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WITH **SUE SMITH, CPA**

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 **VIRTUAL December 4 or 5**

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Speaker**



**Carla McCall, CPA, CGMA**  
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## Agenda

**8:00 a.m.**  
Program Begins

**12:00-1:00 p.m.**  
Lunch

**4:00 p.m.**  
Program Ends

With sweeping legislation, evolving IRS guidance and shifting case law, staying current has never been more critical. In this session we'll cover essential updates on the latest federal tax developments, including newly enacted laws, key regulations and significant judicial decisions. Content is continually refreshed to reflect the most recent changes, ensuring you leave with actionable knowledge to better serve your clients and organizations.

### Highlights

- **One Big Beautiful Bill Act (OBBBA)** – Explore major tax reform proposals, including tip income and Social Security tax exemptions, overtime pay relief, temporary senior deduction, auto loan interest, SALT and charitable contribution deductions, a lower corporate tax rate, restoration of 100% bonus depreciation, research and development (R&D) expensing, Qualified Small Business Stock exclusion, Form 1099 reporting thresholds and permanent extension of select Tax Cuts and Jobs Act (TCJA) provisions.
- **Digital Assets and Tax Implications** – Understand the new Form 1099-DA for reporting digital asset transactions, along with updated IRS guidance on cryptocurrencies, NFTs and broker responsibilities.
- **Artificial Intelligence (AI)** – Discover how AI and generative tools are transforming tax practices, including how the IRS is leveraging AI to enhance audit selection Form 1099-K reporting requirements and evolving IRS thresholds and rules for third-party payment platforms.
- **Pass-Through Entity Interests and Net Investment Income Tax (NIIT)** – Analyze the tax implications of selling interests in pass-through entities, including relevant examples and how the NIIT applies to these transactions.
- **Tax Practice Aids** – Access a comprehensive set of current-year reference tools, including inflation-adjusted amounts, mileage rates, retirement contributions and more.
- **Advanced Planning and Practice Topics** – Engage with forward-thinking strategies and complex reporting issues designed to spark discussion and support client service.

### Questions during the conference? Contact the CPE team:



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# Federal TAX CAMP WITH SUE SMITH, CPA



## About the Speaker



**Susan Smith, CPA**

*Surgent*

Susan Smith, CPA, manages her own firm specializing in tax planning for individuals and business owners and is a frequent speaker at tax conferences. Prior to this, Smith was a senior manager in the tax department at PwC LLP, where she held the national specialist designation for the real estate and partnership tax practices, and at Peat Marwick (the predecessor of KPMG LLP), where she led the real estate and tax practices locally. Smith was previously an associate adjunct professor at Widener University in the master's taxation program and is a four-time recipient of the James L. McCoy Discussion Leader of the Year Award for excellence in teaching. In 2015, 2016 and 2018, Smith received the Surgent Outstanding Discussion Leader Award for her consistently high evaluations for knowledge and presentation skills.

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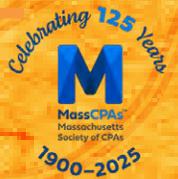
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**Leanne Scott, JD, LL.M.**  
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### Featured Speakers:



**Alyssa Wright**  
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# The One Big Beautiful Bill Act – Individual Provisions

<i>Learning objectives</i>	1
<i>I. Overview</i>	1
<i>II. Individual Tax Provisions of TCJA Made Permanent</i>	1
A. Individual Income Tax Rates	1
B. Standard Deduction	2
C. Personal Exemptions	2
D. Miscellaneous Itemized Deductions	2
E. Pease Limitation	3
F. Casualty Loss Deduction	4
G. Disaster-Related Personal Casualty Losses	4
H. Alternative Minimum Tax (AMT)	4
I. Moving Expenses	4
J. Mortgage Interest Deduction	5
K. Child Tax Credit	6
L. Child and Dependent Care Credit	7
M. Basic Exclusion Amount	8
<i>III. New and Enhanced OBBBA Tax Provisions for Individuals</i>	9
A. Temporary Senior Deduction	9
B. Tip Income Deduction	9
C. Expansion of the FICA Tip Credit to Beauty Service Businesses	11
D. Overtime Pay Deduction	11
E. Trump Accounts	12
F. Car Loan Interest Deduction	13
G. State and Local Tax (SALT) Cap	14
H. Dependent Care Assistance Programs	16
I. Charitable Contribution Deduction	17
J. Adoption Credit	17
K. ABLE Accounts	17
L. Scholarship Credit	18
M. Learning Credits	19
N. Employer Payments of Student Loans	19
O. 529 Plans	19
P. Limitation on Wagering Loss	21
Q. Elimination of Energy Incentives	21



# The One Big Beautiful Bill Act – Individual Provisions

## *Learning objectives*

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

- Evaluate the impact of new OBBBA provisions on individual taxpayers;
- Analyze key provisions extended by the OBBBA; and
- Understand the practical implications of major individual provisions outlined in the OBBBA.

## ***I. Overview***

On December 22, 2017, President Trump signed into law H.R. 1, originally entitled the Tax Cuts & Jobs Act (TCJA). This legislation was the most sweeping, categorical change to the Code in over 30 years. Generally, the TCJA took effect January 1, 2018, although there are exceptions where certain provisions of the TCJA took effect in 2017. Due to complex rules relating to how the TCJA was enacted, most of the provisions of the TCJA are temporary and set to expire after 2025.

On July 4, 2025, President Trump officially signed the "One Big Beautiful Bill Act" (OBBBA) into law. The legislation was narrowly approved by the Senate by a 51–50 vote on July 1, with Vice President JD Vance casting the tie-breaking vote in favor of the bill. The bill was passed under budget reconciliation procedures, requiring only a simple majority vote to advance. The legislation permanently extends, with certain modifications, key provisions that were originally enacted under the 2017 Tax Cuts and Jobs Act (TCJA).

## ***II. Individual Tax Provisions of TCJA Made Permanent***

### **A. Individual Income Tax Rates**

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

The OBBBA also preserves the expanded income thresholds that eliminate the marriage penalty, maintaining joint filer brackets that are generally double those for single filers (except at the top bracket). For tax year 2025, the marriage penalty typically only applies to taxpayers with combined taxable income in excess of \$751,600.

The TCJA did not alter the tax rates applied to net capital gains and qualified dividends, with the rates remaining at 0%, 15%, and 20%. However, the TCJA adjusted the income thresholds that determine which of these rates apply, effective for tax years 2018 through 2025. This OBBBA provision makes permanent the updated income thresholds for long-term capital gains and qualified dividend tax rates.

## B. Standard Deduction

The TCJA temporarily increased the standard deduction amounts for tax years 2018 through 2025. The OBBBA makes permanent the TCJA's expanded standard deduction and further increases the base amounts beginning in 2025. Compared to the inflation-adjusted TCJA levels, the OBBBA provides an additional increase of \$750 for single filers and \$1,500 for married couples filing jointly.

The updated 2025 standard deduction amounts are as follows:

Standard Deduction		
Filing Status	Pre-OBBBA (2025)	Post-OBBBA (2025)
Married Filing Jointly	\$30,000	\$31,500
Surviving Spouse	\$30,000	\$31,500
Head of Household	\$22,500	\$23,625
Single	\$15,000	\$15,750
Married Filing Separately	\$15,000	\$15,750

The standard deduction will continue to be indexed annually for inflation. The OBBBA updates the cost-of-living adjustment (COLA) methodology for the standard deduction, adopting chained CPI for 2024. The additional standard deduction for individuals aged 65 or older and/or blind remains unchanged.

For 2025, the additional deduction amounts are:

- \$2,000 for single filers and heads of household; and
- \$1,600 per qualifying spouse for joint filers and surviving spouses.

## C. Personal Exemptions

Under pre-TCJA law, taxpayers could claim a personal exemption deduction for themselves, their spouse (if filing jointly), and any qualifying dependents. These deductions reduced AGI and were subject to phaseout based on AGI and filing status. The personal exemption amount was indexed annually for inflation, and in many cases provided significant tax savings, particularly for larger families. The TCJA set the personal exemption amount to zero from 2018–2025; however, it left the underlying structure intact for a possible return.

The OBBBA amends §151(d)(5) to permanently set the personal exemption amount to zero, beginning in tax years after December 31, 2024. By codifying a permanent \$0 exemption amount, the OBBBA prevents the automatic return of personal exemptions in 2026 that would have occurred under the TCJA sunset provisions.

## D. Miscellaneous Itemized Deductions

Prior to the TCJA, miscellaneous itemized deductions were allowed if the total exceeded 2% of the taxpayer's adjusted gross income (AGI). Common deductions included unreimbursed employee expenses (like home office or travel costs), investment fees, and certain hobby losses. The TCJA suspended these miscellaneous itemized deductions for tax years 2018 through 2025. Without Congressional action, these deductions would have resumed in 2026.

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

The OBBBA creates an exception that allows qualified educators to deduct unreimbursed employee expenses as a permitted itemized deduction under §67(b). Qualified educators include K–12 teachers, instructors, counselors, principals, aides, and interscholastic sports coaches or administrators who work at least 900 hours in a school year. Deductible expenses include classroom equipment and supplemental instructional materials. This provision is effective for tax years beginning after December 31, 2025.

Since the enactment of the TCJA in 2017, the nature of work has changed substantially. The COVID-19 pandemic accelerated the adoption of remote work across many industries, and many organizations have since embraced flexible work arrangements as a standard practice rather than a temporary solution.

Further, technological advancements, digital collaboration tools, and changing employer policies have made remote and hybrid work models increasingly common and, in many cases, permanent. As a result, a growing number of employees now incur significant out-of-pocket expenses to maintain a work environment at their residence, including home office furniture, equipment, utilities, and other costs that were traditionally employer-provided in physical office settings.

Despite this shift, the permanent disallowance of miscellaneous itemized deductions means that employees can no longer deduct these unreimbursed costs, even when incurred directly in connection with their job responsibilities. This change disproportionately impacts employees in roles where remote work is standard but employer reimbursement policies are limited or nonexistent, including educators, knowledge workers, and professionals in tech, finance, marketing, and customer service. Absent a future change in tax law, these employees must either absorb these costs personally or seek reimbursement from their employers, as there is no longer a tax mechanism to recover these expenses through itemized deductions.

## **E. Pease Limitation**

Prior to the TCJA, the Pease limitation applied to high-income taxpayers by reducing the total value of their itemized deductions. The limitation operated by reducing most itemized deductions (excluding medical expenses, investment interest, and casualty, theft, or gambling losses) by the lesser of 3% of AGI above a specified threshold or 80% of the otherwise allowable itemized deductions. The Pease limitation eroded deductions like charitable contributions, state and local taxes, and mortgage interest for high-income taxpayers.

The TCJA suspended the Pease limitation for tax years 2018 through 2025, allowing taxpayers to claim full itemized deductions, subject only to other applicable limits (e.g., the SALT cap, etc.). However, the TCJA included a sunset clause, meaning the Pease limitation was set to return automatically for tax years beginning after December 31, 2025, absent new legislation.

The OBBBA permanently repeals the §68 Pease limitation, preventing its automatic reinstatement after 2025. In its place, the OBBBA introduces a new cap on the value of itemized deductions for higher-income taxpayers. Under the new rule, allowable itemized deductions are reduced by 2/37 of the lesser of:

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

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

## F. Casualty Loss Deduction

The OBBBA permanently extends the TCJA limitation on itemized deductions for personal casualty losses, restricting them to losses that arise from federally declared disasters. In a significant expansion, the OBBBA now also allows deductions for losses attributable to certain state-declared disasters, providing relief to individuals affected by regionally significant events that may not receive federal designation.

Personal casualty losses from events that are not federally or state-declared disasters are no longer deductible, even if uninsured or substantial. This provision applies to tax years beginning after December 31, 2025.

## G. Disaster-Related Personal Casualty Losses

The OBBBA also extends and modifies disaster relief rules under the Taxpayer Certainty and Disaster Tax Relief Act of 2020, offering expanded relief for individuals in qualified disaster areas. Such taxpayers in qualified disaster areas can claim personal casualty losses without itemizing deductions.

