The IRS summarizes the result: AFSP participants "can represent clients whose returns they prepared and signed, but only before revenue agents, customer service representatives, and similar IRS employees, including the Taxpayer Advocate Service."3 Publication 5227 describes the same scope as "initial audits, customer service matters and before the Taxpayer Advocate Service."4

The vehicle is Form 2848, Part II, designation "h," unenrolled return preparer, with the preparer's Preparer Tax Identification Number **(PTIN)** entered on the form.5 The Form 2848 instructions confine that representation to "an examination of the tax period covered by the tax return they prepared and signed **(or prepared if there is no signature space on the form)**."6

The limits deserve to be named one by one, because this is where an unenrolled preparer gets into trouble. An AFSP participant cannot represent a taxpayer before appeals officers, revenue officers, or attorneys from the Office of Chief Counsel. The participant cannot execute closing agreements, extend the statutory period for assessment or collection, execute waivers, execute claims for refund, or sign any document on behalf of a taxpayer.7 In plain terms: no Appeals, no collections, no revenue officers, no Chief Counsel, and no signing for the client.

B. Three Conditions, All Required

For returns signed after December 31, 2015, the Form 2848 instructions require a valid and active PTIN and two separate Records of Completion.8 Read together with the "prepared and signed" requirement, that produces a three-part test. Each condition must be true at the same time.

⊗ **WARNING: All three must be true, or use Form 8821**

1. You prepared and signed the return or claim for refund under examination (or prepared it, if the form has no signature line).

2. You held a Record of Completion for the calendar year in which you prepared and signed that return or claim.

3. You hold a Record of Completion for the calendar year or years in which you are representing the client.

Plus an active PTIN. If any condition fails, the instructions point to the alternative: the taxpayer "may

1 CAF row: IRM 21.3.7.1.1(3) (Mar. 15, 2023); IRM 21.1.3.3.1(1), (4) (Oct. 1, 2026); IRS Pub. 4019.
2 Rev. Proc. 2014-42, 2014-29 I.R.B. 192, § 6.01.
3 IRS, *Annual Filing Season Program*, irs.gov/tax-professionals/annual-filing-season-program.
4 IRS Pub. 5227, *Annual Filing Season Program* (Rev. 6-2026).
5 Instr. for Form 2848 (Rev. Sept. 2021), Part II, designation h.
6 Instr. for Form 2848 (Rev. Sept. 2021), *Unenrolled return preparer*.
7 Instr. for Form 2848 (Rev. Sept. 2021), *Unenrolled return preparer*; Rev. Proc. 2014-42, 2014-29 I.R.B. 192, § 6.01.
8 Instr. for Form 2848 (Rev. Sept. 2021), *Unenrolled return preparer* (returns signed after Dec. 31, 2015).

authorize the unenrolled return preparer to inspect and/or receive your tax information by filing a Form 8821."1

C. The First Year, Honestly

In the first AFSP year, the representation right is narrow. Only returns signed during that calendar year qualify under condition 2, and the representation must happen while a current record is in place under condition 3. An examination of a return signed in February can easily begin, or continue, after December 31, and at that point the preparer needs the next year's record as well. The value of the program builds with continuous participation.

Timing within the first year also matters. The Record of Completion is "effective for tax returns and claims for refund prepared and signed from the later of January 1 of the year covered by the Record of Completion or the date the Record of Completion is issued until December 31 of that year."2 Returns signed before the record issues are not covered. The IRS will not issue the record until the PTIN is renewed, and issuance "may take up to four weeks following the completion of all requirements."3 A preparer who finishes late can lose the first weeks of the filing season.

WORKPAPER III-1. When does the record start covering returns?

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Facts:   Andre finishes 2027 AFSP CE Dec. 20, 2026.
         Renews PTIN Jan. 12, 2027. Record issues Feb. 3, 2027.
Rule:    Coverage starts at LATER of Jan. 1, 2027 or issue date.
         LATER of (Jan. 1, 2027 ; Feb. 3, 2027) = Feb. 3, 2027

Return A signed Jan. 27, 2027 -> before Feb. 3 -> NOT covered
Return B signed Feb. 9, 2027  -> after Feb. 3  -> covered

Conclusion: Return A can never support designation "h",
no matter how many later records Andre earns (condition 2).
Renew the PTIN as soon as renewal opens.
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Two refinements make the first year more useful than it first appears. First, "the year" in condition 2 is the calendar year the return was **signed**, not the tax year shown on the return.4 An amended return or a late prior-year return that you prepare and sign during your record year counts. Second, for a storefront with an EITC-heavy client base, a same-year examination of a return you signed is common, not rare **(Part III.D)**.

WORKPAPER III-2. Amended and late returns

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Facts:   Lena holds an issued 2026 record. In Aug. 2026 she
         prepares and signs a 2023 Form 1040-X for a client,
         and the IRS later examines THAT claim.

Cond. 1  Prepared and signed the claim?        Yes
Cond. 2  Record for calendar year signed?      2026 -> Yes
         (tax year 2023 is irrelevant to this test)
Cond. 3  Record for year of representation?
         Exam contact Nov. 2026  -> 2026 record  -> Yes
         Exam contact Apr. 2027  -> needs 2027 record

Conclusion: covered in 2026; covered in 2027 only if a 2027
record has actually ISSUED (CE by Dec. 31, 2026, PTIN renewed,
consent given). Signing the 1040-X does not create "h"
eligibility for an exam of a return Lena did not prepare.
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A gap year breaks the chain in two ways. Returns signed during the gap year never qualify, because condition 2 can never be met for them. And during the gap year itself, the preparer cannot represent anyone, because condition 3 fails for every client. Coverage for returns signed in earlier record years comes back when the preparer earns a new record.

1 Instr. for Form 2848 (Rev. Sept. 2021), *Unenrolled return preparer*.
2 Rev. Proc. 2014-42, 2014-29 I.R.B. 192, § 4.04.
3 IRS, *Frequently Asked Questions: Annual Filing Season Program*, irs.gov/tax-professionals.
4 Instr. for Form 2848 (Rev. Sept. 2021), *Unenrolled return preparer*; Rev. Proc. 2014-42, 2014-29 I.R.B. 192, § 4.04.

Table 2. Designation "h" availability with records for 2026 and 2028 but not 2027

Return signed in	Exam in 2026	Exam in 2027	Exam in 2028
2026 (record held)	Yes	No (no 2027 record)	Yes
2027 (no record)	n/a	No	No (cond. 2 fails)
2028 (record held)	n/a	n/a	Yes

Assumes each record listed was actually issued and in effect on the relevant signing date, the preparer prepared and signed the examined return, and the PTIN is active. Completing CE alone does not establish a record. "Exam in" means the calendar year the representation occurs.

D. EITC and ACTC Pre-Refund Examinations

A CP75 notice tells the taxpayer, in substance, that the IRS is auditing the return and holding the EITC or ACTC portion of the refund.1 The IRS screens current-year EITC returns during the filing season, and the IRM provides that the CP75 "generates within 17 days from the date the credit is frozen."2 These cases are opened in the IRS examination inventory system.3 For a storefront preparer, this is the clearest example of a same-year examination of a return you signed.

PRACTICE POINTER: CP75 cases and designation "h"

The IRS calls a CP75 case an audit and opens it as an examination case on AIMS, and the CAF unit adds a designation-"h" representative after verifying that an examination indicator is present on the module.4 An otherwise eligible preparer may therefore represent the client in a CP75 examination, subject to the same three conditions, an active PTIN, and the forum limits. If a designation-"h" Form 2848 comes back, check whether the exam indicator had posted when the form was processed.

E. CP2000 Notices and the Automated Underreporter

A CP2000 is issued by the Automated Underreporter **(AUR)** function when information returns do not match the return. It proposes changes; it is not a bill.5 For purposes of the IRS's examination, inspection, and reopening procedures, it is not an examination either: Rev. Proc. 2005-32 lists a contact to verify a discrepancy with an information return, and adjustments from an information-return matching program, among the actions that are not examinations.6

The CAF procedures use the term differently, for a different administrative purpose, and treat an open CP2000 as an examination when evaluating a designation-"h" authorization. Before adding a designation-"h" representative to the CAF, the CAF unit must "verify the tax year(s) or period(s) are under examination, e.g., FRZ -L, TC 922 or TC 925, is present on the tax module," and if the examination indicator and the preparer's PTIN information are found, it processes the Form 2848.7 Transaction Code **(TC)** 922 is the indicator that posts when AUR issues a CP2000.8 Examiners are likewise directed to check for a TC 922 "every time an examination case is handled."9 The practical result: a preparer who meets all three conditions may represent the client before AUR on an open CP2000 under designation "h."

1 IRS, *Understanding Your CP75 Notice*, irs.gov/individuals/understanding-your-cp75-notice.
2 IRM 21.5.10.4.1(2) (IRM 21.5.10 eff. Oct. 1, 2026).
3 IRM 21.3.1.6.34(1) (IRM 21.3.1 eff. Oct. 1, 2026) (CP 75 case "is open in the Audit Information Management System").
4 IRM 21.3.7.5.6(5)(B), (6) (Mar. 28, 2025).
5 IRS, *Topic No. 652, Notice of Underreported Income – CP2000*, irs.gov/taxtopics/tc652.
6 Rev. Proc. 2005-32, 2005-23 I.R.B. 1206, § 4.03(1)(d)(ii)(C), (iii)(C).
7 IRM 21.3.7.5.6(5)(B), (6) (Mar. 28, 2025).
8 IRM 21.3.1.6.40(3) (IRM 21.3.1 eff. Oct. 1, 2026).
9 IRM 4.19.13.4.2(1) (Jan. 23, 2026).

The usual limits still apply. The authority covers the AUR matter only. It does not reach Appeals, collection revenue officers, or Chief Counsel, and it does not let the preparer sign the CP2000 response or agreement for the client.1 The Record of Completion does not need to be attached to the Form 2848.2

F. Requirements and Deadlines

As of Publication 5227 **(Rev. 6-2026)**, a non-exempt preparer needs 18 hours of continuing education each year: a 6-hour Annual Federal Tax Refresher **(AFTR)** course followed by a 100-question comprehension test **(a maximum of three hours)** with a minimum passing score of 70 percent, plus 10 hours of federal tax law and 2 hours of ethics.3 Exempt preparers need 15 hours: 10 hours of federal tax law, 3 hours of federal tax law updates, and 2 hours of ethics.4

The exempt group includes those who passed the Registered Tax Return Preparer **(RTRP)** test between November 2011 and January 2013; active registrants of the Oregon Board of Tax Practitioners, the California Tax Education Council **(CTEC)**, and the Maryland State Board of Individual Tax Preparers; Special Enrollment Examination **(SEE)** Part I passers within the past three years; VITA volunteers **(Publication 5227 lists quality reviewers, instructors, and return preparers, while the AFSP FAQ lists only quality reviewers and instructors with active PTINs, so confirm eligibility before relying on it)**; and Accreditation Council for Accountancy and Taxation **(ACAT)** Accredited Business Accountant/Advisor and Accredited Tax Preparer credential holders.5

Every participant must also hold an active PTIN for the upcoming year and consent to be subject to the duties and restrictions of Circular 230, Subpart B and § 10.51, for the entire period covered by the record.6 For the 2027 record, "all continuing education must be finished by December 31, 2026."7 The AFTR course and test must be completed by midnight local time on December 31, with no exceptions.8 Applications for the record "must be received by April 15 of the year for which the Record of Completion is sought."9 That is a receipt deadline, not a promise of issuance by April 15, and coverage runs only from the date the record actually issues **(Workpaper III-1)**.

G. Why the AFSP Is Still Worth It

For an EITC-heavy storefront, the representation right reaches exactly the correspondence examinations its clients see most, as long as the preparer signed the return and keeps the records continuous. Participants are also listed in the public Directory of Federal Tax Return Preparers with Credentials and Select Qualifications, and the program provides a structured annual schedule of federal tax education.10 The limits are real, but so is the benefit.

IV. The CAF Number

A. What It Is, and What It Is Not

"A CAF number is a unique nine-digit identification number and is assigned the first time you file a third party authorization with IRS."11 It links your authorizations so the IRS can find them. It is not a credential, and it is

1 Instr. for Form 2848 (Rev. Sept. 2021), *Unenrolled return preparer*; Rev. Proc. 2014-42, 2014-29 I.R.B. 192, § 6.01.
2 Instr. for Form 2848 (Rev. Sept. 2021), Part II, designation h.
3 IRS Pub. 5227 (Rev. 6-2026); IRS, *Annual Filing Season Program*.
4 IRS Pub. 5227 (Rev. 6-2026).
5 IRS Pub. 5227 (Rev. 6-2026); IRS, *Frequently Asked Questions: Annual Filing Season Program*, FAQs 4, 7 (rev. May 29, 2026).
6 Rev. Proc. 2014-42, 2014-29 I.R.B. 192, § 4.05(4); 31 C.F.R. §§ 10.20–10.38, 10.51.
7 IRS Pub. 5227 (Rev. 6-2026).
8 IRS, *CE Provider FAQs: Annual Federal Tax Refresher (AFTR) Course*, irs.gov/tax-professionals.
9 Rev. Proc. 2014-42, 2014-29 I.R.B. 192, § 4.03.
10 IRS, *Annual Filing Season Program*, irs.gov/tax-professionals/annual-filing-season-program.
11 IRS, *The Centralized Authorization File (CAF) Authorization Rules*, irs.gov/businesses/small-businesses-self-employed.

different from a PTIN or a taxpayer identification number.1 Anyone named on an authorization recorded on the CAF gets one, including a designee with no professional standing at all.

B. Getting One

On your first Form 8821 or 2848, enter "None" in the CAF box. The IRS will assign a number and notify you by letter.2 IRS pages describe the assignment notice two ways: the Tax Pro Account page refers to Letter 1727C, and the CP547 page describes CP547 as the notice that assigns a CAF number. Keep whichever one you receive.3 An individual can also obtain a CAF number through Tax Pro Account; a business CAF number requires submitting a Form 2848 or 8821.4

C. One Number, Every Form

Use your assigned CAF number on all future authorizations.5 Enter your name exactly the same way each time.6 In a busy office, the common failure is a staff member writing "None" again on a new client's form because the number is not handy. The IRS can assign more than one CAF number to one person for separate office locations or related entities, but only on a separate written request.7 For storefront purposes, the rule is simple: one preparer, one number, every form.

If you have lost or forgotten your number, call the Practitioner Priority Service. As of the IRS's CP547 guidance updated March 27, 2026, "Once you're verified, your CAF number can be provided over the phone. If we can't verify you, we'll send a letter."8 Some older training materials say the IRS no longer gives out CAF numbers by phone. That is no longer accurate.

D. Linking Your CAF Number to Tax Pro Account

To see your authorized clients in Tax Pro Account, link your CAF number to it. You request a personal identification number **(PIN)**, which is mailed to the address on your CAF record in one to two weeks, and then enter it. Linking is a one-time step and cannot be undone. An individual CAF number links to the holder's Social Security number **(SSN)** or individual taxpayer identification number **(ITIN)**; a business CAF number links to an employer identification number **(EIN)**.9 Because the PIN comes by mail, this is off-season homework. Do it in the fall, not in the first week of February.

V. Completing Form 8821 Correctly

Use the current Form 8821 **(Rev. January 2021)** and its instructions **(Rev. September 2021)**. As of October 22, 2026, the IRS's "About Form 8821" page listed no recent developments.10 Most returned forms fail on line 1 **(the wrong taxpayer or the wrong number)**, line 3 **(vague or impossible periods)**, or line 6 **(the wrong kind of signature)**. The workpapers below show the entries for each storefront client type. All names and numbers are fictional. The SSNs and EINs in the workpapers use invalid prefixes on purpose; the two sample forms in Exhibit 1 keep the placeholder numbers they circulated with. None of these numbers may be used on an actual submission.

A. Line 1: Who Is the Taxpayer?

Line 1 identifies the taxpayer whose information will be disclosed: name, taxpayer identification number, and street address. The designee's information never goes here.11 The address on a Form 8821 does not change the

1 IRM 21.3.7.3(1) (Oct. 1, 2013).
2 Instr. for Form 8821 (Rev. Sept. 2021), *Line 2*.
3 IRS, *Tax Pro Account* (rev. Oct. 16, 2026); IRS, *Understanding Your CP547 Notice* (rev. Mar. 27, 2026).
4 IRS, *Tax Pro Account*, irs.gov/tax-professionals/tax-pro-account.
5 IRS, *The CAF Authorization Rules*, irs.gov.
6 Instr. for Form 8821 (Rev. Sept. 2021), *Line 2*.
7 IRM 21.3.7.3(3) (Oct. 1, 2026).
8 IRS, *Understanding Your CP547 Notice*, irs.gov/individuals (updated Mar. 27, 2026).
9 IRS, *Tax Pro Account*; IRS Pub. 5533-B; IRS, *How to Link a CAF Number*, irs.gov/newsroom.
10 IRS, *About Form 8821*, irs.gov/forms-pubs/about-form-8821 (checked Oct. 22, 2026).
11 Instr. for Form 8821 (Rev. Sept. 2021), *Line 1*.

taxpayer's last known address; that takes Form 8822 or 8822-B.1 The harder question is which taxpayer, and that depends on the client type.

Individuals. Enter the individual's name, SSN or ITIN, and address. **Married filing jointly.** One form cannot cover both spouses. The instructions are direct: "The designee(s) identified will only be authorized for you. Your spouse, or former spouse, must submit a separate Form 8821."2 Each spouse's form may name the same designee.

WORKPAPER V-1. Individual: Marco Ruiz (new client, 2025 return on extension)

```
Line 1  Marco A. Ruiz
        100 Magnolia Ln., Gulfport, MS 39501
        TIN 000-41-7729
Line 3  (a) Type    (b) Form  (c) Periods          (d) Matters
        Income      1040      2022 through 2026    not applicable
Line 6  Signed and dated by Marco (handwritten if faxed)
```

WORKPAPER V-2. Married filing jointly: Darnell and Keisha Hollins

```
Form #1  Line 1  Darnell T. Hollins   TIN 000-52-1180
Form #2  Line 1  Keisha R. Hollins    TIN 000-52-9043
         (same address on both)
Line 3 on each:  Income | 1040 | 2022 through 2026 | not applicable
Line 2 on each:  same designee, same name, same CAF number
Line 6:  each spouse signs only his or her own form

Common error: one form listing both names and both SSNs.
```

Sole proprietors. A Schedule C business is not a separate taxpayer for income tax. The 8821 for income tax names the owner, with the owner's own SSN, and lists Form 1040. The business EIN belongs only on authorizations for business-level taxes, such as employment taxes reported on Forms 941 and 940. The Line 1 box allows more than one identification number, but as a practitioner judgment, a separate Form 8821 for the EIN-level taxes keeps each authorization tied to one number and is easier to track.

WORKPAPER V-3. Sole proprietor with employees: Rosa Delgado

```
Form #1  Line 1  Rosa M. Delgado            TIN 000-63-2214
         Line 3  Income | 1040 | 2022 through 2026 | not applicable

Form #2  Line 1  Rosa M. Delgado, dba Delgado Lawn Care
                 TIN (EIN) 00-0004821
         Line 3  Employment | 941 | 1st 2024 through 4th 2026 | n/a
                 Employment | 940 | 2024 through 2026        | n/a
Both forms: signed by Rosa as the individual taxpayer.
```

Single-member LLCs. A single-member LLC that has not elected corporate treatment is disregarded for income tax, but it is treated as a corporation for employment taxes and certain excise taxes, using its own name and EIN.3 The authorization should follow that split. Workpaper V-4 assumes an individual owner; if another entity owns the LLC, the income-tax authorization follows that owner's return, not Form 1040.

WORKPAPER V-4. Single-member LLC: Gulf Coast Mobile Detailing LLC (owner Trent Ladner)

```
Form #1 (income tax)
  Line 1  Trent J. Ladner                 TIN 000-74-3306
  Line 3  Income | 1040 | 2022 through 2026 | not applicable

Form #2 (employment tax)
  Line 1  Gulf Coast Mobile Detailing LLC TIN (EIN) 00-0007315
  Line 3  Employment | 941 | 1st 2024 through 4th 2026 | n/a
          Employment | 940 | 2024 through 2026        | n/a

Error to avoid: the LLC name and EIN on the income-tax form.
```

⚠ CAUTION: The split is law; the two forms are practice

The owner-versus-LLC split comes from the entity classification regulations. Using two separate Forms 8821

1 Instr. for Form 8821 (Rev. Sept. 2021), *Line 1*.

2 Instr. for Form 8821 (Rev. Sept. 2021), *Line 1*, *Individuals*.

3 Treas. Reg. § 301.7701-2(c)(2)(iv)–(v); IRS, *Single Member Limited Liability Companies*, irs.gov.

to carry it out is a practice recommendation, not a regulatory requirement, and the Form 8821 instructions do not address disregarded entities directly. If the CAF unit returns a form, the return letter will say why.

Corporations and partnerships. Enter the entity's name, EIN, and business address.1 A corporation's form is signed by an officer with authority under state law to bind the corporation **(or another person the instructions list)**, with the officer's title; a partnership's form may generally be signed by anyone who was a partner during any part of the period covered, but if the form covers more than one year or period, the signer must have been a partner during all or part of **each** year or period listed.2 List only the forms that apply to the taxpayer for the periods listed. A shotgun list such as Forms 1120, 1120-S, 1065, and 1041 for the same EIN is a red flag. Different income-tax forms can be right for different periods, though, when the entity's filing obligations changed **(a C corporation that later elected S status, for example)**.

WORKPAPER V-5. S corporation: Pine Belt Tire & Lube, Inc.

```
Line 1  Pine Belt Tire & Lube, Inc.     TIN (EIN) 00-0002267
        200 Commerce Dr., Hattiesburg, MS 39401
Line 3  Income     | 1120-S | 2022 through 2026        | n/a
        Employment | 941    | 1st 2024 through 4th 2026 | n/a
        Employment | 940    | 2024 through 2026         | n/a
Line 6  Angela B. Pruitt, President

The shareholder's own Form 1040 is NOT covered. Angela signs
a separate 8821, as an individual, for her Form 1040.
```

B. Line 2: The Designee

Line 2 names the designee: full name, address, CAF number **(or "None")**, PTIN, telephone, and fax. Use the full name exactly the same way on every submission.3 The PTIN line appears on the form, although the instructions do not discuss it; a paid preparer should fill it in, because Practitioner Priority Service expects a PTIN from preparers. A designee who is not a preparer, such as a bookkeeper or family member, does not need a PTIN to receive information under Form 8821. Up to two designees fit on the form; for more, check the box and attach a list.4

Check the box under a designee's name only if that designee should receive copies of notices and communications. No more than two designees may receive copies for the same matters, and designees do not receive forms or publications with the correspondence. Check the "new" boxes if your address, phone, or fax has changed since your CAF number was issued.5

C. Line 3: Tax Information

Line 3 has four columns: **(a)** type of tax, **(b)** form number, **(c)** years or periods, and **(d)** specific tax matters. The instructions give examples such as "Income, 1040," annual periods such as "2017 thru 2019," quarterly periods such as "2nd 2017–3rd 2018," and fiscal years written as YYYYMM.6 General references fail: "Any tax information authorization with a general reference will be returned."7 Do not write "All years," "All periods," or "All taxes" anywhere on the form. In column **(d)**, enter "not applicable" unless you are limiting the authorization to a specific matter.8

Future periods are allowed, with a limit. The IRS "will not record on the CAF system future tax years or periods listed that exceed 3 years from December 31 of the year that the IRS receives the tax information authorization."9 The rule is about tax periods, measured from the year of receipt. It is not a rule that the form may be "dated" three years in the future, which is how some training material has described it.