Instead of claiming the loss as an itemized deduction, affected taxpayers may increase their standard deduction by the amount of the net disaster loss, calculated as the excess of qualified disaster-related personal casualty losses over any casualty gains. The per-casualty floor for losses has been raised from \$100 to \$500 under these disaster provisions. To qualify, the loss must arise on or after the first day of the incident period in a qualified disaster area.

## H. Alternative Minimum Tax (AMT)

The Alternative Minimum Tax (AMT) is a parallel tax system designed to ensure that higher-income individuals pay at least a minimum level of tax, regardless of deductions, exemptions, or credits claimed under the regular income tax system. The OBBBA permanently extends the increased individual AMT exemption amounts originally enacted by the TCJA, which were previously set to expire after 2025. The OBBBA also resets the phase-out thresholds to their lower 2018 levels. As such, beginning in 2026, the phase-out thresholds are:

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

The AMT exemption phaseout rate doubles from 25% to 50%, causing higher-income taxpayers to lose the exemption twice as quickly as income exceeds the applicable threshold. This change results in higher effective AMT liabilities for high-income taxpayers whose incomes fall well above the threshold, despite the increased exemption amounts. The AMT still applies only if it results in more tax than under the regular system, ensuring high-income taxpayers pay a minimum amount of tax, regardless of deductions or credits claimed under the regular system.

## I. Moving Expenses

Prior to 2018, taxpayers who met specific distance and employment criteria could deduct qualified moving expenses regardless of whether they itemized, and employer reimbursements for qualified moving

expenses were excluded from gross income and wages for tax and employment purposes. Originally enacted as a temporary measure, the TCJA suspended both the deduction and exclusion for most individuals from 2018-2025, retaining the benefit only for active-duty military moves under official orders.

The OBBBA makes permanent the suspension of the moving expense deduction under §217 and the employer-paid moving expense exclusion under §132(g) for most taxpayers. As a result, for tax years beginning after December 31, 2025, most taxpayers can no longer deduct moving expenses or exclude employer reimbursements from gross income.

For employers, moving expense reimbursements are taxable compensation for most employees, and must be included on Form W-2. For most employees, relocating for a new job is fully out-of-pocket unless they fall under one of the narrow exemptions, with no federal tax relief for qualifying expenses.

Limited exceptions remain in place:

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

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

## **J. Mortgage Interest Deduction**

Prior to the TCJA, taxpayers could deduct interest on up to \$1,000,000 of acquisition mortgage debt (\$500,000 for married filing separately), as well as interest on up to \$100,000 of home equity debt (\$50,000 for married filing separately).

Under the TCJA, the deduction became temporarily limited for tax years 2018 through 2025 to the first \$750,000 of acquisition debt (\$375,000 married filing separately), while home equity interest was disallowed unless used to buy, build, or substantially improve the home. Loans dated before December 15, 2017, were grandfathered, permitting continued deduction under old the limit.

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

The OBBBA also permanently excludes interest on home equity indebtedness from the definition of qualified residence interest, unless the proceeds are used to acquire or improve the residence. Lastly, the OBBBA treats certain mortgage insurance premiums paid on acquisition indebtedness as qualified residence interest, thus allowing their deductibility. This provision applies to tax years beginning after December 31, 2025.

## K. Child Tax Credit

Prior to the TCJA, taxpayers could claim a Child Tax Credit of up to \$1,000 per qualifying child. The entire \$1,000 credit was potentially refundable through the Additional Child Tax Credit. The earned income threshold to access the refundable portion was \$3,000, and the credit phased out at lower MAGI thresholds:

- \$110,000 for married filing jointly;
- \$75,000 for single or head of household; and
- \$55,000 for married filing separately.
- *Note:* These thresholds were not indexed for inflation.

Further, identification requirements allowed the use of either a Social Security Number (SSN) or an Individual Taxpayer Identification Number (ITIN) for the qualifying child.

The TCJA temporarily increased the CTC from \$1,000 to \$2,000 per qualifying child, and this amount was not indexed for inflation.

Under the TCJA, up to \$1,400 of the \$2,000 credit was made refundable through the Additional Child Tax Credit, as indexed for inflation. The earned income threshold to access the refundable portion was reduced to \$2,500, making the credit more accessible to lower-income households. Under the TCJA, the MAGI phase-out thresholds were significantly increased to:

- \$400,000 for married filing jointly; and
- \$200,000 for all other filers.
- *Note:* These thresholds were not indexed for inflation.

The TCJA also added a strict SSN requirement:

- The qualifying child(ren) must have a valid SSN issued by the return due date; and
- Children with only ITINs no longer qualified.

The TCJA introduced a temporary \$500 nonrefundable credit for “other dependents” for tax years 2018 through 2025, and this credit was not indexed for inflation. All of these provisions were set to sunset after 2025, reverting to pre-TCJA rules unless extended by future legislation.

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

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

Finally, the OBBBA tightens identification requirements. Under OBBBA, not only must the qualifying child have a Social Security Number (SSN), but also the taxpayer (or at least spouse, if filing jointly) must have

a valid SSN to claim the credit. The omission of a valid SSN for either the child or taxpayer will now be treated as a mathematical or clerical error, allowing the IRS to deny the credit without a full audit. This new rule is effective for tax years beginning after December 31, 2024.

Child Tax Credit (CTC): Pre-OBBBA vs. Post-OBBBA				
Provision	Pre-TCJA	TCJA (2018-2025)	Post-OBBBA (2025 onward)	Notes
<b>Total CTC per Qualifying Child</b>	\$1,000	\$2,000	\$2,200	Nonrefundable portion increased by \$200 by OBBBA; indexed for inflation starting 2026
<b>Refundable Portion</b>	up to \$1,000	up to \$1,400 (indexed to \$1,700)	up to \$1,700 (Permanent)	Under OBBBA, adjusted for inflation annually
<b>Earned Income Threshold</b>	\$3,000	\$2,500	\$2,500	Lower threshold made permanent by OBBBA
<b>Phaseout Threshold</b>	\$55,000 (MFS) / \$75,000 (single/HOH) / \$110,000 (MFJ)	\$200,000 (single/others) / \$400,000 (MFJ)	Same (Permanent)	Not indexed for inflation
<b>Credit for Other Dependents</b>	None	\$500	\$500 (Permanent)	Not indexed for inflation
<b>SSN Requirement – Child</b>	Either SSN or ITIN	Required	Required	No change
<b>SSN Requirement – Taxpayer/Spouse</b>	Not Required	Not required	Now Required	IRS can disallow CTC automatically if SSN is missing
<b>Sunset Date</b>	End of 2017 (pre-TCJA law)	End of 2025 (pre-OBBBA law)	No expiration	Permanence increases planning certainty

## L. Child and Dependent Care Credit

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

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

The OBBBA permanently increases the maximum credit rate from 35% to 50%, effective for tax years after December 31, 2025. The 50% credit rate is gradually reduced by one percentage point for every \$2,000 (or fraction thereof) by which the taxpayer's AGI exceeds \$15,000, but this reduction cannot lower the rate below 35%. For taxpayers with AGI between \$43,001 and \$75,000 (\$86,001 to \$150,000 for joint filers), the credit rate is fixed at 35%. For AGI between \$75,001 and \$105,000 (\$150,001 to \$210,000 for joint filers), the credit rate is further phased down to a minimum of 20%. In other words, the credit rate phases down in two stages: first from 50% to a minimum of 35% as AGI exceeds \$15,000, then from 35% to a minimum of 20% as AGI surpasses \$75,000 (or \$150,000 for joint filers).

Child and Dependent Care Credit – Single Taxpayers	
AGI Range	Credit Percentage
\$0 – \$15,000	50%
\$15,001 – \$45,000	Phases down from 50% to 35%
\$45,001 – \$75,000	35%
\$75,001 – \$105,000	Phases down from 35% to 20%
Over \$105,000	20%

Child and Dependent Care Credit – MFJ Taxpayers	
AGI Range	Credit Percentage
\$0 – \$15,000	50%
\$15,001 – \$45,000	Phases down from 50% to 35%
\$45,001 – \$150,000	35%
\$150,001 – \$210,000	Phases down from 35% to 20%
Over \$210,000	20%

Under the OBBBA, the qualifying expense caps remain unchanged:

- \$3,000 for one qualifying individual; and
- \$6,000 for two or more qualifying individuals.

The maximum credit under OBBBA is:

- Up to \$1,500 (one child); and
- Up to \$3,000 (two or more).

These OBBBA changes are not temporary, as the 50% rate and updated phase-out thresholds are permanent changes.

## M. Basic Exclusion Amount

A basic exclusion amount, also known as the lifetime gift and estate tax exemption, is the combined lifetime exemption for estate tax, gift tax, and generation-skipping transfer (GST) tax. This unified exemption means that any portion used during one’s lifetime (e.g., for lifetime gifts) reduces the remaining exemption available at death for the estate.

Under pre-TCJA law, the basic exclusion amount for estate, gift, and GST taxes was \$5 million per person. This exclusion amount was adjusted annually for inflation. In addition, the deceased spousal unused exclusion (DSUE) amount was introduced as a portability provision, enabling the surviving spouse to utilize any unused exclusion from their deceased partner. Without future legislative changes, this \$5 million exclusion (as indexed for inflation) would have remained.

The TCJA temporarily doubled the basic exclusion amount from \$5 million to \$10 million per person (indexed annually for inflation), effective for gifts made and estates of decedents dying between 2018 and 2025. The temporary \$10 million (inflation-adjusted) exclusion enacted under the TCJA was set to revert to approximately \$7 million per person in 2026 absent legislative changes.

The OBBBA permanently increases the federal estate, gift, and generation-skipping transfer (GST) tax exclusion amount to \$15 million per person (or \$30 million for married couples filing jointly) for estates of decedents dying after December 31, 2025. The new \$15 million exclusion is adjusted annually for inflation, beginning in 2026. This expanded exemption applies to lifetime transfers and transfers at death. Lastly, portability rules remain intact, allowing the surviving spouse to claim any unused exclusion from the deceased spouse’s estate by timely filing an estate tax return.

Although the OBBBA offers a significant and permanent increase in the exclusion amount, estate planners should remain cautious, as future legislation could reverse or reduce the exclusion, increase transfer tax rates, or alter the structure of estate taxation entirely. Given the potential for legislative change, high-net-worth individuals may still benefit from using some or all of their available exclusion sooner rather than later.

### ***III. New and Enhanced OBBBA Tax Provisions for Individuals***

#### **A. Temporary Senior Deduction**

The OBBBA introduces a temporary deduction for taxpayers age 65 and older, effective for 2025 through 2028. Qualified individuals can deduct \$6,000 per eligible senior. This means single seniors can claim \$6,000, and married couples filing jointly can claim up to \$12,000 if both spouses qualify.

To qualify, an individual must be age 65 or older before the close of the taxable year. This deduction is available in addition to the standard deduction, making it particularly beneficial for seniors who do not itemize.

The deduction is phased out when MAGI exceeds:

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

The deduction is fully phased out when MAGI exceeds:

- \$175,000 for single filers; and
- \$250,000 for married filing jointly.

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

#### **B. Tip Income Deduction**

Prior to the OBBBA, all tip income was includible in gross income and subject to both federal income tax and employment taxes (Social Security and Medicare). All tips received by an individual are subject to federal income taxation including:

- Cash tips received directly from customers;
- Electronically paid tips from credit and debit card charge customers; and
- Tips received under a tip-splitting or tip-pooling arrangement.

The value of noncash tips received, such as tickets, passes or other goods or commodities that a customer gives the individual are generally also subject to income taxation. Service charges added by the employer to a customer's bill (e.g., mandatory 18% gratuity) are not tips, and they are treated as wages and taxed accordingly.

To be classified as a "tip," the following conditions must generally apply:

- The payment is made voluntarily, not compelled;

- The amount is determined by the customer;
- The payment is not subject to negotiation or dictated by employer policy; and
- The customer decides who receives the tip.