1 Instr. for Form 8821 (Rev. Sept. 2021), *Line 1*.
2 Instr. for Form 8821 (Rev. Sept. 2021), *Line 6*.
3 Instr. for Form 8821 (Rev. Sept. 2021), *Line 2*.
4 Instr. for Form 8821 (Rev. Sept. 2021), *Line 2*.
5 Instr. for Form 8821 (Rev. Sept. 2021), *Line 2*.
6 Instr. for Form 8821 (Rev. Sept. 2021), *Line 3*.
7 Instr. for Form 8821 (Rev. Sept. 2021), *Line 3*, columns (a)–(c).
8 Instr. for Form 8821 (Rev. Sept. 2021), *Line 3*, column (d).
9 Instr. for Form 8821 (Rev. Sept. 2021), *Line 3*.

WORKPAPER V-6. The three-year future-period limit

```
Facts:   Form 8821 received by the IRS Nov. 10, 2026.
Step 1   Year of receipt                          2026
Step 2   Dec. 31 of that year                     Dec. 31, 2026
Step 3   Plus 3 years                             Dec. 31, 2029
Result:  Latest period the CAF will record:  tax year 2029
         (for quarterly forms, 4th quarter 2029)

Listed "2020 through 2031" -> 2020-2029 recorded;
                              2030-2031 not recorded
Listed "2022 through 2026" -> all recorded
```

Civil penalties. For a civil-penalty-only authorization, enter "civil penalty" in column **(a)**, "N/A" in column **(b)**, and the years in column **(c)**. If a specific return is already listed, such as Form 1040 for the same years, the authorization already covers penalties and payments related to that return.1 A separate civil-penalty row is needed only for penalties not tied to a listed return. One exception: for penalties related to an individual retirement account, enter "IRA civil penalty" in column **(a)** and leave columns **(b)** and **(d)** blank.2

The Intermediate Service Provider (ISP) box. An ISP is a private company, not affiliated with the IRS, that retrieves tax information on a designee's behalf. Unless the taxpayer checks the box on line 3, the designee "is not authorized to use an Intermediate Service Provider to retrieve your confidential tax information indirectly from the IRS." The box does not affect the designee's own direct access through e-Services.3 Check it only if your office actually uses an ISP and the client agrees.

D. Line 4: Specific Use Not Recorded on the CAF

Line 4 is for one-time disclosures, such as to a lender or a school, or for certain information forms. If it is checked, the form is not recorded on the CAF, line 5 is skipped, earlier authorizations stay in place, and the form goes to the IRS office handling the specific matter.4 A form that is not on the CAF cannot be used with Tax Pro Account or TDS. The storefront default is to leave line 4 unchecked. Watch the timing on a lender-type form: when Form 8821 is used for a purpose other than resolving a tax matter with the IRS **(income verification for a lender, for example)**, the IRS must receive it within 120 days of the taxpayer's signature date. The 120-day rule does not apply to an 8821 for assistance with a tax matter, and it is separate from the 120-day approval window in Tax Pro Account.5

E. Line 5: Retention and Revocation

Unless line 4 is checked, filing a new Form 8821 automatically revokes all prior tax information authorizations on file for the same matters. To keep them, the taxpayer checks the line 5 box and attaches copies of the authorizations to be retained.6 A new 8821 does not revoke a Form 2848 that is in effect.7

⊗ **WARNING: You can knock out someone else's authorization**
If the client's bookkeeper, a prior preparer, or an adult child already holds an 8821 for the same years, your new form will revoke it unless the client checks line 5 and attaches a copy. Ask at intake: "Has anyone else been given permission to talk to the IRS about your taxes?"

F. Line 6: Signature

Only the taxpayer signs; the designee does not. The form itself warns: "IF NOT COMPLETED, SIGNED, AND DATED, THIS TAX INFORMATION AUTHORIZATION WILL BE RETURNED" and "DON'T SIGN THIS FORM IF IT IS BLANK OR INCOMPLETE."8 Never have a client sign a blank form to be completed later.

"You must handwrite your signature on Form 8821 if you file it by mail or by fax." Digital, electronic, or typed-font signatures are not valid for mail or fax; an electronically signed form must be submitted through the online

1 Instr. for Form 8821 (Rev. Sept. 2021), *Line 3*, civil penalty.
2 Instr. for Form 8821 (Rev. Sept. 2021), *Line 3*, IRA civil penalty.
3 Instr. for Form 8821 (Rev. Sept. 2021), *Line 3*, Intermediate Service Provider.
4 Instr. for Form 8821 (Rev. Sept. 2021), *Line 4*.
5 Instr. for Form 8821 (Rev. Sept. 2021), *When To File*; Treas. Reg. § 301.6103(c)-1(b)(2).
6 Instr. for Form 8821 (Rev. Sept. 2021), *Line 5*.
7 IRM 13.1.23.11(3), note (Mar. 16, 2026).
8 Form 8821 (Rev. Jan. 2021), line 6.

tool.1 The form instructions describe remote-signature authentication broadly: inspecting a photo ID by self-photo or video conference, recording identifying details, and checking a secondary document.2 The current upload page narrows when it is required **(when you have no personal or business relationship with the taxpayer and the taxpayer signs electronically in a remote transaction)**, recommends it as a best practice for anyone you do not know, and for an entity adds confirming the signer's authority.3 The conservative office procedure is to authenticate and document every remote signer and keep the records.

G. Red Pen: Reviewing Two Sample Forms

Two completed Forms 8821 have circulated as handouts in earlier presentations of this material: an individual sample for Clark Kent of Smallville, and an S corporation sample for Superman, Inc., signed by Clark Kent as President. Both name Bob Smith as designee. Both are useful precisely because they contain errors. Review a form you did not prepare the way you would review a return you did not prepare. Table 3 lists each problem; Exhibit 1, which follows the table, shows both forms as circulated and as corrected, with the changed entries highlighted.

Table 3. Red-pen review of the two sample forms (A = individual; B = S corporation)

Line	Sample shows	Problem	Correct entry
A and B: Line 2, CAF	"CAF Number or None"	Template text left in the box	The 9-digit CAF number, or "None"
A and B: Line 2, PTIN, phone, fax	P00000000; 555-555-5555; "Optional"	Placeholders; dangerous if the form is signed as-is	Real PTIN and phone; leave fax blank if none
A: Line 3, civil penalty	Civil Penalty | 1040, 1040x | 2020-2028	Form numbers in column (b)	"N/A" in (b); row unnecessary, since the Income/1040 row covers return-related penalties
A: Line 3, periods	2020-2028	None if received in 2026 (limit 2029)	No change if received in 2025 or later; 2028 would not be recorded on a form received in 2024
A and B: Line 3, ISP box	Checked on both	Not an error, but not a default	Check only if an ISP is used
B: Line 1, TIN	11-000000	Eight digits	Nine digits, XX-XXXXXXX
B: Line 3, civil penalty	Civil Penalty | 1120s	Form number in (b)	"N/A" in (b), or drop the row
B: Line 3, payroll	Payroll | 940, 941, 943 | 2000-2028	"2000" may be a typo for 2020, but it is not invalid on its face; 943 is the agricultural employer return	**Exhibit assumes a 2020 start:** confirm the intended scope before changing; list 943 only if the corporation files it
B: Line 6	Clark Kent; "President"	None	**Correct:** officer name and title
B: Scope	Corporation only	The shareholder's Form 1040 is not covered	Separate 8821 for the shareholder

Sources: Instr. for Form 8821, lines 1–3 and 6. The "1040, 1040x" and quarterly-period entries are not addressed by the instructions and are not treated as errors here.

Exhibit 1. The two sample Forms 8821, as circulated (left) and as corrected (right). Corrected entries are highlighted. See Table 3. The corrected forms are data-entry examples only, not complete authorizations: they are unsigned and undated, and all identifiers are illustrative.

1 Instr. for Form 8821 (Rev. Sept. 2021), *Line 6*.
2 Instr. for Form 8821 (Rev. Sept. 2021), *Line 6*, electronic signatures.
3 IRS, *Submit Forms 2848 and 8821 Online* (rev. June 28, 2026).

A. Individual (Clark Kent), as circulated	*A. Individual, corrected*
B. S corporation (Superman, Inc.), as circulated	*B. S corporation, corrected (assumes no Form 943 filing obligation)*

H. The Returned-Form Checklist

Before a Form 8821 leaves the office, check it against the eight most common reasons for return or rejection:

1. "All years," "all periods," or "all taxes" written anywhere.
2. Lines 1, 2, or 3 incomplete when signed, or the form signed blank.
3. One Form 8821 for both spouses.
4. An electronic or typed signature on a faxed or mailed form.



Form **8821** (Rev. January 2021) — Department of the Treasury, Internal Revenue Service

Tax Information Authorization

▶ Go to www.irs.gov/Form8821 for instructions and the latest information.
▶ Don't sign this form unless all applicable lines have been completed.
▶ Don't use Form 8821 to request copies of your tax returns or to authorize someone to represent you. See instructions.

For IRS Use Only — Received; Name; Telephone; Function; Date

1 Taxpayer information. Taxpayer must sign and date this form on line 6.

Taxpayer name and address	Taxpayer identification number(s)
Clark Kent 1234 Main St Smallville, KS 54321	111-11-1111
	Daytime telephone number / Plan number (if applicable)

2 Designee(s). If you wish to name more than two designees, attach a list to this form. **Check here if a list of additional designees is attached ▶** ☐

Name and address	
Bob Smith 6789 1st Avenue Smallville, KS 54321	CAF No. CAF Number or None PTIN P00000000 Telephone No. 555-555-5555 Fax No. Optional
Check if to be sent copies of notices and communications ☑	Check if new: Address ☐ Telephone No. ☐ Fax No. ☐
Name and address	CAF No. PTIN Telephone No. Fax No.
Check if to be sent copies of notices and communications ☐	Check if new: Address ☐ Telephone No. ☐ Fax No. ☐

3 Tax information. Each designee is authorized to inspect and/or receive confidential tax information for the type of tax, forms, periods, and specific matters you list below. See the line 3 instructions.

☑ By checking here, I authorize access to my IRS records via an Intermediate Service Provider.

(a) Type of Tax Information (Income, Employment, Payroll, Excise, Estate, Gift, Civil Penalty, Sec. 4980H Payments, etc.)	(b) Tax Form Number (1040, 941, 720, etc.)	(c) Year(s) or Period(s)	(d) Specific Tax Matters
Income	1040, 1040x	2020-2020	not applicable
Civil Penalty	1040, 1040x	2020-2020	not applicable

4 Specific use not recorded on the Centralized Authorization File (CAF). If the tax information authorization is for a specific use not recorded on CAF, check this box. See the instructions. If you check this box, skip line 5 . . . . . ▶ ☐

5 Retention/revocation of prior tax information authorizations. If the line 4 box is checked, skip this line. If the line 4 box isn't checked, the IRS will automatically revoke all prior tax information authorizations on file unless you check the line 5 box and **attach a copy** of the tax information authorization(s) that you want to retain . . . . . ▶ ☐
To revoke a prior tax information authorization(s) without submitting a new authorization, see the line 5 instructions.

6 Taxpayer signature. If signed by a corporate officer, partner, guardian, partnership representative (or designated individual, if applicable), executor, receiver, administrator, trustee, or individual other than the taxpayer, I certify that I have the legal authority to execute this form with respect to the tax matters and tax periods shown on line 3 above.

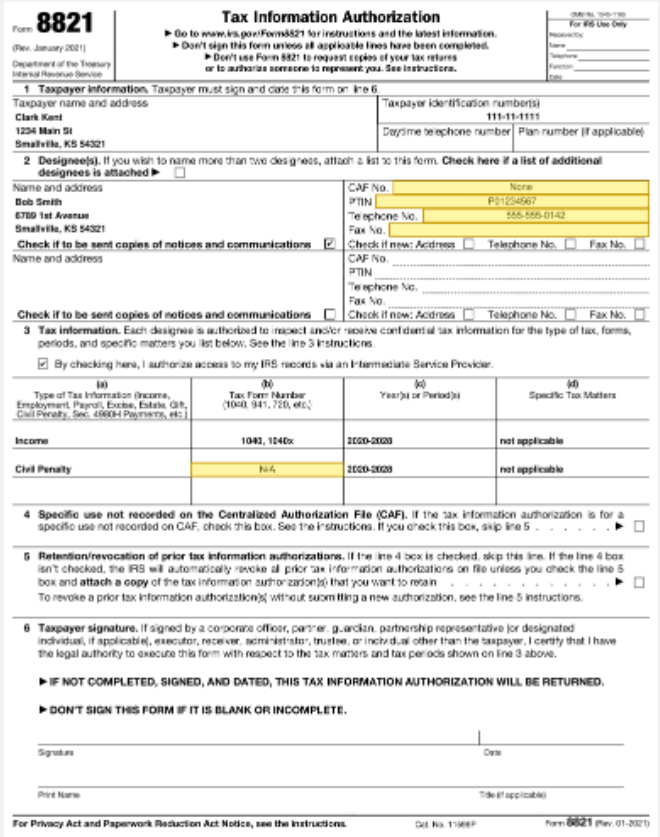
▶ IF NOT COMPLETED, SIGNED, AND DATED, THIS TAX INFORMATION AUTHORIZATION WILL BE RETURNED.

▶ DON'T SIGN THIS FORM IF IT IS BLANK OR INCOMPLETE.

Signature — Date

Print Name — Title (if applicable)

For Privacy Act and Paperwork Reduction Act Notice, see the instructions. Cat. No. 11980P Form 8821 (Rev. 01-2021)



Form **8821** (Rev. January 2021) — Department of the Treasury, Internal Revenue Service

Tax Information Authorization

▶ Go to www.irs.gov/Form8821 for instructions and the latest information.
▶ Don't sign this form unless all applicable lines have been completed.
▶ Don't use Form 8821 to request copies of your tax returns or to authorize someone to represent you. See instructions.

For IRS Use Only — Received; Name; Telephone; Function; Date

1 Taxpayer information. Taxpayer must sign and date this form on line 6.

Taxpayer name and address	Taxpayer identification number(s)
Clark Kent 1234 Main St Smallville, KS 54321	111-11-1111
	Daytime telephone number / Plan number (if applicable)

2 Designee(s). If you wish to name more than two designees, attach a list to this form. **Check here if a list of additional designees is attached ▶** ☐

Name and address	
Bob Smith 6789 1st Avenue Smallville, KS 54321	CAF No. None PTIN P01234567 Telephone No. 555-555-0142 Fax No.
Check if to be sent copies of notices and communications ☑	Check if new: Address ☐ Telephone No. ☐ Fax No. ☐
Name and address	CAF No. PTIN Telephone No. Fax No.
Check if to be sent copies of notices and communications ☐	Check if new: Address ☐ Telephone No. ☐ Fax No. ☐

3 Tax information. Each designee is authorized to inspect and/or receive confidential tax information for the type of tax, forms, periods, and specific matters you list below. See the line 3 instructions.

☑ By checking here, I authorize access to my IRS records via an Intermediate Service Provider.

(a) Type of Tax Information (Income, Employment, Payroll, Excise, Estate, Gift, Civil Penalty, Sec. 4980H Payments, etc.)	(b) Tax Form Number (1040, 941, 720, etc.)	(c) Year(s) or Period(s)	(d) Specific Tax Matters
Income	1040, 1040x	2020-2020	not applicable
Civil Penalty	N/A	2020-2020	not applicable

4 Specific use not recorded on the Centralized Authorization File (CAF). If the tax information authorization is for a specific use not recorded on CAF, check this box. See the instructions. If you check this box, skip line 5 . . . . . ▶ ☐

5 Retention/revocation of prior tax information authorizations. If the line 4 box is checked, skip this line. If the line 4 box isn't checked, the IRS will automatically revoke all prior tax information authorizations on file unless you check the line 5 box and **attach a copy** of the tax information authorization(s) that you want to retain . . . . . ▶ ☐
To revoke a prior tax information authorization(s) without submitting a new authorization, see the line 5 instructions.

6 Taxpayer signature. If signed by a corporate officer, partner, guardian, partnership representative (or designated individual, if applicable), executor, receiver, administrator, trustee, or individual other than the taxpayer, I certify that I have the legal authority to execute this form with respect to the tax matters and tax periods shown on line 3 above.

▶ IF NOT COMPLETED, SIGNED, AND DATED, THIS TAX INFORMATION AUTHORIZATION WILL BE RETURNED.

▶ DON'T SIGN THIS FORM IF IT IS BLANK OR INCOMPLETE.

Signature — Date

Print Name — Title (if applicable)

For Privacy Act and Paperwork Reduction Act Notice, see the instructions. Cat. No. 11980P Form 8821 (Rev. 01-2021)



S corp example

Form **8821** (Rev. January 2021)

Tax Information Authorization

▶ Go to www.irs.gov/Form8821 for instructions and the latest information.
▶ Don't sign this form unless all applicable lines have been completed.
▶ Don't use Form 8821 to request copies of your tax returns or to authorize someone to represent you. See instructions.

Department of the Treasury
Internal Revenue Service

OMB No. 1545-1165
For IRS Use Only
Received by/Date
Name
Telephone
Function
Date

1 Taxpayer information. Taxpayer must sign and date this form on line 6.

Taxpayer name and address	Taxpayer identification number(s)	
Superman, Inc 1234 Main St Smallville, KS 54321	11-0000000	
	Daytime telephone number	Plan number (if applicable)

2 Designee(s). If you wish to name more than two designees, attach a list to this form. **Check here if a list of additional designees is attached ▶** ☐

Name and address		
Bob Smith 6789 1st Avenue Smallville, KS 54321	CAF No.	CAF Number or None
	PTIN	P00000000
	Telephone No.	555-555-5555
	Fax No.	Optional
Check if to be sent copies of notices and communications ☑	Check if new: Address ☐	Telephone No. ☐ Fax No. ☐
Name and address	CAF No.	
	PTIN	
	Telephone No.	
	Fax No.	
Check if to be sent copies of notices and communications ☐	Check if new: Address ☐	Telephone No. ☐ Fax No. ☐

3 Tax information. Each designee is authorized to inspect and/or receive confidential tax information for the type of tax, forms, periods, and specific matters you list below. See the line 3 instructions.

☑ By checking here, I authorize access to my IRS records via an Intermediate Service Provider.

(a) Type of Tax Information (Income, Employment, Payroll, Excise, Estate, Gift, Civil Penalty, Sec. 4980H Payments, etc.)	(b) Tax Form Number (1040, 941, 720, etc.)	(c) Year(s) or Period(s)	(d) Specific Tax Matters
Income	1120s	2020-2026	not applicable
Civil Penalty	1120s	2020-2026	not applicable
Payroll	940, 941, 943	2020-2026	not applicable

4 Specific use not recorded on the Centralized Authorization File (CAF). If the tax information authorization is for a specific use not recorded on CAF, check this box. See the instructions. If you check this box, skip line 5 . . . . . ▶ ☐

5 Retention/revocation of prior tax information authorizations. If the line 4 box is checked, skip this line. If the line 4 box isn't checked, the IRS will automatically revoke all prior tax information authorizations on file unless you check the line 5 box and **attach a copy** of the tax information authorization(s) that you want to retain . . . . . ▶ ☐
To revoke a prior tax information authorization(s) without submitting a new authorization, see the line 5 instructions.

6 Taxpayer signature. If signed by a corporate officer, partner, guardian, partnership representative (or designated individual, if applicable), executor, receiver, administrator, trustee, or individual other than the taxpayer, I certify that I have the legal authority to execute this form with respect to the tax matters and tax periods shown on line 3 above.

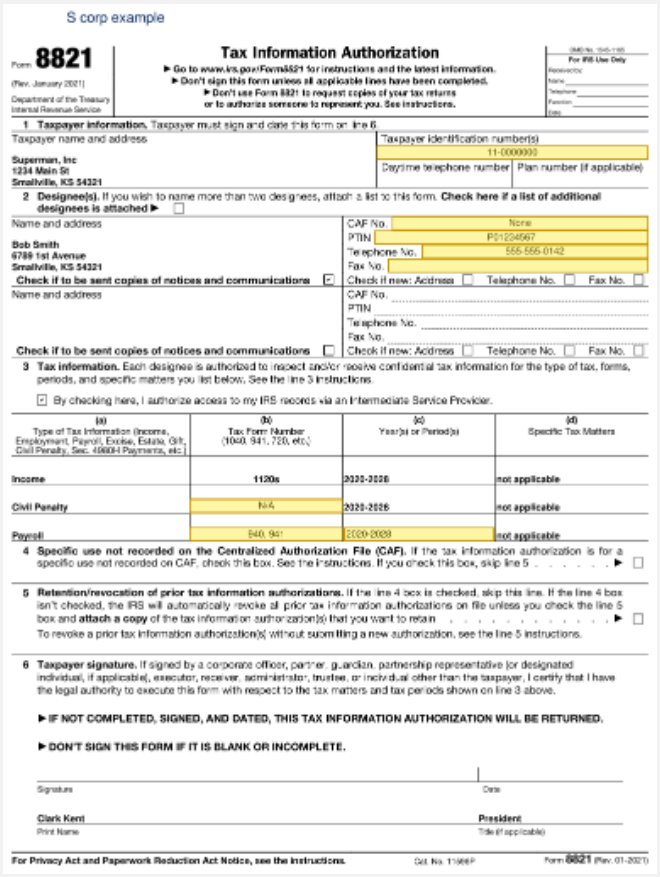
▶ IF NOT COMPLETED, SIGNED, AND DATED, THIS TAX INFORMATION AUTHORIZATION WILL BE RETURNED.

▶ DON'T SIGN THIS FORM IF IT IS BLANK OR INCOMPLETE.

Signature | Date

Clark Kent | **President**
Print Name | Title (if applicable)

For Privacy Act and Paperwork Reduction Act Notice, see the instructions. Cat. No. 11980P Form **8821** (Rev. 01-2021)



S corp example

Form **8821** (Rev. January 2021)

Tax Information Authorization

▶ Go to www.irs.gov/Form8821 for instructions and the latest information.
▶ Don't sign this form unless all applicable lines have been completed.
▶ Don't use Form 8821 to request copies of your tax returns or to authorize someone to represent you. See instructions.