Employees normally include tips in income when they are received. However, employees who are required to report cash tips to their employer in a written statement are treated as receiving the tips when they provide this statement. If an employee receives cash tips of \$20 or more in any calendar month, the employee must report those tips to the employer in one or more written statements by the tenth of the month following the month the tips were received. The employer reports that tip income to the employee on the employee's W-2.

The OBBBA introduces a temporary deduction for qualified tip income, available for tax years 2025 through 2028. Under this provision, individuals in occupations that customarily receive tips may deduct up to \$25,000 in qualified tip income annually. The deduction is available to both employees (who receive Form W-2) and independent contractors who report tips on Form 1099-K, Form 1099-NEC, or Form 4317 (used to report unreported tip income). No deduction for qualified tips is allowed unless the taxpayer includes his or her SSN on the tax return for the taxable year. Itemizing is not required to take this deduction. Tip income remains subject to payroll taxes (i.e., Social Security and Medicare) and state income taxes.

The deduction is reduced by \$100 for every \$1,000 of MAGI exceeding \$150,000 (or \$300,000 for joint filers). To qualify as "tips," tips must be:

- Voluntary (not negotiated) and properly reported on IRS forms (W-2, 1099, etc.);
- Cash tips earned in occupations listed by the IRS as customarily tipped as of December 31, 2024; and
- Not received in "specified service trades or businesses" (as defined under §199A(d)(2)).
- *Note:* Cash tips include tips received from customers that are paid in cash or charged, and, in the case of an employee, tips received under any tip-sharing arrangement.

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

For 2025 only, employers may use any reasonable method to estimate tip amounts for reporting. The IRS will publish a list of eligible tipped occupations within 90 days of enactment, based on tipping practices before 2025. The IRS is also required to update withholding procedures starting in 2026 to reflect the new deduction. Reporting entities (employers, platforms, third-party payers) must:

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

The new tip income deduction targets service industry and gig economy workers, many of whom experience income volatility and lack benefits. It also encourages accurate and transparent tip reporting, potentially reducing underreporting of tip income. Lastly, the deduction may result in increased compliance costs for employers and platforms handling payment processing and reporting.

**Example:** Sofia is a nail technician (in a tipped occupation) and files jointly with her spouse. Their MAGI is \$320,000. Sofia earns \$28,000 in qualified tip income, all properly reported on Form 1099-NEC.

The deduction is capped at \$25,000 per return under the OBBBA. Since their MAGI exceeds the \$300,000 threshold by \$20,000, the deduction is reduced:

- Phaseout:  $\$20,000/100 = \$2,000$

The tip income deduction is equal to \$23,000 (\$25,000 less \$2,000 phaseout).

### C. Expansion of the FICA Tip Credit to Beauty Service Businesses

Prior to the OBBBA, only restaurants and other food and beverage establishments could claim a FICA tip credit under IRC §45B. The OBBBA permanently expands the FICA tip credit to include eligible beauty service businesses, effective for tax years beginning after 2024. Qualifying employers can now claim a FICA tip credit on tips paid to employees for services where tipping is customary, such as:

- Hair care;
- Nail care;
- Esthetics / skincare; and
- Body treatments and spa services.

### D. Overtime Pay Deduction

Prior to the OBBBA, all overtime compensation received by employees was fully includible in gross income and subject to both federal income taxes and FICA taxes. Overtime pay was considered wage income and taxed identically to regular hourly earnings. There was no specific deduction or exclusion that existed for overtime pay.

The OBBBA introduces a temporary deduction for qualified overtime compensation, available for tax years 2025 through 2028. Per the bill, “qualified overtime compensation” is defined as overtime pay received under Section 7 of the Fair Labor Standards Act of 1938, specifically, wages paid at a rate above the employee’s regular rate of pay for overtime hours. Tips already deducted under new §224 are excluded when calculating the overtime pay deduction. Taxpayers may deduct up to \$12,500 per year (\$25,000 for MFJ filers) in qualified overtime compensation. The deduction phases out at a rate of \$100 for every \$1,000 of MAGI above the following thresholds:

- \$150,000 for single/other filers; and
- \$300,000 for MFJ filers.
- *Note:* The phaseout is not indexed for inflation.

The deduction is available to both employees and independent contractors/self-employed, provided the compensation is properly reported on Form W-2 or applicable 1099. To qualify, taxpayers must provide a valid SSN on the return. Additionally, married taxpayers must file jointly to claim the deduction. Any omission of an SSN is treated as a mathematical or clerical error under §6213(g)(2), allowing the IRS to deny the deduction without audit. Non-itemizers are eligible to claim the deduction, and it applies in addition to the standard deduction.

Similar to qualified tips, overtime is subject to payroll taxes and state tax. A transition rule applies to qualified overtime compensation required to be reported for periods before January 1, 2026, allowing those required to file certain returns and statements to approximate the amounts designated as qualified

overtime compensation by any reasonable method specified by the Secretary. Taxpayers working substantial overtime should consider:

- Tracking separately reported overtime amounts;
- Monitoring MAGI levels to assess phase-out impact; and
- Coordinating with employers to ensure proper reporting.

This deduction, combined with the tip income deduction, creates opportunities for wage earners in service occupations to reduce taxable income.

**Example:** Max is a single filer with MAGI of \$165,000. He earns \$15,000 in qualified overtime pay under the FLSA and has no tip income.

Max's deduction is capped at \$12,500 per year under the OBBBA. Since Max's MAGI exceeds the \$150,000 threshold by \$15,000, his deduction is reduced:

- $\$15,000/100 = \$1,500$  phaseout

Max's allowable deduction is \$11,000 (\$12,500 less \$1,500 phaseout).

## E. Trump Accounts

The OBBBA establishes "Trump Accounts," a new type of tax-deferred investment account for children under age 18. These accounts are structured similarly to Roth IRAs, but with additional restrictions, for the exclusive benefit of minors. To qualify, the child must:

- Be under age 18 at year-end;
- Be a U.S. citizen; and
- Possess a valid Social Security Number (SSN).

Accounts must be clearly designated as Trump Accounts at setup and follow strict compliance rules. Funds in the Trump account must be invested in a qualified mutual fund. To qualify, the mutual fund must track either the S&P 500 or another broad-based index made up primarily of U.S. equity investments, with regulated futures contracts traded on a recognized exchange. The index cannot be industry- or sector-specific, but may be based on market capitalization. Additionally, the fund's annual fees and expenses must not exceed 0.1% of the invested balance.

The annual contribution limit is \$5,000 per beneficiary beginning in 2026 and adjusted for inflation beginning in 2028. Per the OBBBA, no contributions will be accepted before July 4, 2026 (12 months after enactment). Contributions may come from parents, relatives, employers, charitable organizations, and government entities. Employer contributions (up to \$2,500) are excluded from the employee's gross income, if made under a compliant plan. General funding contributions from charities or government bodies are exempt from the \$5,000 limit, as long as they benefit a defined group (e.g., a specific birth year or geographic region).

Contributions cannot be made to the account after the beneficiary turns 18. Distributions generally are not permitted before age 18, unless due to:

- Rollover to another Trump Account;
- Rollover to an ABLE account; or
- Correction of excess contributions.

If the account beneficiary dies before the calendar year in which they would have turned 18, the account will no longer be treated as a Trump Account and will be included in the gross income of the beneficiary's estate.

After age 18, funds may be withdrawn for:

- Education expenses;
- First-time home purchases; or
- Small business investments.

Nonqualified distributions are taxed and may face penalties, similar to traditional IRA rules. Additionally, until age 18, assets in Trump Accounts are not counted for means-tested programs (e.g., SSI, SNAP, VA benefits).

Under a pilot program, a \$1,000 one-time federal contribution will be made to accounts for U.S. citizens born between Jan. 1, 2025, and Dec. 31, 2028. The pilot program contribution does not count against the annual \$5,000 contribution limit per Trump Account. If a qualifying child does not have an account by the time they are claimed on a tax return, the IRS will automatically open one, unless parents opt out. As discussed, contributions to Trump Accounts may not begin until 12 months after the bill's enactment, and the entire provision is effective for tax years beginning after December 31, 2025.

## **F. Car Loan Interest Deduction**

The OBBBA introduces a temporary tax deduction for interest paid on loans used to purchase new personal-use passenger vehicles, effective for tax years 2025 through 2028. Taxpayers may deduct up to \$10,000 of qualified car loan interest per year, regardless of whether they itemize deductions or claim the standard deduction. This provision marks a significant departure from existing law by removing certain auto loan interest from the definition of nondeductible "personal interest" under §163(h). This provision applies only to qualified indebtedness incurred after December 31, 2024.

Interest must be paid or accrued on qualified indebtedness:

- Incurred after December 31, 2024;
- Used to purchase a new vehicle; and
- Secured by a first lien on that vehicle.

The vehicle must be intended for personal (non-business) use, and the original use must begin with the taxpayer. Leases, used vehicles, or unsecured loans do not qualify for the deduction.

To qualify for the deduction, the vehicle must meet all of the following:

- Original use commences with the taxpayer;
- Primarily manufactured for use on public streets, roads, and highways;
- Must have at least two wheels;
- Vehicle types include: cars, minivans, vans, SUVs, pickup trucks, and motorcycles;
- Has a gross vehicle weight rating (GVWR) under 14,000 pounds;
- Must be a "motor vehicle" under Title II of the Clean Air Act; and
- Has final assembly that occurs in the United States.

“Final assembly” means the process by which a manufacturer produces a vehicle at, or through the use of, a plant, factory, or other place from which the vehicle is delivered to a dealer with all component parts necessary for the mechanical operation of the vehicle included with the vehicle, whether or not the component parts are permanently installed in or on the vehicle. VIN and assembly information can be confirmed via dealer sticker labels, or the National Highway Traffic Safety Administration (NHTSA) VIN Decoder.

The deduction does not apply to:

- Used vehicles;
- Trailers;
- Campers;
- ATVs, RVs;
- Leased vehicles;
- Unsecured loans or loans without a first lien; or
- Vehicles not assembled in the U.S.

The deduction begins to phase out at \$100,000 MAGI for single filers and \$200,000 MAGI for married filing jointly filers. For every \$1,000 of MAGI above these thresholds, the deduction is reduced by \$200 until fully phased out. Taxpayers must include the Vehicle Identification Number (VIN) on the tax return. Lenders (or any person receiving interest) must file an information return with the IRS and provide a statement to the borrower. Reporting is required for any interest received of \$600 or more that may be deducted under this provision.

**Example:** Mariah purchases a new U.S.-assembled SUV in 2025, taking out a \$40,000 auto loan with 6% interest. She paid \$2,400 in interest during 2025, and the car/loan meet all requirements for the car loan interest deduction. She files using the Single filing status and has \$105,000 of AGI.

The base deduction limit is \$10,000, and the \$2,400 of interest paid is fully within that limit. However, phaseout begins at \$100,000 for single filers. Mariah is \$5,000 over the threshold, so her deduction is reduced as follows:  $\$5,000/1,000 = 5 * \$200 = \$1,000$  reduction. Her resulting deduction is \$1,400 (\$2,400 interest paid less \$1,000 phaseout).

## G. State and Local Tax (SALT) Cap

Prior to the TCJA, taxpayers were allowed to claim a deduction for certain state, local, and foreign taxes paid or accrued, including:

- Real property taxes (state, local, foreign);
- Personal property taxes (state and local); and
- State, local and foreign income, war profits, and excess profits taxes.

Taxpayers could elect to deduct state and local sales general taxes in lieu of income taxes. No dollar cap applied, as deductions were limited only by the overall itemized deduction rules, and no AGI thresholds or phaseouts applied specifically to SALT deductions.

The TCJA imposed a \$10,000 annual cap on the deduction of state and local taxes:

- \$10,000 for single and MFJ filers; and
- \$5,000 for MFS.

Deductible SALT categories under the TCJA SALT cap included:

- State and local income taxes;
- State and local real property taxes; and
- State and local sales taxes.

Under the TCJA, the deduction of foreign real property taxes was disallowed unless incurred in a trade or business. Additionally, under the TCJA, the SALT cap did not apply to state and local taxes paid in connection with:

- A trade or business; or
- The production of income (e.g., a rental property).

The TCJA did not adjust the SALT cap for inflation, and the SALT cap provision was set to expire after December 31, 2025.

The IRS and Treasury issued regulations to curtail SALT workaround schemes (e.g., charitable contributions for tax credits), and states responded by creating Passthrough Entity Tax (PTET) regimes. PTET allowed entities to pay tax at the entity level, bypassing the SALT cap for individual partners/shareholders. IRS Notice 2020-75 endorsed PTET deductibility at the entity level.

The OBBBA temporarily increases the SALT deduction cap from \$10,000 to \$40,000 for most filers (or \$20,000 for married individuals filing separately) for tax years 2025 through 2029. The cap will be adjusted for inflation, rising to \$40,400 in 2026 and increasing by 1% annually through 2029. Further, the OBBBA permanently disallows deduction of personal foreign real property taxes. Beginning in 2030, the SALT cap will revert to its current level of \$10,000 (\$5,000 for married separate filers), which was established by the TCJA.

A phaseout begins at \$500,000 MAGI (\$250,000 for MFS) in 2025:

- The deduction is reduced by 30% of the amount by which MAGI exceeds the threshold.
- The phaseout reduces the increased cap but never falls below a \$10,000 floor (\$5,000 for MFS).

The phase-out threshold increases to \$505,000 in 2026 and continues to rise by 1% annually through 2029. The maximum phasedown reaches the \$10,000 floor once MAGI reaches \$600,000 (\$300,000 for MFS). This phaseout applies only through 2029, after which the cap reverts to its original level.

SALT Deduction Cap Phaseout – All Filers Except MFS			
Tax Year	MAGI Limit	SALT Cap	MAGI at Full Phaseout
2026	\$505,000	\$40,400	\$606,333
2027	\$510,050	\$40,804	\$612,730
2028	\$515,151	\$41,212	\$619,191
2029	\$520,302	\$41,624	\$625,716
2030 and beyond	N/A	\$10,000	N/A

SALT Deduction Cap Phaseout – Married Filing Separately (MFS)			
Tax Year	MAGI Limit	SALT Cap	MAGI at Full Phaseout
2026	\$252,500	\$20,200	\$303,167
2027	\$255,025	\$20,402	\$306,365
2028	\$257,575	\$20,606	\$309,595
2029	\$260,151	\$20,812	\$312,858
2030 and beyond	N/A	\$5,000	N/A

While the temporary increase in the SALT deduction cap offers greater potential benefit for taxpayers who itemize, those with higher incomes may find their benefit limited due to new restrictions on the overall value of itemized deductions. Further, because SALT deductions are added back when calculating AMT liability, the expanded deduction under OBBBA may inadvertently trigger AMT exposure for more taxpayers, particularly those in high-tax jurisdictions. Lastly, the OBBBA does not modify the current treatment of taxes paid under state PTET regimes. As a result, states may continue to offer PTET elections, which remain a viable workaround for high-income individuals seeking to bypass the individual SALT deduction limitations.

- Example 1:** Jimmy is a single taxpayer with MAGI of \$550,000 for 2025. In 2025, he pays the following state and local taxes:
- State income tax: \$25,000
  - Local property tax: \$15,000
  - Total SALT paid: \$40,000

In 2025, the base SALT cap is \$40,000 and the phase-out threshold for single taxpayers is \$500,000.

Jimmy exceeds the threshold by \$50,000 (\$550,000 MAGI less \$500,000). The phase-out amount is \$15,000 (30% x \$50,000).

Jimmy is allowed a \$25,000 SALT deduction (\$40,000 cap less \$15,000 phaseout).

- Example 2:** Ron is a single taxpayer with MAGI of \$650,000 for 2025. In 2025, he pays the following state and local taxes:
- State income tax: \$30,000
  - Local property tax: \$15,000
  - Total SALT paid: \$45,000

In 2025, the base SALT cap is \$40,000 and the phase-out threshold for single taxpayers is \$500,000.

Ron exceeds the threshold by \$150,000 (\$650,000 MAGI less \$500,000). The phase-out amount is \$45,000 (30% x \$150,000).

Even if the phase-out amount exceeds the cap (as it does here), the SALT deduction cannot fall below \$10,000, so Ron can deduct \$10,000.

## H. Dependent Care Assistance Programs

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

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

## **I. Charitable Contribution Deduction**

For itemizing taxpayers, the OBBBA introduces a new 0.5% AGI floor on itemized charitable deductions beginning in 2026. Only the portion of aggregate charitable contributions that exceeds 0.5% of AGI is deductible. Any portion of a contribution disallowed due to the 0.5% floor may be carried forward, provided the taxpayer has sufficient charitable contribution carryforwards. The OBBBA permanently extends the 60% AGI limit for cash contributions to public charities, originally set to expire after 2025 under the TCJA.

Beginning in 2026, the OBBBA allows non-itemizers to deduct up to \$1,000 (\$2,000 for MFJ filers) for qualified charitable contributions. To qualify, contributions must be:

- Cash donations.
- Made to public charities under §170(p).

This change revives and expands the temporary charitable deduction allowed briefly during the COVID-19 pandemic, now made permanent under the OBBBA. It provides a modest benefit to standard deduction filers, many of whom previously received no tax incentive for giving. The permanent nature of both the deduction for non-itemizers and the 60% AGI limit for itemizers provides a stable framework for long-term charitable planning.

## **J. Adoption Credit**

Prior to the OBBBA, the Adoption Tax Credit was nonrefundable, meaning it could only reduce a taxpayer's federal income tax liability to zero. The OBBBA enhances the existing adoption credit by making up to \$5,000 of the credit refundable beginning in tax year 2025. The \$5,000 refundable limit will be adjusted annually for inflation, beginning in 2025.

The total maximum adoption credit for 2025 is \$17,280 per child, which includes both refundable and nonrefundable components. The refundable portion of the credit is not eligible for carryforward. The remaining portion of the credit (up to the total limit) remains nonrefundable and continues to be subject to five-year carryforward rules. This enhancement applies to tax years beginning after December 31, 2024.

## **K. ABLE Accounts**

ABLE accounts (Achieving a Better Life Experience accounts) are tax-advantaged savings accounts designed to help individuals with disabilities save for qualified disability-related expenses without losing eligibility for certain public benefits, such as SSI (Supplemental Security Income) and Medicaid. The base amount of the limit on contributions to Achieving a Better Life Experience (ABLE) accounts for individuals with disabilities is equal to the gift tax exclusion in effect for the year (\$19,000 in 2025).

The TCJA originally enacted a provision allowing employed individuals with disabilities to make additional contributions to ABLE accounts, and this provision was set to expire on December 31, 2025. These additional contributions are allowed on top of the standard annual ABLE contribution limit. The OBBBA

permanently extends the TCJA provision allowing employed individuals with disabilities to make these additional contributions.

The additional contributions are limited to the lesser of:

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

This rule provides greater flexibility and savings potential for disabled individuals who are able to work, enabling them to accumulate more resources in a tax-advantaged account.

Prior to the OBBBA, eligibility for the Saver's Credit for designated beneficiaries who make qualified contributions to their ABLE accounts was set to expire on December 31, 2025. The OBBBA permanently permits ABLE account contributions to qualify for the Saver's Credit. Under this provision, for taxable years beginning after December 31, 2026, eligible Saver's Credit contributions are limited to ABLE account contributions made during the taxable year by the account's beneficiary.

For tax years before 2027, the OBBBA provides a calculation that includes retirement contributions, elective deferrals, and voluntary employee contributions. The OBBBA increases the maximum annual contribution amount eligible for the Saver's Credit amount from \$2,000 to \$2,100 starting in tax years after December 31, 2026.

Lastly, the OBBBA permanently allows tax-free rollovers from §529 qualified tuition programs to ABLE accounts. This provision, enacted by the TCJA and originally set to expire at the end of 2025, is now a permanent feature of the tax code. These rollovers:

- Must be made to an ABLE account for the same beneficiary (or a qualifying family member); and
- Count toward the annual contribution limit for ABLE accounts (including any additional contributions permitted for employed beneficiaries)

The provision increases flexibility for families with unused 529 plan funds, particularly when educational goals change or a student has special needs.

## **L. Scholarship Credit**

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

The credit amount is reduced by any state tax credit received for the same contribution. A qualified contribution is a charitable contribution of cash made to a scholarship granting organization that uses the contribution to fund scholarships for eligible students attending elementary or secondary schools solely within the State in which the SGO is listed.

A qualifying SGO must be a public charity under §501(c)(3) and must maintain segregated accounts for qualified contributions. Qualified contributions must be in cash only and are not eligible for a charitable deduction under §170 if used to claim the credit. If a taxpayer's federal credit exceeds the limit on nonrefundable personal credits under §26(a), the excess may be carried forward up to five years.

Contributions are subject to a national \$4 billion annual cap, with credits allocated on a first-come, first-served basis.

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

## **M. Learning Credits**

Prior to the OBBBA, taxpayers could claim the American Opportunity Tax Credit (AOTC) or the Lifetime Learning Credit (LLC) by including the name and Taxpayer Identification Number (TIN) of the student on their return. Beginning in 2026, the OBBBA imposes stricter identification requirements for claiming education these credits, tightening eligibility and compliance verification. To claim either the AOTC or LLC, taxpayers must include:

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

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

## **N. Employer Payments of Student Loans**

Prior to the OBBBA, employees could exclude up to \$5,250 per year of “educational assistance” provided by an employer under a qualified educational assistance program. This exclusion covered various education-related costs, including tuition, fees, books, supplies, and equipment, provided they were for the employee's own educational benefit.

The CARES Act (2020) expanded this benefit temporarily to include employer payments of student loans, including both principal and interest, as a form of tax-free educational assistance. However, the inclusion of student loan repayment assistance was scheduled to expire after December 31, 2025, meaning any payments made after that date would have been taxable to employees.

The OBBBA makes the student loan repayment exclusion permanent, ensuring employer-paid student loan assistance remains tax-free to employees beyond 2025. Employers may continue to provide up to \$5,250 annually toward the repayment of an employee’s qualified education loans. Beginning in 2027, the \$5,250 annual limit will be adjusted for inflation each year, ensuring the benefit retains its real value over time. This permanent extension provides long-term planning certainty for both employers and employees looking to use student loan repayment as a tax-advantaged compensation strategy.

## **O. 529 Plans**

Prior to 2002, a qualified tuition program (QTP), sometimes referred to as a §529 plan, generally referred to a program established and maintained by a state. Contributions by donors are eligible for the \$19,000 annual gift-tax exclusion (\$38,000 for “split” gifts by married couples in 2025). Cash distributions made from qualified tuition programs are excluded from gross income to the extent that the distribution is used

to pay for qualified higher-education expenses (as reduced by any in-kind distributions). This exclusion from gross income extends to distributions from qualified tuition programs established and maintained by an entity other than a state (or agency or instrumentality thereof).

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

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

The expanded list of qualified K–12 expenses is effective for distributions made after the date of enactment.

The OBBBA also introduces §529(f), allowing 529 plan funds to be used for certain qualified postsecondary credentialing expenses. Postsecondary credentialing expenses include tuition, fees, books, supplies, and equipment required for participation in recognized postsecondary credential programs. Also included are costs for testing and continuing education required to obtain or maintain a recognized credential. This provision applies to distributions made after the date of enactment.

A “recognized postsecondary credential program” includes those that:

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

Covered credentials include:

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

Historically, 529 plans were primarily viewed as vehicles for college savings. The OBBBA further transforms them into multi-stage education funding tools, now supporting K–12, career credentialing, and non-traditional education pathways. It remains important to coordinate 529 distributions with other tax benefits such as:

- The American Opportunity Tax Credit (AOTC);
- The Lifetime Learning Credit (LLC); and
- Scholarship tax benefits.

## P. Limitation on Wagering Loss

Prior to the enactment of the OBBBA, losses from wagering transactions were deductible only to the extent of gains from such transactions. As a result, between 2018 and 2025, “losses” included all allowable deductions incurred in carrying on any wagering activity. The OBBBA permanently limits the deductibility of gambling-related losses to 90% of the amount of such losses, still only to the extent of gains from wagering transactions. As a result, a portion (10%) of losses will remain non-deductible, even when gains and losses are equal. This change is effective for tax years beginning after December 31, 2025.