Department of the Treasury
Internal Revenue Service

OMB No. 1545-1165
For IRS Use Only
Received by/Date
Name
Telephone
Function
Date

1 Taxpayer information. Taxpayer must sign and date this form on line 6.

Taxpayer name and address	Taxpayer identification number(s)	
Superman, Inc 1234 Main St Smallville, KS 54321	11-0000000	
	Daytime telephone number	Plan number (if applicable)

2 Designee(s). If you wish to name more than two designees, attach a list to this form. **Check here if a list of additional designees is attached ▶** ☐

Name and address		
Bob Smith 6789 1st Avenue Smallville, KS 54321	CAF No.	None
	PTIN	P01234567
	Telephone No.	555-555-0142
	Fax No.	
Check if to be sent copies of notices and communications ☑	Check if new: Address ☐	Telephone No. ☐ Fax No. ☐
Name and address	CAF No.	
	PTIN	
	Telephone No.	
	Fax No.	
Check if to be sent copies of notices and communications ☐	Check if new: Address ☐	Telephone No. ☐ Fax No. ☐

3 Tax information. Each designee is authorized to inspect and/or receive confidential tax information for the type of tax, forms, periods, and specific matters you list below. See the line 3 instructions.

☑ By checking here, I authorize access to my IRS records via an Intermediate Service Provider.

(a) Type of Tax Information (Income, Employment, Payroll, Excise, Estate, Gift, Civil Penalty, Sec. 4980H Payments, etc.)	(b) Tax Form Number (1040, 941, 720, etc.)	(c) Year(s) or Period(s)	(d) Specific Tax Matters
Income	1120s	2020-2026	not applicable
Civil Penalty	N/A	2020-2026	not applicable
Payroll	940, 941	2009-2009	not applicable

4 Specific use not recorded on the Centralized Authorization File (CAF). If the tax information authorization is for a specific use not recorded on CAF, check this box. See the instructions. If you check this box, skip line 5 . . . . . ▶ ☐

5 Retention/revocation of prior tax information authorizations. If the line 4 box is checked, skip this line. If the line 4 box isn't checked, the IRS will automatically revoke all prior tax information authorizations on file unless you check the line 5 box and **attach a copy** of the tax information authorization(s) that you want to retain . . . . . ▶ ☐
To revoke a prior tax information authorization(s) without submitting a new authorization, see the line 5 instructions.

6 Taxpayer signature. If signed by a corporate officer, partner, guardian, partnership representative (or designated individual, if applicable), executor, receiver, administrator, trustee, or individual other than the taxpayer, I certify that I have the legal authority to execute this form with respect to the tax matters and tax periods shown on line 3 above.

▶ IF NOT COMPLETED, SIGNED, AND DATED, THIS TAX INFORMATION AUTHORIZATION WILL BE RETURNED.

▶ DON'T SIGN THIS FORM IF IT IS BLANK OR INCOMPLETE.

Signature | Date

Clark Kent | **President**
Print Name | Title (if applicable)

For Privacy Act and Paperwork Reduction Act Notice, see the instructions. Cat. No. 11980P Form **8821** (Rev. 01-2021)

☑ 5. No form number for a tax matter, except "N/A" for civil-penalty-only matters or a blank column (b) for IRA civil penalties.

☑ 6. The LLC's name and EIN on a single-member LLC's income-tax authorization.

☑ 7. A designee name or CAF number that does not match prior forms.

☑ 8. The same form sent more than one way (fax and upload, for example).

Items 1, 2, and 4 come directly from the form and its instructions; item 3 from the line 1 instructions; item 5 from line 3; item 6 from the LLC guidance discussed above; item 7 from the line 2 instructions; and item 8 from the IRS processing-status page.1

VI. Submitting, Tracking, Revoking, and Withdrawing

A. Tax Pro Account (Individual Clients)

For individual clients, the fastest route is Tax Pro Account. The IRS describes it as "automated and processed to CAF in real time once approved by the client."2 "Anyone can request TIA."3 You send the request; the client approves it in his or her own IRS Online Account within 120 days. The client does not need an Online Account before you send the request, but must be able to create one and sign in. Names and addresses must match IRS records, and IRS materials differ on address eligibility: the current Tax Pro Account page requires an address in a U.S. state or the District of Columbia, while Publication 5533-B includes territories and military addresses. Confirm before relying on it, and use a paper or uploaded Form 8821 when the online request is not available.4

The catch for many storefront clients is the Online Account itself. A client who cannot complete identity verification cannot approve the request. New authorization requests in Tax Pro Account are "currently ... only

1 Instr. for Form 8821 (Rev. Sept. 2021), lines 1–3, 6; IRS, *Processing Status for Tax Forms*, irs.gov/help.
2 IRS, *Request a Power of Attorney (POA) or Tax Information Authorization (TIA)*, irs.gov.
3 IRS, *Tax Pro Account*, irs.gov/tax-professionals/tax-pro-account.
4 IRS, *Tax Pro Account* (rev. Oct. 16, 2026); IRS Pub. 5533-B.

available for POA and TIA requests to individuals"; for a new business authorization, submit Form 8821 by upload, fax, or mail. Once a business CAF number is linked, however, Tax Pro Account does let you view business taxpayer information within your existing authorizations, view business authorizations on the CAF, and withdraw them.1 Capabilities are expanding; recheck the page before relying on this list.

WARNING: The online request can knock out other authorizations too
A Tax Pro Account request revokes "prior authorizations on file for the same tax matters, tax periods and authorization types," and the online request has no retention box. If a bookkeeper or another preparer needs to stay on, submit a paper or uploaded Form 8821 with the line 5 box checked and a copy attached instead. When more than one designee will use Tax Pro Account, each sends his or her own request, and the client must approve all of them on the same day.2

B. Online Submission

The "Submit Forms 2848 and 8821 Online" tool **(IRS.gov/Submit8821)** accepts an uploaded signed form, including an electronically signed one. It requires a Secure Access account. Online uploads are processed first-in, first-out along with faxed and mailed forms, so they are not faster than fax; the advantage is that electronic signatures are allowed.3

C. Fax or Mail (Mississippi Taxpayers)

For a taxpayer in Mississippi, send a paper Form 8821 to Internal Revenue Service, 5333 Getwell Road, Stop 8423, Memphis, TN 38118, or fax it to 855-214-7519.4 The instructions note that fax numbers may change without notice. Pick one method and use it once. "Please don't submit a duplicate form."5

D. Tracking

The IRS "Processing status for tax forms" page reports current turnaround times. As of mid-October 2026, it showed Forms 2848 and 8821 as "Processed 3 business days after receipt."6 Some older training materials cite four to six weeks by mail and two weeks by fax. The current number is the one on the page the day you check; treat any figure, including this one, as "as of."

PRACTICE POINTER: You do not always have to wait for the CAF
CAF posting is required for Tax Pro Account and TDS, but not for every conversation with the IRS. The IRS's guidance for forms not yet processed says that if you need to discuss the case immediately, you may fax the form, with a "wet" ink signature, to the IRS employee handling the matter, or contact PPS.7 The IRM directs employees to review unprocessed paper or faxed authorizations, faxing first-time submissions to the CAF unit within 24 hours and treating copies of forms already submitted as classified waste after the call.8 Giving the employee a copy this way is different from re-sending duplicates to the CAF unit. Do not expect a first-time caller to get every service, such as SOR delivery, before the CAF record exists.

E. Revoke Versus Withdraw

Taxpayers revoke; designees withdraw. To revoke, the taxpayer writes "REVOKE" across the top of a copy of the authorization and adds a current signature and date. Without a copy, the taxpayer sends a signed and dated statement listing the designees and matters being revoked, or stating "revoke all years/periods."9

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1 IRS, *Tax Pro Account*, irs.gov/tax-professionals/tax-pro-account (rev. Oct. 16, 2026).
2 IRS, *Tax Pro Account*, irs.gov/tax-professionals/tax-pro-account (rev. Oct. 16, 2026).
3 IRS, *Tax Pro Account*; Instr. for Form 8821 (Rev. Sept. 2021), *Where To File*.
4 Instr. for Form 8821 (Rev. Sept. 2021), *Where To File Chart* (Memphis); IRM 21.3.7.1.9(7) (Oct. 26, 2023).
5 IRS, *Processing Status for Tax Forms*, irs.gov/help/processing-status-for-tax-forms (rev. Oct. 16, 2026).
6 IRS, *Processing Status for Tax Forms* (rev. Oct. 16, 2026).
7 IRS, *Submit Forms 2848 and 8821 Online: FAQs*, "If your form isn't yet processed" (rev. June 28, 2026).
8 IRM 21.1.3.3(13) (Oct. 1, 2026).
9 Instr. for Form 8821 (Rev. Sept. 2021), *Line 5*, revocation.

A designee who wants out writes “Withdraw” across the top of the first page of a copy of the authorization and adds a signature and the current date.1 Withdrawals must be in writing; the CAF unit does not accept oral withdrawals.2 Once your CAF number is linked, you can also withdraw in Tax Pro Account, where the withdrawal posts in real time.3 The Form 8821 instructions themselves do not describe designee withdrawal.

VII. Putting the 8821 to Work

A. Tax Pro Account

With a linked CAF number, Tax Pro Account lets you view taxpayer information for your authorized clients, limited to the forms and periods your authorization covers.4 Screens shown in earlier versions of this program displayed tabs for an overview, authorizations, account balance, payment activity, payment options, and audit status. Screens change, so treat any screenshot as illustrative. The point is that balance, payment history, and audit status for an individual client are often available without a phone call.

B. Practitioner Priority Service

The Practitioner Priority Service **(PPS)** line is 866-860-4259, staffed weekdays from 7 a.m. to 7 p.m. local time **(Alaska and Hawaii follow Pacific time)**. “PPS is available to all tax professionals with valid third-party authorizations, i.e., Forms 2848, 8821 and/or 8655.”5 An 8821 designee qualifies. Have your CAF number, PTIN, and the client’s identifying information ready before you dial.

Since April 8, 2024, the IRS’s PPS page describes PPS as the telephone route for transcripts delivered to your e-Services Secure Object Repository **(SOR)** mailbox for the domestic account matters discussed here, and you must verify your e-Services Short ID on the call. If you cannot be verified, the transcripts are mailed to the client’s address of record. Requests are subject to “a combined limit of 30 per client with a maximum of 10 IDRS internal transcripts per client.”6 For delivery to the practitioner, unmasked wage and income transcripts use the authenticated SOR route and require a CAF number in good standing and an e-Services account with SOR access; under IRS procedures they can also be mailed to the taxpayer’s address of record.7

C. The Transcript Delivery System: Two Gates

The Transcript Delivery System **(TDS)** lets authorized users pull transcripts online. Two separate gates must both be open. The first is firm and user access. The second is a client authorization on file.

Gate 1: firm and user access. An electronic return originator **(ERO)** firm qualifies for TDS by e-filing a minimum number of accepted returns in the current or prior season; IRS web pages state the ordinary ERO threshold as five or more. A separate Circular 230 TDS-only e-file application has its own restriction: delegated users can be added only once the firm e-files “more than five returns.” Know which kind of application your office holds.8 A seasonal preparer does not get TDS access merely by preparing returns under the office owner’s EFIN. Instead, an authorized Principal, Principal Consent, or Responsible Official opens the firm’s IRS e-file application, goes to the Authorized Users screen, and selects Add, then Delegated User, entering the employee’s name, title, SSN, and email address.9 The TDS permission “must be manually assigned to a delegated user”; adding the user without that permission is not enough.10

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1 IRM 13.1.23.11(5) (Mar. 16, 2026).
2 IRM 21.3.7.10.1(1) (Aug. 31, 2021).
3 IRS Pub. 5533-B.
4 IRS, *Tax Pro Account*, irs.gov/tax-professionals/tax-pro-account.
5 IRS, *Practitioner Priority Service*, irs.gov/tax-professionals (rev. July 30, 2026).
6 IRS, *Practitioner Priority Service*.
7 IRM 21.2.3.5.3.2(1) (Nov. 21, 2024); IRS, *Steps for Tax Professionals to Obtain Wage and Income Transcripts*, irs.gov/newsroom.
8 IRS, *Practitioner Priority Service*; IRS, *E-file Provider Services*; IRM 3.42.10.5.6(3) (Oct. 1, 2022).
9 IRM 3.42.10.4.8(1)–(2) (Sept. 11, 2019).
10 IRM 3.42.8.8(2), note (Oct. 1, 2026); IRS Pub. 3112 (Rev. 11-2025).