**Example:** John has \$100,000 in gambling winnings and \$100,000 in gambling losses. Under pre-OBBBA law, no tax would be due, as losses fully offset winnings.

Under the new OBBBA 90% limitation, only \$90,000 of the losses are deductible. The remaining \$10,000 becomes taxable income. Assuming an effective tax rate of 24%, this results in \$2,400 in tax owed, despite a break-even year. This change will particularly impact professional and high-volume bettors, including those in states with legalized sports betting.

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

## Q. Elimination of Energy Incentives

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

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



# The One Big Beautiful Bill Act – Business Provisions

<i>Learning objectives</i>	<b>1</b>
<b><i>I. New and Enhanced OBBBA Tax Provisions for Businesses</i></b>	<b>1</b>
<b>A. Section 199A QBI Deduction</b>	<b>1</b>
<b>B. Bonus Depreciation</b>	<b>3</b>
<b>C. Section 179 Expensing</b>	<b>5</b>
<b>D. Research and Experimental Expenditures</b>	<b>6</b>
<b>E. Advanced Manufacturing Investment Credit (CHIPS Credit)</b>	<b>8</b>
<b>F. §163(j) Business Interest</b>	<b>8</b>
<b>G. Qualified Small Business Stock Exclusion</b>	<b>9</b>
<b>H. Excess Business Loss Limitation</b>	<b>11</b>
<b>I. Corporate Charitable Contribution Deduction</b>	<b>12</b>
<b>J. Paid Family and Medical Leave Credit (IRC §45S)</b>	<b>12</b>
<b>K. Employer-Provided Child Care Credit</b>	<b>13</b>
<b>L. Payments from Partnerships to Partners for Property or Services</b>	<b>14</b>
<b>M. Form 1099 Reporting Thresholds</b>	<b>14</b>
<b>N. Form 1099-K Reporting Changes</b>	<b>15</b>
<b>O. Qualified Bicycle Commuting Reimbursement Exclusion</b>	<b>16</b>
<b>P. Opportunity Zones</b>	<b>16</b>
<b>Q. Employee Retention Tax Credit (ERTC)</b>	<b>17</b>
<b>R. Elimination of energy incentives</b>	<b>18</b>



# The One Big Beautiful Bill Act – Business Provisions

## *Learning objectives*

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

- Evaluate the impact of new OBBBA provisions on business taxpayers;
- Analyze key provisions extended by the OBBBA; and
- Understand the practical implications of major business provisions outlined in the OBBBA.

## ***I. New and Enhanced OBBBA Tax Provisions for Businesses***

### **A. Section 199A QBI Deduction**

The TCJA introduced the §199A QBI deduction, effective for tax years 2018 through 2025. This deduction allows non-corporate taxpayers, including sole proprietors, S corporation shareholders, and partners, to deduct 20% of their qualified business income (QBI). The deduction is also available for:

- Qualified REIT dividends; and
- Income from publicly traded partnerships (PTPs).
- The deduction is limited to 20% of taxable income, reduced by net capital gain.

For higher-income taxpayers, the deduction was subject to:

- A W-2 wage and capital investment limitation; and
- A disqualification for Specified Service Trades or Businesses (SSTBs), such as health, law, accounting, and consulting services.

These limitations phased in over fixed income ranges:

- \$50,000 for all taxpayers except joint filers; and
- \$100,000 for MFJ.

For 2025, the income thresholds are indexed and set at \$197,300 for individuals and \$394,600 for MFJ. Absent legislation, this deduction was set to expire after December 31, 2025.

The OBBBA makes permanent the §199A QBI deduction, eliminating the TCJA's 2025 sunset clause. The deduction continues to allow non-corporate taxpayers, including sole proprietors, S corporation shareholders, and partners, to deduct 20% of qualified business income. The final legislation does not increase the deduction rate from 20% to 23%, as had been proposed in an earlier House version of the bill. By keeping the 20% deduction in place, pass-through business owners avoid returning to higher effective marginal tax rates after 2025.

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

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

These expanded thresholds reduce the impact of wage and capital limitations and broaden access to the full deduction for higher-earning taxpayers. This provision is effective for taxable years beginning after December 31, 2025. Inflation adjustments will apply to these thresholds for tax years beginning after 2026. This change particularly benefits taxpayers with income near the upper threshold of eligibility, especially those in specified service trades or businesses (SSTBs).

The OBBBA also introduces a minimum QBI deduction of \$400 for taxpayers with at least \$1,000 of QBI from one or more active qualified trades or businesses. An "active qualified trade or business" requires material participation by the taxpayer, as defined under §469(h). The minimum deduction ensures that eligible taxpayers with modest QBI amounts are not excluded entirely from the deduction due to income level or complexity. This provision is effective for taxable years beginning after December 31, 2025. The \$400 minimum is adjusted for inflation beginning in tax years after 2026.

***Minimum QBI Deduction Example:***

Emma is a sole proprietor who operates a small Etsy shop. She files her taxes as a single taxpayer, and in the 2026 tax year, she earns \$1,100 in QBI from her shop.

Emma materially participates in her business, meaning she is actively involved in its operations, and therefore meets the "active qualified trade or business" requirement under §469(h). Emma does not pay any wages and has no significant capital investment in the business. Her QBI is her only income from a qualified trade or business.

Under prior law, Emma would be entitled to a deduction equal to 20% of her qualified business income. In her case, that would be 20% of \$1,100, which equals a \$220 deduction. However, under the new rule enacted by the OBBBA, Emma is now eligible for a minimum §199A deduction of \$400, provided she:

- Has at least \$1,000 of QBI from one or more active qualified trades or businesses; and
- Materially participates in those businesses.

Since Emma satisfies both conditions (she has more than \$1,000 in QBI and is actively involved in the business), the minimum deduction rule applies. Since the minimum deduction of \$400 is greater than her calculated deduction of \$220, Emma will now claim a \$400 deduction instead of \$220.

***SSTB Phase-In Expanded Example:***

David is a self-employed licensed attorney who files as a single taxpayer. In 2026, David earns \$230,000 in taxable income, all of which qualifies as QBI from his solo legal practice. He pays himself a reasonable salary and has no employees. His business qualifies as an SSTB under §199A rules, so it is subject to phaseout. Assume the inflation-adjusted threshold amount is \$197,300 for purposes of this example.

Under prior law (TCJA), David's ability to claim the §199A deduction would begin to phase out once his taxable income exceeded \$197,300, and it would completely phase out by \$247,300, a \$50,000 phase-in range for single filers. Under the OBBBA, the phase-in range is expanded from \$50,000 to \$75,000 for single filers. This means the SSTB phaseout now begins at \$197,300 and ends at \$272,300, rather than stopping at \$247,300.

- Taxable Income = \$230,000
- SSTB Phase-In Range = \$197,300 to \$272,300
- Total range = \$75,000
- Amount over threshold = \$32,700 (\$230,000 – \$197,300)
- Percentage through phase-out =  $\$32,700 \div \$75,000 = 43.6\%$
- Full potential deduction (before phaseout) = \$46,000 (20% × \$230,000)
- Apply phase-out reduction: 43.6% of \$46,000 = \$20,056 disallowed
- §199A deduction allowed = \$25,944 (\$46,000 – \$20,056)

**REIT and PTP Income Example:**

Barbara is retired and earns \$70,000 in total income in 2026, and \$25,000 of this income is from qualified REIT dividends and publicly traded partnership (PTP) income. Under OBBBA, REIT and PTP income still qualifies for the §199A deduction:

- $20\% \times \$25,000 = \$5,000$  §199A deduction;
- The §199A deduction continues to be beneficial for taxpayers with REITs/PTPs.

**Minimum Deduction Trap Example:**

Tom owns 25% of a partnership that runs a retail kiosk, but he does not materially participate. The business generates \$1,200 of QBI for Tom's share. Because Tom is not materially participating, he does not qualify for the \$400 minimum deduction. Tom still receives the normal 20% §199A deduction of \$240 ( $20\% \times \$1,200$ ). Taxpayers should be careful about assuming the minimum deduction applies to all low-QBI taxpayers, as it does not apply to passive investors.

Making §199A permanent ensures long-term certainty for pass-through business owners and continues to support tax parity with C corporations. The expansion of phase-in thresholds will benefit many upper-middle-income business owners, especially in professional services who were previously subject to partial or full loss of the deduction. The minimum deduction helps simplify planning for smaller businesses and micro-entrepreneurs. Taxpayers should revisit entity structure, wage strategies, and business participation (especially SSTB classification) in light of these permanent rules.

## B. Bonus Depreciation

Bonus depreciation accelerates the depreciation of qualified property, lowering the cost of capital for investment in those assets and boosting the cash flow of businesses making such investments. Prior to the TCJA, bonus depreciation existed, but at reduced rates and often required the property to be new (not used). Congress initially created the allowance to spur increased business investment during periods of negative or sluggish economic growth.

The Job Creation and Worker Assistance Act of 2002 created the bonus depreciation allowance. It was initially set at 30% and applied to qualified property acquired and placed in service between September 12, 2001, and December 31, 2004. In 2003, Congress raised the bonus depreciation allowance to 50% of the cost of qualified property acquired and placed in service from 2003 to 2005. It expired at the end of 2005. Congress reinstated the bonus depreciation allowance in 2007 for property acquired and placed in service in 2008 (or 2009 for property with long production times and certain aircraft). Due to several subsequent extensions and enhancements, a bonus depreciation allowance of 50% or 100% was available for property acquired and placed in service in 2009 to 2015.

The TCJA increased bonus depreciation to 100% for qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023. For the first time, used property became eligible for bonus depreciation, provided it had not previously been used by the taxpayer or acquired from a related party or through a nonrecognition transaction, a major departure from prior law. The TCJA implemented a phase-down schedule as follows:

- 100% through 2022;
- 80% in 2023;
- 60% in 2024;
- 40% in 2025;
- 20% in 2026; and
- 0% in 2027 and beyond.

The OBBBA permanently reinstates 100% bonus depreciation under §168(k) for qualified property acquired and placed in service after January 19, 2025. Property acquired under a binding written contract before January 19, 2025, is not eligible for 100% bonus depreciation under the OBBBA. The OBBBA essentially eliminates the TCJA phase-out schedule, restoring full expensing as a permanent tax benefit.

Qualified property continues to include:

- Tangible property with a recovery period of 20 years or less;
- Used property, if not previously used by the taxpayer and not acquired from a related party; and
- QIP, water utility property, and certain computer software.

Additionally, specified plants planted or grafted after January 19, 2025, are now eligible for full expensing. Further, the OBBBA removes the prior limitation requiring self-constructed property to be completed before 2027, a significant simplification for long-term projects.

A limited transitional election allows taxpayers to apply the pre-OBBBA phase-down rates in lieu of full expensing for certain assets. The transitional election is modeled after the original TCJA election, which allowed a 50% deduction for certain 2017-year-end taxpayers. Specifically, taxpayers may elect to claim a reduced depreciation deduction of 40% (or 60% for certain aircraft or property with a longer production period) for certain qualified property placed in service during the first tax year ending after January 19, 2025. This election offers administrative simplicity for fiscal-year taxpayers already using prior-year depreciation schedules.

The OBBBA creates an elective 100% depreciation allowance under §168(n) for Qualified Production Property (QPP), defined as nonresidential real property used as an integral part of a Qualified Production Activity (QPA). This represents a historic departure from prior law, which excluded real property (other than QIP) from bonus depreciation treatment and typically required real property to be depreciated over 39 years. The term “Qualified Production Activity” means the manufacturing, production, or refining of a qualified product. The term “Qualified Product” means any tangible personal property if such property is not a food or beverage prepared in the same building as a retail establishment in which such property is sold. In other words, restaurants and cafes attached to retail establishments are ineligible.

Such buildings are eligible for 100% bonus depreciation, but only if placed in service before January 1, 2031. The property must meet either the original use requirement or pass modified criteria for used property:

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

QPP does not include:

- Property subject to the Alternative Depreciation System (ADS);
- Property leased to third parties; or
- Sales or research offices.

Additionally, when a taxpayer elects to treat a property as QPP under §168(n) and claims 100% bonus depreciation on that basis, they are not allowed to also claim bonus depreciation under §168(k) for that same property. This means a business must choose one path for each property:

- Claim 100% expensing under §168(n); OR
- Claim bonus depreciation under §168(k).

Taxpayers cannot stack or combine both benefits for the same asset.

Electing taxpayers must formally designate the real property and the portion thereof for which the §168(n) deduction is claimed on their tax return in the year it is placed in service. The QPP election is irrevocable unless “extraordinary circumstances” exist, and approval is granted by the Treasury Secretary. A 10-year recapture rule under §1245 applies if the property ceases to be used in a QPA.

Because the QPP election is irrevocable, businesses should create tax models comparing:

- The benefit of treating the property as QPP under §168(n), especially if it’s a real property asset like a manufacturing facility; and
- The benefit of doing a cost segregation study to carve out tangible personal property (like equipment, HVAC, electrical components) eligible for bonus depreciation under §168(k).

For example, a building used for manufacturing might qualify as QPP, but if a cost segregation study identifies personal property components, it might be more tax-efficient to apply §168(k) to those components without electing QPP for the entire building. Electing QPP treatment could forfeit the chance to depreciate personal property elements under §168(k).

The permanent nature of 100% expensing creates long-term certainty for businesses planning capital expenditures. Strategic timing of acquisitions and construction starts is critical to QPP eligibility.

Businesses should carefully evaluate whether to:

- Take immediate 100% expensing under §168(k) or §168(n); or
- Elect transitional 40%/60% depreciation.

Industries with heavy fixed-asset investments, such as manufacturing, transportation, and logistics, stand to benefit most from the OBBBA provisions. Strategic timing of asset acquisition and construction is critical to align with eligibility rules and maximize tax outcomes.

Other considerations include:

- **State conformity:** Many states decouple from federal bonus depreciation, and some may not adopt the new §168(n) QPP provisions;
- **Proper asset classification:** Misclassification may disqualify property from bonus depreciation or trigger unintended recapture;
- **Contract review:** Binding written contracts signed before January 19, 2025, may disqualify otherwise eligible property under the OBBBA framework. Fiscal-year taxpayers must carefully track transitional elections; and
- **Election timing and substantiation:** The requirement to designate the property and portion expensed must be documented clearly on the return.

## C. Section 179 Expensing

Section 179 is a permanent tax provision that gives firms in all lines of business and all sizes the option, within certain limits, of expensing the cost of new and used qualified property in the tax year when the assets are placed in service. Business taxpayers that cannot (or choose not to) claim the allowance may recover capital costs over longer periods and at slower rates by claiming the appropriate depreciation

deductions under the Modified Accelerated Cost Recovery System (MACRS) or Alternative Depreciation System (ADS).

Use of the allowance is subject to two limitations: an investment (or dollar) limitation and an income limitation:

- Under the **dollar limitation**, the maximum allowance a taxpayer is permitted to claim in a tax year is reduced, dollar for dollar but not below zero, by the amount by which the aggregate cost of the qualified property a firm buys and places in service during that year exceeds a phase-out threshold; and
- The **income limitation** bars a taxpayer from claiming a §179 allowance greater than its taxable income (including wages and salaries) from the active conduct of a trade or business.

Prior to the OBBBA, the §179 expensing limit was \$1,000,000 (\$1,250,000 as indexed for inflation in 2025), with a phase-out threshold of \$2,500,000 (\$3,130,000 as indexed for inflation in 2025). The OBBBA increases the statutory maximum amount that a taxpayer may expense under §179 to \$2,500,000 and raises the phase-out threshold to \$4,000,000. These new limits are permanently indexed for inflation beginning in tax years starting in 2026.

The deduction continues to phase out dollar-for-dollar when the total cost of qualifying property exceeds the \$4,000,000 threshold. The scope of eligible property remains unchanged, including tangible personal property, certain real property improvements, and software. The SUV limitation of \$25,000 (inflation-adjusted) remains in place and is unaffected by the OBBBA. These apply to property placed in service in tax years beginning after December 31, 2024.

It is important to note that §179 deductions reduce the basis of property before applying bonus depreciation. Additionally, §179 elections can be made for a specified dollar amount of one or more assets placed in service during the year. Under the OBBBA, taxpayers may apply §179 to eligible property and then claim 100% bonus depreciation (under §168(k)) for the remaining basis, provided acquisition and service timing align with bonus depreciation rules. Taxpayers should carefully coordinate acquisition and placed-in-service dates to align with both:

- The new §179 thresholds; and
- The reinstated 100% bonus depreciation under §168(k) (applicable for property acquired after Jan. 19, 2025).

## D. Research and Experimental Expenditures

Before January 1, 2022, taxpayers could typically treat Research and Experimental (R&E) Expenditures in any of the following ways:

- Deduct in current tax year paid or incurred (§174(a));
- Capitalize and amortize over a period not less than 60 months, beginning with the month in which the taxpayer first realizes benefits from such expenditures (§174(b)); or
- Capitalize and amortize over 10 years, beginning with the taxable year in which the expenditure was made (§59(e) election).

Rev. Proc. 2000-50 provided specific guidance on computer software costs. Taxpayers could generally:

- Expense the development costs in the year incurred;

- Capitalize and amortize over a period not less than 60 months, beginning the month the development is completed; or
- Capitalize and amortize over 36 months from the date the software is placed in service.

Under the TCJA, for tax years beginning after December 31, 2021, taxpayers were required to capitalize and amortize all specified research or experimental (R&E) expenditures over:

- 5 years for domestic research activity; or
- 15 years for foreign research activity.
- Note: Amortization began at the midpoint of the taxable year in which the expenditures were paid or incurred.

Software development costs were explicitly included as R&E expenditures subject to capitalization. No immediate deduction was permitted, even if the research-related property was abandoned, disposed, or retired, and taxpayers were required to continue amortization over the remaining statutory period.

The cash flow impact of mandatory capitalization was significant, particularly for startup companies. Further, coordination with the §41 research credit under §280C required taxpayers to:

- Reduce the capital account for amounts in excess of deductible §174 expenditures; or
- Elect a reduced credit equal to the corporate tax rate (21%).

The OBBBA permanently restores immediate expensing for domestic research or experimental (R&E) expenditures incurred in tax years beginning after December 31, 2024. This change is implemented through new §174A, which allows taxpayers to either:

- Fully deduct domestic R&E costs in the year incurred; or
- Elect to capitalize and amortize them ratably over a 60-month period.

Foreign R&E expenditures must still be capitalized and amortized over 15 years under the existing provisions of §174. This change effectively reverses the TCJA's requirement that all R&E expenses be amortized, providing greater flexibility and cash flow benefits for U.S.-based research activities.

The OBBBA provides two transitional relief options for taxpayers who capitalized domestic R&E costs in 2022 through 2024 under the TCJA rules:

- Taxpayers may elect to fully deduct the unamortized portion of those expenses in the first tax year beginning after December 31, 2024; or
- Taxpayers may elect to amortize the remaining balance ratably over a two-year period beginning in that same year.

Additionally, the OBBBA preserves the small business taxpayer election under prior law. Small business taxpayers (those meeting the §448(c) gross receipts test with average annual gross receipts not exceeding \$31 million for the prior three years) may elect to retroactively apply §174A to prior tax years beginning after 12/31/2021 by either:

- Filing amended returns; or
- Adopting an accounting method change under §481(a).

On August 28, 2025, the IRS issued Rev. Proc. 2025-28, providing transitional guidance for implementing the OBBBA's changes to §174. Specifically, to elect the deduction or two-year amortization, taxpayers must attach a statement to their timely filed return (including extensions) for the election year. The

election is binding for that year and subsequent years unless IRS consent is obtained. In many cases, Form 3115, *Application for Change in Accounting Method*, is not required, and a statement with the following info will suffice:

- Description of the domestic R&E costs;
- Year(s) the expenditures were incurred; and
- Reason for the accounting method change.

Elections must be made by July 6, 2026 (due to July 4, 2026 falling on a Saturday). Special transition rules apply for returns filed before September 15, 2025, and for method changes made before November 15, 2025. Taxpayers who filed 2024 returns before September 15, 2025, without extensions, may file superseding returns up to six months later to make or revoke elections or apply method changes under the new guidance. This relief applies to individuals, partnerships, S corporations, C corporations, trusts, estates, and exempt organizations with taxable years ending before 9/15/2025 and with an original due date before that date.

The restoration of immediate expensing for domestic R&E is expected to have a positive impact on liquidity and after-tax cash flow, especially for innovation-intensive businesses and early-stage companies. Taxpayers must evaluate their accounting method to conform with §174A, as well as assess the impact of elections on current and prior year returns. Companies with foreign research activity must continue to segregate and track foreign R&E costs separately, given the ongoing requirement to amortize such costs over 15 years. The permanent nature of the provision provides long-term planning certainty and may influence decisions related to capital investment, hiring, and domestic R&E expansion.

## **E. Advanced Manufacturing Investment Credit (CHIPS Credit)**

Prior to the OBBBA, under §48D, a 25% Advanced Manufacturing Investment Credit was available to eligible taxpayers investing in qualified advanced manufacturing facilities. An “advanced manufacturing facility” is defined as a facility whose primary purpose is the manufacturing of:

- Semiconductors; or
- Semiconductor manufacturing equipment.

The OBBBA increases the Advanced Manufacturing Investment Credit under IRC §48D, commonly referred to as the CHIPS Credit, from 25% to 35%. The enhanced 35% credit applies to qualified property placed in service after December 31, 2025, not when construction begins.

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

## **F. §163(j) Business Interest**

The TCJA introduced a limitation on business interest expense, allowing deductions only up to:

- 30% of Adjusted Taxable Income (ATI);
- Plus business interest income;
- And floor-plan financing interest.

Floor-Plan Financing Interest is interest paid or accrued on indebtedness used to finance the acquisition of motor vehicles held for sale or lease to retail customers and secured by the inventory so acquired. A “motor vehicle” means a motor vehicle that is: (1) any self-propelled vehicle designed for transporting person or property on a public street, highway or road; (2) a boat; or (3) farm machinery or equipment.

For tax years 2018 through 2021, ATI was calculated using a tax-basis EBITDA approach, meaning depreciation, amortization, and depletion (DDA) were added back to taxable income, allowing greater deduction capacity. For tax years 2022 through 2024, the calculation shifted to a more restrictive EBIT model, thereby including depreciation, amortization, and depletion in ATI. This change significantly reduced the deductible interest for capital-intensive and amortizing businesses. The shift was widely regarded as creating a disadvantage for manufacturers, infrastructure firms, and other asset-heavy industries.

The OBBBA permanently reinstates the more favorable EBITDA-based limitation for business interest deductions under §163(j), effective for tax years beginning after December 31, 2024. This means adjusted taxable income (ATI) will now be calculated before depreciation, amortization, and depletion deductions. The OBBBA also permanently modifies the definition of “motor vehicle” to include certain trailers and campers designed to be towed by or affixed to a motor vehicle. This change allows interest on floor plan financing for such trailers and campers to be deducted, enabling additional deductible interest for relevant industries.

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

The new provisions enacted under the OBBBA are expected to be favorable for domestic capital investment, especially in manufacturing and infrastructure-heavy industries. Further, industries with high leverage, such as real estate, manufacturing, and private equity, are expected to benefit greatly from these changes. When combined with 100% bonus depreciation, these provisions create a multiplier effect: for every \$10 of investment, a company may be able to deduct up to \$3 more in interest expense.

## **G. Qualified Small Business Stock Exclusion**

Under §1202, noncorporate taxpayers could exclude a portion of capital gains from the sale of Qualified Small Business Stock (QSBS) held for more than five years, subject to certain limits. The exclusion percentage was determined by the date of acquisition:

- 50% exclusion for QSBS acquired after August 10, 1993 and before February 18, 2009; and
- 75% exclusion for QSBS acquired after February 17, 2009 and before September 28, 2010.