The employee then signs in with his or her **own** e-Services credentials, opens TDS, and selects the firm's organization.1 There is no need to make ordinary seasonal staff Responsible Officials. When the employee's duties end, a Principal or Responsible Official must change or delete the delegated user's access.2 If a properly added user still cannot reach TDS, the IRS e-help Desk is 866-255-0654.3

Gate 2: client authorization on file. Delegated-user status opens the TDS application. It does not open every client's records. "A properly executed Form 2848, Power of Attorney or Form 8821, Tax Information Authorization must be on file" for the taxpayer, form, and period requested.4 A Form 8821 is enough; TDS is not limited to power-of-attorney holders, whatever an older screenshot may suggest. For married clients who filed jointly, an authorization from at least one spouse is enough for the joint return, account, and record of account transcripts; wage and income transcripts and verification of non-filing letters are available only for the spouse who signed the authorization.5

⊗ **WARNING: Never share the owner's login**
Each person who uses e-Services signs in as himself or herself. Using the office owner's credentials, even "just for transcripts," undermines the access controls that protect the clients' data and the firm's e-file standing. If staff need TDS, add them as delegated users and remove them when the season ends. The IRM is blunt: e-Services "login credentials are personal login, not a company login."6

D. Which Transcript Answers Which Question

Table 4. Individual transcript types

Transcript	Shows	Availability	Storefront use
Tax return	Most line items from the original return	Current year plus 3 prior	Prior-year AGI, carryovers, new-client history
Tax account	**Postings:** payments, adjustments, refunds, notices	Any account active on the Master File	Refund status, offsets, payments, penalties
Record of account	Return and account transcripts combined	Current year plus 3 prior	Full picture in one document
Wage and income	Information-return data (W-2, 1099, 1098, 5498)	Up to 10 years; current year in TDS from mid-February, may be incomplete until July	Missing W-2s and 1099s; CP2000 work
Verification of non-filing	That no return was processed	**Online:** current year plus 3 prior; older years by Form 4506-T; current year generally after June 15	Lenders, financial aid

*Sources: IRS, e-Services and You (2022 Nat'l Tax Forum); IRM 3.42.8; IRS TDS transcript updates (current-year W&I available Feb. 17 in 2026). Individual transcripts are masked, and standard business transcripts have been partially masked since Dec. 13, 2020 (the Business Entity transcript excepted).*7

Three cautions apply to the table. First, wage and income data for the year just ended **(tax year 2025 during the 2026 filing season)** posts in stages, so a transcript pulled in February or March may be missing forms that appear later; even a complete-looking transcript shows only the information returns the IRS has received, not every item of income. Second, a verification of non-filing letter confirms only that no processed return is on record, not that the client had no filing obligation. Third, transcripts are masked: individual transcripts

1 IRM 3.42.8.3.1.2(1), 3.42.8.8(2) (IRM 3.42.8 eff. Oct. 1, 2026); IRS, *Circular 230 Practitioner e-Services Access*, irs.gov.
2 IRS Pub. 3112 (Rev. 11-2025).
3 IRS, *Circular 230 Practitioner e-Services Access*, irs.gov.
4 IRS, *Transcript Delivery System (TDS)*, irs.gov/tax-professionals.
5 IRM 3.42.8.8.3(1) (Jan. 23, 2014).
6 IRM 3.42.8.3.1.2(1) (IRM 3.42.8 eff. Oct. 1, 2026).
7 IRM 21.2.3.3.1(3) (Apr. 21, 2026); IRM 21.2.3.5.7(6) (May 28, 2026); Form 4506-T (Rev. 6-2025), lines 6c, 7.

since 2018, and standard business transcripts, which show only the last four digits of an EIN, since December 13, 2020; the Business Entity transcript is the one business transcript still provided unmasked.1 The wage and income transcript is the only individual transcript the IRS will provide unmasked, and only under narrow exceptions. The one that applies to a storefront office is preparing and filing a federal tax return, and the assistor will verify that no return has been filed for that year. The unmasked transcript is meant for the case where the employer information is still needed to prepare the return and the client does not have it, and it is delivered to the practitioner only through the SOR **(or mailed to the client's address of record)**.2 Wanting the full employer EIN for a CP2000 on an already-filed return does not, by itself, fit that exception.

E. Read the Transcript Before You Call

Melissa is convinced the IRS sent her a refund twice by mistake and wants to know whether to send it back. Her 2023 account transcript shows the original return posting **(TC 150)** and a refund **(TC 846)**, followed by entries captioned "Amended tax return or claim forwarded for processing" **(TC 971)**, a reduction of prior tax **(TC 291)**, a second refund **(TC 846)**, and interest **(TC 776)**. Read in order, the entries are consistent with an adjustment from her amended return followed by a second refund. The captions alone do not prove why the refund issued or whether she is entitled to keep it; compare the actual amended return, the adjustment notice, the dates, and the refund amount. Before telling a client the IRS made an error, read the whole module, and explain only what the transcript's own captions say.

VIII. Storefront Cases

Each case below poses the same question: which authority, and what can you do with it?

A. Marco: Missing W-2s

Marco is a new client. He filed his own extension for 2025 and comes in during August 2026, unsure whether he has every W-2. **Authority:** Form 8821 **(Income, 1040, the years needed)**. Marco can approve a Tax Pro Account request on his phone, which posts the authorization in real time. **Action:** pull the 2025 wage and income transcript through TDS if your office qualifies and you are a delegated user; otherwise request it through PPS for delivery to your SOR **(or by mail to Marco)**. Because Marco's 2025 return has not been filed, if the masked transcript leaves out an employer's full EIN and address and Marco does not have them, you may request the unmasked version through PPS for SOR delivery. **Timing:** by August, most tax-year 2025 information returns have generally posted, but the transcript is still not a guaranteed complete inventory. Had Marco come in during March, the transcript might have been missing forms.3

B. Denise: A CP75 EITC Examination

Lena prepared and signed Denise's 2025 return on February 10, 2026. In March, Denise receives a CP75: her EITC and ACTC are held pending an audit. **Without the AFSP**, Lena would use a Form 8821 to see the case and help Denise assemble documents. Form 886-H-EIC lists acceptable proof, and Denise can upload through the IRS Exam Document Upload Tool, but Denise responds herself.4

1 IRS FS-2018-20 (archived); IRS News Release IR-2020-254 (Nov. 13, 2020); IRM 21.2.3.5.10.1.1(1) (Dec. 9, 2024).

2 IRM 21.2.3.5.10.2.1(1)–(2) (Dec. 9, 2024); IRM 21.2.3.5.3.2.2(1), (4) (Apr. 22, 2024); IRS FS-2018-20 (archived).

3 IRS, *TDS Transcript Updates* (current-year W&I may be incomplete until July).

4 IRS, *Topic No. 654*, irs.gov/taxtopics/tc654; IRS, *Understanding Your CP75 Notice*.

WORKPAPER VIII-1. Denise: can Lena use designation "h"?

```
Lena's 2026 record issued early Jan. 2026 (before Feb. 10).

Cond. 1  Lena prepared and signed the return?  Yes (Feb. 10, 2026)
Cond. 2  Record for calendar year signed?      2026 -> Yes
Cond. 3  Record for year of representation?    2026 -> Yes
PTIN     Active?                               Yes

Result:  Denise may sign a Form 2848 naming Lena under "h"
         for the exam (see Part III.D).
Limit:   exam only. No Appeals; no collection. If the exam
         runs into 2027, Lena needs a 2027 record.
```

C. Michael: The Estimated Tax Penalty

Michael's 2025 account transcript shows estimated tax payments **(TC 660)** only on July 15, 2025, and January 15, 2026, an assessment captioned "Penalty for not pre-paying tax" **(TC 176)**, and a CP30. He asks about reasonable cause. **Authority to get the facts:** Form 8821.

The technical answer surprises many clients. The estimated tax penalty "cannot be removed or waived for reasonable cause alone."1 First-time abatement covers failure-to-file, failure-to-pay, and failure-to-deposit penalties, not this one.2 The tools are the annualized income installment method on Form 2210, Schedule AI, which may help if Michael's income actually arrived late in the year. The large January payment hints at that but does not prove it; reconstruct when the income was received, and the related deductions, before using Schedule AI.3 The other tools are the statutory waivers: one for casualty, disaster, or other unusual circumstances where imposing the penalty "would be against equity and good conscience," and one for a taxpayer who, in the year the payments were required or the year before, retired after reaching age 62 or became disabled, where the underpayment was due to reasonable cause and not willful neglect. For 2025, that means retiring or becoming disabled in 2024 or 2025.4

The waiver request is the taxpayer's. Under the Form 2210 instructions, it is made by checking the applicable waiver box, attaching Form 2210 and a statement explaining the reasons and the period involved, and including documentation.5 Michael's penalty has already been assessed, so the request comes after the CP30. It does not go on Form 843, whose instructions send estimated tax penalty requests to Form 2210,6 and it does not require an amended return. Form 2210 may be filed on its own after the IRS has notified the taxpayer of the assessment, with the waiver box checked and the statement and documentation attached; IRS notice guidance also invites a written explanation, "signed under penalty of perjury," sent to the address on the notice.7 Either way, the request is Michael's. "All penalty abatement or waiver requests must be in writing, and if not part of the return, must be signed by the taxpayer," and a casualty, disaster, or unusual-circumstances waiver cannot be granted on an oral request.8 **Boundary:** as an 8821 designee, you may supply information that supports relief, but you may not argue for it. Preparing Form 2210 with an original or amended return is return preparation.

D. Teresa: A Taxpayer Advocate Service Case

Teresa signed a Form 8821 naming Lena for the relevant taxes and periods. She then filed Form 911 with the Taxpayer Advocate Service **(TAS)** herself, identified Lena in **Section** II-B, "Form 8821, Authorization to Receive Notices," and included a copy of the 8821. TAS calls Lena with an update. Yes, TAS may share information with Lena as the 8821 designee, and the form itself notes that the 8821 does not let her advocate. Naming Lena on Form 911 would not have been enough by itself: **Section** II "is for information purposes only to assist TAS in the case creation process" and does not create an authorization.9 If TAS relies on oral consent instead, written

1 IRM 20.1.3.2.7.1(1) (Dec. 10, 2013).
2 IRS, *Penalty Relief Due to First Time Abate or Other Administrative Waiver*, irs.gov/payments.
3 I.R.C. § 6654(d)(2)(A); IRS, *Underpayment of Estimated Tax by Individuals Penalty*, irs.gov/payments.
4 I.R.C. § 6654(e)(3)(A), (B); Instr. for Form 2210 (2025), *Waiver of Penalty*.
5 Instr. for Form 2210 (2025), *Waiver of Penalty*.
6 Instr. for Form 843 (Rev. Dec. 2024), *Do Not Use Form 843*.
7 IRM 20.1.3.3.1.7.1(1), (4); IRM 21.3.1.6.20(1) (Mar. 17, 2016); IRS, *Understanding Your CP30 Notice*.
8 IRM 20.1.3.3.2.1(3); IRM 20.1.3.3.2.1.2(8).
9 IRS Form 911 (Rev. 6-2026), Section II and instructions.

correspondence goes to the taxpayer with a copy to the third party.1 The IRS's AFSP page lists TAS among the places AFSP participants may appear, but the Form 2848 instructions tie designation "h" to an examination of a return the preparer signed. For a TAS case that is not about such an examination, use the 8821.