The per-issuer limitation on eligible gain was the greater of:

- \$10 million (\$5 million for MFS), reduced by prior excluded gain from the same issuer; or
- 10 times the taxpayer’s basis in the disposed QSBS.

A corporation was qualified to issue QSBS only if its aggregate gross assets did not exceed \$50 million before, at the time of, and immediately after stock issuance.

Prior to the OBBBA, for QSBS acquired after September 27, 2010, a 100% exclusion of gain applied if the stock was held for more than five years. Gain excluded under §1202 was not treated as a tax preference item for AMT, applicable to post-2010 acquisitions. QSBS was still subject to:

- The same \$10 million per-issuer cap or 10x basis rule; and
- The \$50 million gross asset test for qualifying corporations.

Prior law continued to disallow any gain exclusion if the QSBS holding period was less than five years, unless rolled over under nonrecognition provisions.

The OBBBA significantly expands the benefits available under §1202, which allows noncorporate taxpayers to exclude gain from the sale of qualified small business stock (QSBS). The changes apply to stock acquired on or after July 4, 2025, and include tiered gain exclusions, increased per-issuer dollar caps, and a higher gross asset test for qualifying corporations. These reforms are intended to stimulate investment in growing private companies, particularly startups and emerging businesses. Investors in qualified startups and growth-stage businesses will benefit from greater exclusions, longer investment flexibility, and expanded issuer eligibility.

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

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

The percentage of gain excluded increases based on the holding period, incentivizing longer-term investment in small businesses. The OBBBA raises the lifetime per-issuer cap for QSBS gain exclusion from \$10 million to \$15 million for stock acquired after July 4, 2025. The new \$15 million cap is indexed for inflation beginning in 2027, using 2025 as the base year. For married taxpayers filing separately, the cap is reduced to \$7.5 million, as under prior law. If the taxpayer exceeds the cap in a given year, the exclusion in subsequent years may be reduced to zero, even with inflation indexing.

To qualify for the QSBS exclusion, the issuing corporation must meet an aggregate gross asset limit. The OBBBA raises this limit from \$50 million to \$75 million, effective for stock issued after July 4, 2025. The \$75 million threshold is also indexed for inflation beginning in 2027, rounded to the nearest \$10,000. The change allows larger small businesses to qualify, broadening the reach of §1202 benefits.

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

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

The tiered exclusion structure incentivizes capital to flow more flexibly into startups and growth-stage companies, allowing partial tax benefits for medium-term investments. Increasing the per-issuer cap and asset threshold:

- Broadens access to §1202 benefits for later-stage or capital-intensive private companies; and
- Encourages continued investment beyond the seed and Series A stages, which often disqualified companies under the prior \$50M asset cap issuance.

## H. Excess Business Loss Limitation

Prior to the enactment of the TCJA, there was no limitation under IRC §461(l) on the ability of noncorporate taxpayers to deduct business losses against other types of income. Business losses could fully offset non-business income, such as wages, dividends, interest, and capital gains, provided that other limitations (e.g., at-risk, passive activity loss rules) were met. This allowed noncorporate taxpayers, including sole proprietors, partners, and S corporation shareholders, to shelter significant amounts of non-business income using business losses in a given tax year.

The TCJA introduced IRC §461(l), creating a new limitation on the use of “excess business losses” by noncorporate taxpayers for tax years 2018 through 2025, later extended through 2028. The excess business loss is the amount by which aggregate trade or business deductions exceed the sum of:

- Aggregate trade or business income or gain; and
- A statutory threshold amount, adjusted annually for inflation.

For 2025, these inflation-adjusted thresholds are:

- \$626,000 for married filing jointly (MFJ); and
- \$313,000 for all other taxpayers.

Excess Business Loss rules apply after the application of:

- Passive activity loss limitations under §469;
- At-risk limitations under §465; and
- For flow-through entities, limitations based on the taxpayer’s basis in the entity.

Excess Business Losses that are disallowed in the current year are converted into a Net Operating Loss (NOL) and carried forward to future years under the NOL rules. These disallowed losses are not subject to re-testing under §461(l) once carried forward, as they become ordinary NOLs. The limitation on excess farm losses under §461(j) was suspended by the TCJA. Prior to the enactment of the OBBBA, §461(l) was scheduled to expire for tax years beginning after December 31, 2028, effectively restoring full deductibility of business losses absent further legislation.

The OBBBA permanently codifies the EBL limitation under §461(l), removing the sunset provision scheduled for 2028. Under the OBBBA, disallowed EBLs will continue to be treated as NOLs, preserving the existing mechanics:

- Carried forward under §172 NOL rules; and

- Not subject to re-testing under §461(l) in subsequent years.

Further, the OBBBA makes permanent the application of the excess business loss rules to farming losses, eliminating the prior exclusion under §461(j). As a result, farming businesses are now fully subject to the excess business loss limitation in the same manner as all other noncorporate businesses.

## **I. Corporate Charitable Contribution Deduction**

Prior to the OBBBA, under §170(b)(2), corporate taxpayers were allowed to deduct charitable contributions up to 10% of taxable income, computed without regard to the charitable contribution itself, NOL carrybacks, and other specified adjustments. Any excess contributions above the 10% cap could be carried forward for up to five years, subject to the same 10% limitation in subsequent years. There was no minimum threshold or floor for deductibility, as even nominal charitable contributions were deductible if within the 10% cap.

The OBBBA amends §170(b)(2)(A) to introduce a new “1% floor” for corporate charitable contribution deductions. In other words, a deduction is allowed only to the extent aggregate contributions exceed 1% of taxable income. This means corporations must now contribute more than 1% of taxable income before any amount becomes deductible. Contributions equal to or below 1% are disallowed for deduction. Further, charitable contributions must not exceed 10 percent of the taxpayer’s taxable income (the “10% limit”). Thus, in the case of a taxpayer that makes aggregate contributions exceeding the 1% floor, the contributions are allowable only for the portion of such contributions exceeding the floor (subject to the 10% limit).

Contributions in excess of the 10% limit may be carried forward to the subsequent five taxable years and are treated as allowed on a first-in, first-out basis. The amount of charitable contributions disallowed under the 1% floor may be carried forward only from years in which the taxpayer’s charitable contributions exceed the 10% limit. Any carryforward is applied after contributions made in the current taxable year for the purposes of the 1% and 10% limit.

This policy change aims to reduce minor or de minimis deductions by requiring a threshold level of charitable giving before corporations may claim a tax benefit. However, it may have a disincentivizing effect on smaller or routine corporate donations that previously benefited from full deductibility under the 10% cap. This provision applies for taxable years beginning after December 31, 2025.

## **J. Paid Family and Medical Leave Credit (IRC §45S)**

Enacted under the TCJA, §45S established a temporary business tax credit for employers providing paid family and medical leave. The credit was scheduled to expire for tax years beginning after December 31, 2025. Employers could claim a general business credit equal to 12.5% of wages paid to qualifying employees during FMLA leave. The credit increased by 0.25 percentage points for each percentage point by which the wage replacement rate exceeded 50%, up to a maximum of 25%. The credit applied for up to 12 weeks of leave per qualifying employee per year.

Under the TCJA written policy was required to be in place, providing:

- At least two weeks of paid FMLA leave for all qualifying eligible employees annually;
- A written policy; and

- A guarantee that at least 50% of wages would be paid to qualifying employees during the leave period.

Additionally, under the TCJA, a qualifying employee was a full- or part-time employee that has:

- Worked for the employer for at least one year; and
- Earned no more than 60 percent of the “highly compensated employee” limit (\$96,000 in 2025).

The credit applied to FMLA leave but other types of leave (e.g., vacation, personal, sick leave) were excluded, and paid leave required or subsidized by state/local governments did not qualify for the credit.

The OBBBA makes the §45S paid family and medical leave credit permanent, effective for tax years beginning after December 31, 2025. Employers may now elect between:

- A credit based on wages paid to qualifying employees (as under prior law); or
- Premiums paid for qualifying insurance policies that provide paid family and medical leave.
- Note: An employer may elect only one method per year, either wages or premiums, not both.

The 12.5% to 25% credit rate structure remains in place, tied to the wage replacement percentage, and the credit remains limited to up to 12 weeks per qualifying employee per year.

Under the OBBBA, paid leave mandated or funded by state or local governments counts toward meeting the eligibility threshold but does not generate a credit. Additionally, under the OBBBA, employers may now elect to treat employees as qualifying if employed for at least six months (formerly one year). Further, the definition of eligible employees is expanded to include those working at least 20 hours per week. Lastly, aggregation rules are clarified to treat employers under §§414(a) and 414(b) as a single employer for credit purposes.

## **K. Employer-Provided Child Care Credit**

Prior to the OBBBA, the employer-provided child care credit provided businesses a nonrefundable tax credit of up to \$150,000 per year on up to 25% of qualified child care expenses provided to employees plus up to 10% of qualified child care resource and referral expenditures. Therefore, an employer had to spend at least \$600,000 on child care related expenses to receive the full \$150,000 credit. Qualified child care expenditures subject to the 25% limit included:

- The costs of acquiring, constructing, rehabilitating, or expanding property used as a qualified child care facility;
- The costs of operating a qualified child care facility (including training costs, certain compensation for employees, and scholarship programs); and
- The costs for contracting with a qualified child care facility to provide child care.

Qualified child care resource and referral service expenditures subject to the 10% limit included:

- Expenses incurred to help employees find child care services.

Under the OBBBA, beginning in 2026, the credit percentage for qualified child care expenditures under §45F increases from 25% to 40% for regular businesses and to 50% for eligible small businesses. The

maximum annual credit increases from \$150,000 to \$500,000 for regular businesses and is further increased to \$600,000 for eligible small businesses, with both limits indexed for inflation beginning in 2027. Under the OBBBA, an eligible small business is defined using a 5-year gross receipts test, instead of the standard 3-year lookback, broadening eligibility. To claim the full \$500,000 credit, a general business must incur at least \$1.25 million in qualifying expenditures. To claim the full \$600,000 credit, a small business must incur at least \$1.2 million in qualifying expenditures.

The credit is also expanded to cover third-party intermediary arrangements and jointly owned or operated child care facilities, offering additional flexibility in structuring child care support. Additionally, the OBBBA permits small businesses to pool resources to jointly operate or finance child care facilities, with each business eligible to claim its proportional share of the credit. These enhancements are effective for amounts paid or incurred after December 31, 2025.

<b>Employer-Provided Child Care Tax Credit (Section 45F)</b>		
<b>Provision</b>	<b>Pre-OBBBA</b>	<b>OBBBA</b>
Maximum Credit	\$150,000	\$500,000
Maximum Credit (Small Businesses)	\$150,000	\$600,000
% of Qualified Child Care Expenses Covered	25%	40%
% Covered (Small Businesses)	25%	50%
Small Business Pooling	No	Yes
Use of Intermediaries Allowed	No	Yes

## **L. Payments from Partnerships to Partners for Property or Services**

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

The OBBBA removes the requirement that recharacterization must occur pursuant to IRS regulations, thereby allowing the IRS to recharacterize qualifying transactions even in the absence of formal guidance. The change does not apply retroactively and is effective for services performed or property transferred after July 4, 2025. This amendment is significant for partnerships and their partners, as it provides the IRS with greater flexibility to challenge partner-level transactions that resemble arm's-length compensation or property sales.

## **M. Form 1099 Reporting Thresholds**

Prior to the OBBBA, under §§6041 and 6041A, the general threshold for filing Forms 1099-MISC and 1099-NEC was \$600. This \$600 reporting threshold applied to a wide range of payments made in the course of a trade or business, including:

- Nonemployee compensation;
- Rents;
- Prizes and awards; and
- Other miscellaneous payments.

Backup withholding under IRC §3406 was triggered if required taxpayer identification information was not provided, applying once the \$600 reporting threshold was met.