E. Freddy: A Former Client

Lena's Form 8821 for Freddy is still on file, but Freddy has moved to another office and is now under audit. Lena should withdraw: in Tax Pro Account in real time, or by writing "Withdraw" across the top of the first page of a copy, signing, dating, and sending it to the CAF unit.2 A designation "h" Form 2848, if one were on file, is withdrawn the same way. Leaving stale authorizations in place means notices keep arriving for a client you no longer serve.

IX. Professional Responsibility

A. Confidentiality and Data Security

Two separate rule sets govern the information an 8821 brings into your office. First, as a designee, you may not use the information "for any purpose other than the express purpose for which consent was granted," and you may not pass it on to anyone else without the taxpayer's express permission or request.3 Second, information furnished to you for, or in connection with, preparing a return falls under the preparer rules, subject to their exceptions. A preparer who knowingly or recklessly discloses or uses that information other than as permitted commits a misdemeanor punishable by a fine, up to one year in prison, or both,4 and faces a civil penalty of $250 per improper disclosure or use, up to $10,000 per calendar year. When the disclosure or use is connected with a crime involving misappropriation of another person's taxpayer identity, those figures rise to $1,000 and $50,000.5 A Form 8821 is not a substitute for any consent the § 7216 regulations require.6 Transcripts in your SOR mailbox, printouts on the counter, and screenshots on a phone are all covered.

The Federal Trade Commission's Safeguards Rule treats "an accountant or other tax preparation service that is in the business of completing income tax returns" as a financial institution.7 It requires a written information security program with specific elements, including a qualified individual, a risk assessment, safeguards, monitoring, personnel procedures, and service-provider oversight.8 A firm that maintains customer information on fewer than 5,000 consumers is exempt from four specific elements, including the written incident response plan and the annual written report, but not from the Rule itself.9 Separately, a notification event involving the information of at least 500 consumers must be reported to the FTC "as soon as possible, and no later than 30 days after discovery of the event."10 Not every security incident is a notification event, and state notification laws are a separate question. Transcript access belongs inside the program.

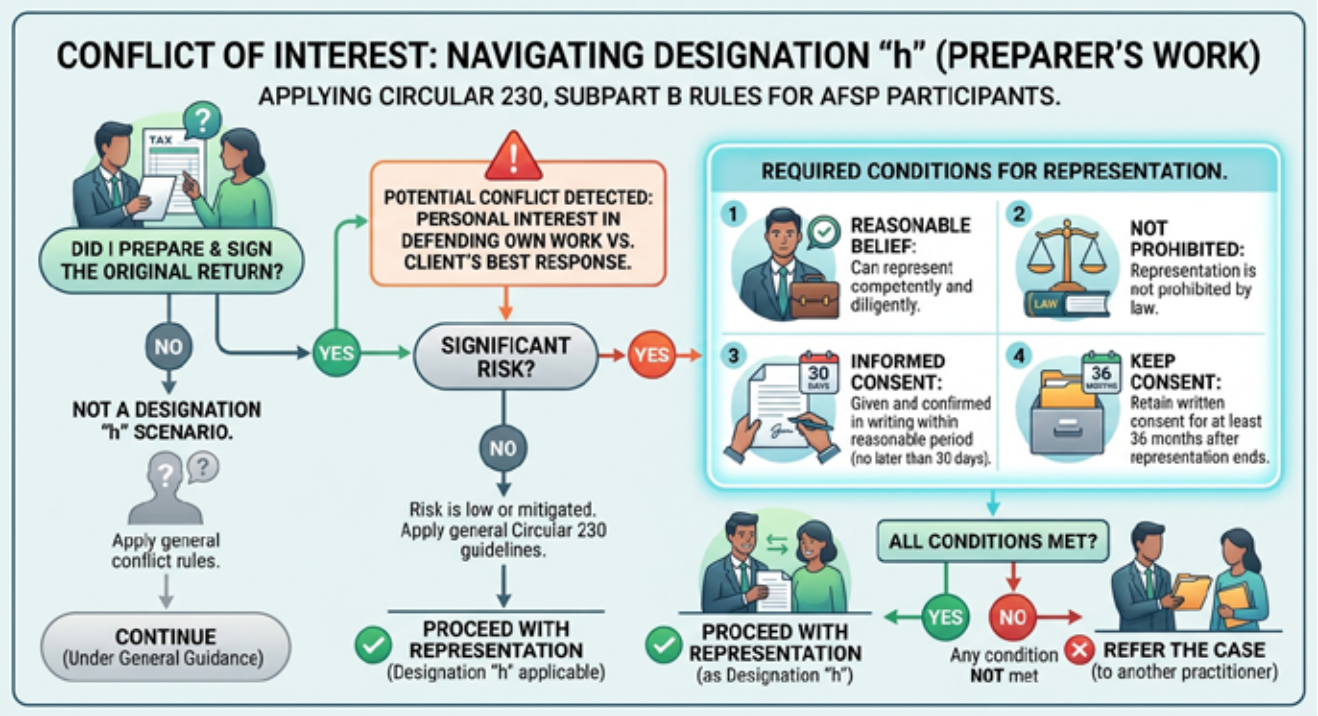
B. Diligence and the Signature

A preparer is responsible for the return he or she signs. The preparer penalty applies when an understatement is due to a position the preparer knew, or reasonably should have known, was unreasonable. The general standard is substantial authority. An adequately disclosed position requires a reasonable basis unless it involves a tax shelter or a reportable transaction to which § 6662A applies. A position involving a tax shelter, or a reportable transaction to which § 6662A applies, needs a reasonable belief that it would more likely than not be sustained on its merits. The penalty is the greater of $1,000 or 50 percent of the income derived **(or to be derived)** from the return or claim, with an exception for reasonable cause and good faith.11 Willful or reckless conduct carries

1 IRM 13.1.23.3.1.3(3), note (Mar. 16, 2026).
2 IRM 13.1.23.11(5); IRS Pub. 5533-B.
3 I.R.C. § 6103(c).
4 I.R.C. § 7216(a).
5 I.R.C. § 6713(a)–(b).
6 Treas. Reg. § 301.7216-3(a)(1).
7 16 C.F.R. § 314.2(h)(2)(viii).
8 16 C.F.R. § 314.4(a)–(i).
9 16 C.F.R. § 314.6 (exempting § 314.4(b)(1), (d)(2), (h), (i)).
10 16 C.F.R. § 314.4(j).
11 I.R.C. § 6694(a)(1)–(3).

a separate penalty of the greater of $5,000 or 75 percent of that income, reduced by any § 6694(a) penalty paid for the same return or claim.1 A wage and income transcript pulled before preparation is one of the cheapest diligence tools available to a storefront practice, because omitted information returns are what generate CP2000s. AFSP participants have also consented to the duties of Circular 230, Subpart B, including the duty to exercise due diligence.2

C. Representing on a Return You Prepared



Designation "h" only works for a return you prepared and signed, which builds in a potential conflict: your interest in defending your own work may not match the client's best response. AFSP participants have consented to Circular 230, Subpart B, which includes the conflict-of-interest rule.3 If there is a significant risk that your personal interest will materially limit the representation, you may proceed only if you reasonably believe you can represent the client competently and diligently, the representation is not prohibited by law, and the client gives informed consent, confirmed in writing within a reasonable period and no later than 30 days. Keep the written consent for at least 36 months after the representation ends.4 If those conditions cannot be met, refer the case.

D. Staying on the Information Side of the Line

Table 5. The line between information and advocacy

Information (Form 8821 is enough)	Advocacy (requires Form 2848)
Ask what a notice says and what the IRS needs	Argue that the client is entitled to relief
Request transcripts and account balances	Negotiate the amount owed or a payment arrangement
Confirm that a payment or document was received	Agree to an adjustment on the client's behalf
Supply facts that support abatement (IRM 21.1.3.3(21))	Request abatement and argue for it
Help the client assemble documents she sends herself	Sign a response, waiver, or agreement for the client

1 I.R.C. § 6694(b).
2 Rev. Proc. 2014-42, 2014-29 I.R.B. 192, § 4.05(4); 31 C.F.R. § 10.22(a).
3 Rev. Proc. 2014-42, 2014-29 I.R.B. 192, § 4.05(4).
4 31 C.F.R. § 10.29(a)–(c).

An AFSP participant meeting all three conditions may cross into the right-hand column only within an examination of a return he or she prepared and signed, and never for the signing items.

X. Next Steps

Three actions are worth taking this week. First, get or locate your CAF number. If you have one, find the Letter 1727C or call PPS; if you do not, your next Form 8821 with "None" in the CAF box will produce one. Second, set up Tax Pro Account and request the PIN to link your CAF number now, while the mail can arrive before the season. Third, build Form 8821 into new-client intake, with a correct template for each client type in Part V: individual, married filing jointly **(two forms)**, sole proprietor, single-member LLC **(two forms)**, and corporation.

On credentials: the AFSP is a strong first step, particularly for an EITC-heavy practice, because it reaches the correspondence examinations those clients see most. The deadline to complete continuing education for the 2027 Record of Completion is December 31, 2026. The enrolled agent credential is the path to unlimited representation rights before the IRS.

Cherie's Case, Resolved

Return to Lena's office in March 2026. Cherie had checked the Third Party Designee box on her 2024 return, naming Lena. That authority was still alive in March 2026, but it did not help: the notice turned out to be compliance activity, which the check box does not reach.1 Tax Pro Account was out, because Cherie could not get into an IRS Online Account. So Lena prepared a paper Form 8821.

WORKPAPER R-1. Cherie's Form 8821

```
Line 1  Cherie L. Watts, 300 Live Oak Dr., Gulfport, MS 39503
        TIN 000-85-6612
Line 2  Lena M. Broussard, Broussard Tax Service
        CAF No. None     PTIN P01234567    Tel. 228-555-0142
        [x] copies of notices and communications
Line 3  Income | 1040 | 2022 through 2026 | not applicable
        ISP box: unchecked (office does not use an ISP)
Line 4  unchecked (record on CAF)
Line 5  unchecked (Cherie confirmed no other TIA on file)
Line 6  Cherie signs and dates by hand
Submit  Fax to 855-214-7519 (Memphis). No duplicate upload.
Check   2026 + 3 = 2029 >= 2026, latest period listed. OK.
```

Cherie's response date was still several weeks out, so Lena let the CAF unit process the form. Had the date been close, she would not have had to wait: she could have faxed the wet-signed form to the IRS employee handling the matter or contacted PPS **(Part VI.D)**. After the form was processed **(the IRS was reporting about three business days in the fall of 2026; filing-season turnaround can differ)**, Lena called PPS. She had no assignment letter yet, but after verification the assistor could give her the newly assigned CAF number by phone.2 She requested Cherie's 2024 account and wage and income transcripts to her SOR mailbox. The account transcript showed a TC 922, the Automated Underreporter indicator.3 The notice was a CP2000. The wage and income transcript showed a Form 1099-NEC from a weekend catering job that Cherie had not brought in when Lena prepared the return.

Could Lena represent Cherie before AUR under designation "h"? The CAF unit would accept a TC 922 case as an examination, so the question turned on the three conditions.

WORKPAPER R-2. Cherie's CP2000 and designation "h"

```
Return:  2024 Form 1040, signed by Lena Feb. 2025

Cond. 1  Lena prepared and signed it?          Yes
Cond. 2  Record for calendar year signed?      2025 -> NO
         (Lena's first record is for 2026)
Cond. 3  Record for year of representation?    2026 -> Yes

Result:  Condition 2 fails. No designation "h".
         Form 8821 path only.
```

1 IRM 13.1.23.3.1.4(3).

2 IRS, *Understanding Your CP547 Notice* (updated Mar. 27, 2026).

3 IRM 21.3.1.6.40(3) (IRM 21.3.1 eff. Oct. 1, 2026).

So Lena stayed on the information side of the line. She printed the full notice details and transcripts, walked Cherie through what the IRS proposed and why, and helped her gather the 1099-NEC and her records for the catering work. Cherie decided how to respond, and Cherie signed the response. The CP2000 response form also has a third-party authorization section that lets the taxpayer authorize someone to discuss that notice with the IRS, which gave Lena a way to make follow-up inquiries.1 Lena did not argue the case, negotiate, or sign anything for Cherie.

The ending points forward. Lena signed Cherie's 2025 return in February 2026, under her 2026 record. If a CP2000 for 2025 arrives in 2027, conditions 1 and 2 will be met. Condition 3 will be met only if Lena holds an issued 2027 Record of Completion. That means finishing her continuing education by December 31, 2026, renewing her PTIN, giving the Circular 230 consent, and confirming that the record has issued. Lena also linked her CAF number to Tax Pro Account that fall and made Form 8821 part of her intake for every new client. The next time a client walks in with page 3 of a notice, she will be one phone call from the answer.

Quick Reference: IRS Authorizations for Unenrolled Preparers

Not a CPA or EA Yet? Here's How to Help Your Clients Anyway | Southern Regional Tax Conference, Biloxi, MS, Nov. 6–7, 2026 | John Sheeley, EA, LTC

1. Three types of authority

	Third Party Designee	Form 8821 (TIA)	Form 2848 (POA)
Who can hold it	Anyone named on the return	Any individual or organization	Eligible practitioner; as preparer, unenrolled only under "h"* (officer, employee, family capacities separate)
What it allows	Info on that return; certain math-error, offset, preparation notices	Inspect and receive info for listed taxes, forms, periods	Receive info and represent
Advocacy	No	No	Yes (limited under "h")
Scope	One return	Listed forms and periods	Listed forms and periods
How long	Ends by next year's due date (no ext.)	Until revoked, withdrawn, or replaced	Until revoked, withdrawn, or replaced
On CAF	No (on the tax module)	Yes, unless line 4	Yes, unless line 4
Who signs	Client (signs the return)	Client only	Client and representative

**Designation "h" (AFSP Record of Completion holders): examinations of returns you prepared and signed, before revenue agents, customer service, and TAS only. No Appeals, revenue officers, Chief Counsel, waivers, extensions, or signing for the client.*

5. Where to submit and whom to call [As of Oct. 22, 2026; confirm at IRS.gov]

- **Tax Pro Account:** new requests for individuals only (client approves in Online Account within 120 days; posts in real time). Revokes prior same-matter authorizations; no retention box. With a linked business CAF, view and withdraw business authorizations., **Online upload:** IRS.gov/Submit8821 (Secure Access; e-signatures allowed).
- **Mississippi fax/mail:** 855-214-7519; IRS, 5333 Getwell Road, Stop 8423, Memphis, TN 38118. Send one way only.
- **PPS:** 866-860-4259, weekdays 7 a.m.–7 p.m. local; 8821 holders eligible; transcripts to SOR; 30 per client (max 10 IDRS).
- **Processing status:** IRS.gov/help/processing-status-for-tax-forms (2848/8821: "Processed 3 business days after receipt").

Sources: irs.gov/instructions/i8821 | irs.gov/instructions/i2848 | Rev. Proc. 2014-42 | irs.gov/tax-professionals/annual-filing-season-program | irs.gov/tax-professionals/tax-pro-account | irs.gov/tax-professionals/practitioner-priority-service | IRM 13.1.23

1 IRS, *Topic No. 652*, irs.gov/taxtopics/tc652.

AFTR OVERVIEW



Course Details	
Name of the CE Provider	AmData
Program name	Annual Federal Tax Refresher
IRS program number	A5BAX-A-00133-26-S
CE	6
Delivery Method:	Self-Study
CE Program Category	Annual Federal Tax Refresher - A Program which follows three subject area domains outlined annually by the IRS to educate and test a participant's comprehension to receive an Annual Filing Season Record of Completion.



Completion of the course requires:

- Pass a 100 question Final Exam with a 70% accuracy in one sitting
- You are allowed 3 hours to complete the exam
- Multiple attempts are allowed for exam
- EAs can take the Exam but cannot receive credit for the AFTR course

Introduction

The AFTR **(Annual Federal Tax Refresher)** course is designed to meet the requirements of the IRS voluntary AFSP **(Annual Filing Season program)**. It discusses new tax law and recent updates for the upcoming filing season, provides a general tax review, and examines important rules governing tax return preparer ethics **(Circular 230)**, practices and procedures. The AFTR is divided into 3 domains (domain is used in place of the more common "chapter"; to more closely follow the language of

Activity	Start Date	End Date
Get the AFTR Course number in the CE Provider system	April 1, 2026	October 1, 2026
Offer AFTR Course to students	June 1, 2026	December 31, 2026
Student's timeframe to complete AFSP CE requirement	January 1, 2026	December 31, 2026

- AFTR providers should follow the CE Provider Standards for any areas not covered in this Publication, including issuing a Certificate of Completion ogram evaluation to attendees completing the AFTR Course. the IRS Annual Federal Tax Refresher course outline. This course must be completed by December 31 of Current Year

#	Category #	QR Codes for Review Question	QR Code
1	#1 Annual Inflation f1040s1-018 1.10.4	**In order to qualify for IRS Direct File, what is the income limit?** (a) A 10% penalty on the entire distribution (b) Ordinary income tax on the entire distribution (c) Ordinary income tax on the earnings portion plus a 10% additional tax on the earnings portion (d) A 20% additional tax on the earnings portion	
2	#2 Trump Accounts irc530a-27 1.13	**Under IRC §530A, in addition to the federal government's initial $1,000 seed contribution to a Trump Account, annual contributions from individuals are limited to:** (a) $500 per year from any source (b) $1,000 per year from any source (c) $5,000 per year from individuals (d) The gift tax annual exclusion amount ($19,000)	
3	#3 Charitable Contributions f1040sa-30 1.11	**single taxpayer takes the standard deduction for TY2026 and made $800 in cash charitable donations. Under the OBBBA permanent non-itemizer deduction, how much may they deduct above the line?** (a) **$0 —** the non-itemizer deduction is only for joint filers (b) **$400 —** only 50% of non-itemizer contributions are deductible (c) **$800 —** up to $1,000 is deductible for single filers (d) **$1,000 —** the full cap regardless of actual donations	
4	#4 - Tax Treatment of the Acquisition and Disposition of DigitalAssets f1099da-069 2.13.1	**A taxpayer purchased Bitcoin for $5,000 and later exchanged it for Ethereum when Bitcoin's FMV was $8,000. This exchange is:** (a) **Not a taxable event —** cryptocurrency exchanges are like-kind exchanges under IRC §1031 (b) **A taxable event —** the taxpayer recognizes a $3,000 capital gain at the time of the exchange (c) Taxable only when the Ethereum received is eventually sold for cash (d) A wash sale that defers the gain	

#	Category #	Question	QR Code
5	#5 Auto Interest Loan Deduction f1040s1-016 1.10.3	**The new auto loan interest deduction under IRC §226 (OBBBA) applies to interest on loans used to purchase:** (a) Any new or used vehicle financed by any lender (b) Any vehicle assembled anywhere in the world (c) **New automobiles assembled in the United States —** purchase money loans only, not refinancing (d) Electric vehicles only, regardless of assembly location	
6	#6 State and Local tax Deduction f1040sa-50 2.11.2	**Which statement is correct regarding the TY2026 SALT deduction limitation?** (a) All taxpayers are limited to the same deduction amount regardless of income (b) The deduction is completely repealed for high-income taxpayers (c) The deduction may be reduced for high-income taxpayers under the phaseout rules (d) State income taxes are no longer deductible	
7	#7 Tax Credits f8863-067 2.12	**Unlike the American Opportunity Credit, the Lifetime Learning Credit:** (a) Is available only for the first four years of post-secondary education (b) Has a 40% refundable portion (c) Has no year limit, is nonrefundable, and is available for any year of higher education or job skills courses (d) Requires at least half-time enrollment in a degree program	
8	#8 Casualty Loss Deduction f4684-25 1.9.3	**Under TY2026 rules, which statement is correct regarding personal casualty losses in a state-declared disaster area?** (a) Personal casualty losses in a state-declared disaster area may qualify for a deduction even if no federal disaster declaration is issued. (b) Personal casualty losses are deductible only when a federal disaster declaration is issued. (c) Personal casualty losses are claimed as an above-the-line deduction on Schedule 1. (d) Personal casualty losses are fully deductible without regard to the $100 per-event or 10% AGI limitations.	

#	Category #	Question	QR Code
9	#9 Information Reporting Threshold f1099nec-040 1.4	**Which statement is true about the general information reporting threshold increase per IRC §6041 and §6041A ?** (a) Form 1099K reporting threshold is $600 (b) Form 1099 DIV reporting threshold is $2,000 (c) Form 1099 NEC reporting threshold increased to $2,000 (d) Form 1099 MISC reporting threshold is required for $10 or more payments	
10	#10 Recordkeeping and Documentation p552-56 2.11.7	**A taxpayer uses the standard mileage method for business driving. Which record should be maintained to substantiate the deduction?** (a) Fuel receipts only (b) Vehicle registration records (c) A contemporaneous mileage log showing date, business purpose, and miles driven (d) A qualified appraisal is required for all vehicle donations regardless of value	
11	**Section** 529 Plans f1099q-095 2.13.5	**A non-qualified distribution from a 529 plan is subject to:** (a) 10% penalty on the entire distribution (b) Ordinary income tax on the entire distribution (c) Ordinary income tax on the earnings portion plus a 10% additional tax on the earnings portion (d) A 20% additional tax on the earnings portion	
12	Safeguarding Taxpayer Data p4557-98 3.2	**When a tax preparer discovers a data breach affecting client information, the IRS requires the preparer to contact the IRS Stakeholder Liaison AND:** (a) The IRS Criminal Investigation Division within 24 hours (b) **Only the affected clients —** no government agency notification is required (c) Their state tax agency and potentially law enforcement, and notify affected clients as required by state breach notification laws (d) **The FTC only —** state agencies are not involved in data breach response	

#	Category #	Question	QR Code
13	fw2g-14 1.9.4 Gambling Losses	**Under OBBBA §70114, a taxpayer with $10,000 in gambling winnings and $12,000 in gambling losses can deduct how much on Schedule A** (a) **$12,000 —** all losses are deductible (b) **$10,000 —** losses limited to winnings under prior law (c) **$9,000 —** losses limited to 90% of winnings ($10,000 × 90%) (d) **$0 —** OBBBA eliminated the gambling loss deduction	
14	p5533-147 3.8 Tax Pro Account	**Through the IRS Tax Pro Account, a practitioner who has been authorized by a client can access:** (a) The client's credit report and financial statements (b) The client's tax account transcripts, payment history, and balance due information (c) The client's Social Security benefits statement (d) The client's state tax records in states that share data with the IRS	
15	3.4 Preparer Penalties irc6695-78	**A preparer fails to include a PTIN on 12 returns. The IRC §6695(c) penalty is assessed:** (a) Once for the entire group of returns (b) Separately for each return (c) Only after a preparer receives a written warning (d) Only if the returns are filed after the due date	
16	#16 f1040s1-099 2.8.2	**Under IRC §183, hobby expenses for TY2026 are:** (a) Deductible on Schedule A as miscellaneous itemized deductions (b) Deductible up to the amount of hobby income (c) Deductible if the activity shows a profit in 3 of the last 5 years (d) Not deductible	

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