The OBBBA enacts substantial and permanent reforms to Form 1099 reporting thresholds, providing long-sought relief for businesses and individuals engaged in low-volume commercial activity. For payments made in the course of a trade or business after December 31, 2025, the general reporting threshold increases from \$600 to \$2,000 under §§6041 and 6041A. This change applies to common payments such as nonemployee compensation, rents, prizes, awards, and other reportable income types made in the course of business.

Beginning in 2027, the \$2,000 threshold is indexed annually for inflation. The backup withholding threshold under §3406 is updated to conform to the new \$2,000 amount, aligning reporting and withholding compliance obligations. This provision reduces the administrative burden and the volume of Form 1099 filings, particularly for businesses making small, infrequent payments to contractors or vendors.

## **N. Form 1099-K Reporting Changes**

A Third Party Settlement Organization (TPSO) is a central organization that has the contractual obligation to make payments to participating payees (generally, a merchant or business) of third party network transactions. For TPSOs, such as payment processors (e.g., PayPal, Venmo, etc.), §6050W originally required filing Form 1099-K only if both of the following conditions were met in a calendar year:

- Gross payments exceeded \$20,000; and
- The number of transactions exceeded 200.

The American Rescue Plan Act of 2021 (ARPA) significantly altered the landscape by lowering the Form 1099-K threshold to \$600 and removing the transaction count requirement entirely, resulting in a substantial expansion of reportable transactions. The ARPA changes were met with industry-wide concern due to the administrative burden and overreporting risks for casual sellers and gig economy participants. Due to implementation difficulties, the IRS delayed full enforcement of the ARPA thresholds, phasing them in as follows:

- \$5,000 for 2024;
- \$2,500 for 2025; and
- \$600 for 2026 and beyond.

Although the IRS delayed the \$600 reporting threshold requirement, the legal requirement for reporting income has not changed, regardless of the reporting threshold for providing a Form 1099-K. Taxpayers are responsible for accurately reporting all income, regardless of whether Form 1099-K (or any other information return, such as Form 1099-MISC or Form 1099-NEC) is received. It is important to note that for payment cards (credit cards, debit cards, gift cards, etc.), there is no threshold amount that has to be met to receive a Form 1099-K due to payments received through a payment card transaction. Therefore, if an individual received \$0.01 of payments from a payment card transaction, they should receive a Form 1099-K for those payments. Additionally, certain states may have a lower reporting threshold for TPSOs, which could result in an individual receiving a Form 1099-K, even if the total gross payments they received in the year did not exceed the federal reporting threshold.

The OBBBA repeals the ARPA changes and restores the original Form 1099-K reporting thresholds, effective retroactively to calendar years beginning after December 31, 2021. Under the restored rule, a TPSO is only required to file a Form 1099-K if both of the following conditions are satisfied:

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

This reversion eliminates the \$600 reporting threshold and removes the transaction minimum introduced by ARPA. The backup withholding rules for TPSOs are also updated to reflect the restored de minimis thresholds. Specifically, backup withholding will only apply if both the \$20,000 and 200-transaction thresholds are met. This change takes effect for calendar years beginning after December 31, 2024.

## **O. Qualified Bicycle Commuting Reimbursement Exclusion**

Prior to the enactment of the OBBBA, §132(f) allowed employers to reimburse employees up to \$20 per month for qualified bicycle commuting expenses as a tax-free fringe benefit. Eligible expenses included costs related to purchasing, maintaining, and storing bicycles used for commuting to work, provided the employee did not also receive other transportation fringe benefits (e.g., parking or transit). This exclusion was suspended for tax years 2018 through 2025 under the TCJA.

Despite its suspension, the bicycle commuting benefit was scheduled to automatically resume on January 1, 2026, allowing for its future reinstatement as an excludable transportation benefit. If reinstated, employer-provided bicycle commuting reimbursements would once again be excluded from an employee's gross income and not subject to payroll taxes.

The OBBBA permanently repeals the §132(f) qualified bicycle commuting reimbursement exclusion, eliminating its scheduled return in 2026. Beginning in 2026 and beyond, any employer reimbursement or allowance for bicycle commuting expenses will be treated as taxable compensation to the employee and must be included in gross income and reported as wages for employment tax purposes. As a result of the repeal, bicycle-related reimbursements will no longer qualify as tax-free transportation fringe benefits, placing them on par with other forms of general compensation.

## **P. Opportunity Zones**

Established by the TCJA, the Opportunity Zone program provided meaningful tax incentives to spur private investment in designated low-income communities (LICs). Low-Income Community (LIC) was defined as a census tract with:

- A poverty rate of at least 20%; or
- Median family income not exceeding 80% of the area's median family income.

States could designate up to 25% of their LICs (or 25 tracts if fewer than 100 existed) as OZs, and adjacent non-LIC (contiguous) tracts could also qualify under certain income constraints.

A Qualified Opportunity Fund (QOF) allowed investors to defer qualified capital gains by reinvesting within 180 days, unlocking three tax benefits:

- Temporary deferral of capital gains until the earlier of sale or Dec 31, 2026;
- Basis step-up: 10% exclusion if held for 5 years, plus an additional 5% if held for 7 years; and
- Permanent exclusion of post-acquisition gains if held for at least 10 years.

The OZ program was scheduled to sunset for new investments after December 31, 2026, with existing benefits expiring thereafter unless the program was renewed.

The OBBBA establishes a permanent OZ policy that builds off of the original OZ structure. This OBBBA provision creates rolling, ten-year OZs that are first designated beginning on July 1, 2026, and available to investors beginning on January 1, 2027. This provision maintains the OZ designation process from the TCJA and narrows the eligibility requirements by updating the definition of an LIC and eliminating the ability for contiguous tracts that are not LICs to be designated as OZs.

Further, the OBBBA narrows the definition of “low-income community” to census tracts that have a poverty rate of at least 20% or a median family income that does not exceed 70% of the area median income. Additionally, under the OBBBA, a “low-income community” cannot include any census tract where the median family income is 125% or greater of the area median family income.

Similar to the OZ policy under the TCJA, taxpayers maintain the ability to temporarily defer the rollover gain and benefit from a permanent exclusion of future gains if the investment is held for at least 10 years, up to 30 years after investment. Another similarity is the 10% reduction that the taxpayer receives in the amount of such gain on the fifth year of the investment. This provision requires taxpayers to recognize their rollover gain on the fifth year after they have received the 10% step-up and repeals the additional 5% reduction in the rollover gain that previously occurred if the investment was held for seven years.

The OBBBA also establishes that a qualified rural opportunity fund (QROF), which is a QOF that invests at least 90 percent in rural OZs, receives more generous tax benefits. Investment in QROFs will receive a step-up in basis equal to 30 percent of the rollover gain, compared to the 10 percent for a non-rural QOF. Additionally, a special rule is created that lowers the “substantial improvement” threshold of existing structures from 100 percent to 50 percent in rural areas. Lastly, the OBBBA adds reporting requirements as well as related penalties for noncompliance for both the QOFs and the qualified opportunity zone businesses. Investors can begin to invest in the newly designated OZs under the new provision beginning on January 1, 2027.

## **Q. Employee Retention Tax Credit (ERTC)**

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

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

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

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

Under the American Rescue Plan Act, the statute of limitations for ERTC assessment was extended to five years as opposed to the standard three-year window.

Due to widespread abuse, especially by ERTC “mills” offering aggressive or misleading services, the IRS implemented a moratorium on processing new ERTC claims on September 14, 2023. The IRS

simultaneously launched a voluntary withdrawal program to allow businesses to retract invalid or unsupported ERTC claims without penalty.

The OBBBA extends the statute of limitations for IRS enforcement actions related to ERTC claims to six years from the date of the claim. This allows the IRS significantly more time to audit, assess, or recover improperly claimed ERTC refunds. The OBBBA creates a provision that applies the 20% penalty for excessive refund claims to include employment tax refund claims. Previously, this penalty applied only to income tax refund claims, leaving a gap for enforcement against improper ERTC refund filings.

The OBBBA bars new ERTC claims filed after January 31, 2024. The OBBBA imposes a \$1,000 penalty per violation on COVID-ERTC promoters who fail to meet due diligence standards in assisting with ERTC claims. A COVID-ERTC promoter is defined as someone advising on ERTC who:

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

Taxpayers should conduct a comprehensive review of all ERTC claims, including:

- Verifying eligibility and wage documentation;
- Ensuring proper adjustment of wage expense deductions;
- Documenting promoter relationships and advice; and
- Preparing for possible IRS review through 2030 or later, depending on claim timing.

## R. Elimination of energy incentives

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

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

# Emerging Trends: Digital Asset Compliance, Artificial Intelligence, and the Gig Economy

<b>Learning objectives</b>	<b>1</b>
<b>I. Cryptocurrency and the Tax Code: Decoding digital assets</b>	<b>1</b>
<b>A. Overview and types of digital assets</b>	<b>1</b>
<b>B. Taxable/nontaxable events</b>	<b>4</b>
1. Compensation	4
2. Mining income	5
3. Rewards	5
4. Airdrops	5
5. Interest income	5
6. Hard forks	5
7. Sales/purchases	6
8. Charitable donations (deductible)	6
9. Receipt of digital assets after purchase from an exchange	6
10. Receiving digital assets as a bona fide gift	7
11. Gifting digital assets	7
12. Self-transactions (transfers between wallets or accounts)	7
13. Receipt of digital assets after coin swap/migration	7
14. Soft forks	7
<b>C. Reporting</b>	<b>7</b>
<b>D. Form 1099-DA and broker reporting</b>	<b>9</b>
<b>E. Digital asset scrutiny</b>	<b>12</b>
<b>II. Artificial intelligence</b>	<b>13</b>
<b>A. Overview</b>	<b>13</b>
<b>B. Automated data entry and categorization</b>	<b>14</b>
1. Income and expense tracking	14
2. Bank and credit card reconciliation	15
3. Data extraction	15
4. Tax form population	15
5. Client data management	15
6. Multi-state compliance	15
7. Benefits	16
<b>C. Predictive analytics for tax planning</b>	<b>16</b>
1. Forecasting tax liabilities	16
2. Identifying tax saving opportunities	17
3. Compliance risk assessment	17
4. Scenario planning	17
5. Cash flow optimization	17
6. Multi-jurisdictional tax planning	17
<b>D. Risks</b>	<b>18</b>
<b>E. Use of AI in the IRS</b>	<b>18</b>
<b>III. The Gig Economy</b>	<b>21</b>
<b>A. Introduction</b>	<b>21</b>
<b>B. Rev. Rul. 87-41</b>	<b>23</b>
<b>C. Three-factor test</b>	<b>24</b>
<b>D. DOL worker classification</b>	<b>30</b>
<b>E. Tax implications</b>	<b>36</b>
1. Reporting income	37
2. Self-employment taxes	38
3. Quarterly estimated taxes	39
4. Deductions	40
5. Other considerations	40



# Emerging Trends: Digital Asset Compliance, Artificial Intelligence, and the Gig Economy

## *Learning objectives*

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

- Identify and apply current IRS guidance and tax reporting requirements for various types of digital asset transactions;
- Evaluate how artificial intelligence can be integrated into tax practice;
- Understand the fundamentals of the gig economy, including its definition and key characteristics;
- Analyze the complexities of worker classification within the gig economy, distinguishing between independent contractors and employees, and evaluating the factors that influence classification status; and
- Evaluate the tax implications of the gig economy for both gig economy workers and platforms.

## ***I. Cryptocurrency and the Tax Code: Decoding digital assets***

### **A. Overview and types of digital assets**

A digital asset is any digital representation of value recorded on a cryptographically secured, distributed ledger (blockchain) or similar technology. Examples of digital assets include convertible virtual currencies and cryptocurrencies such as Bitcoin, stablecoins, and nonfungible tokens (NFTs). A digital asset is stored electronically and can be bought, sold, owned, transferred, or traded.

The IRS defines virtual currency as “a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value.” In some environments, virtual currency operates like “real” currency (i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance), but it does not have legal tender status in any jurisdiction. Convertible Virtual Currency is virtual currency that has an equivalent value in real, tangible currency or acts as a substitute for real currency.

Cryptocurrency is a specific type of virtual currency that uses cryptography to secure transactions. Cryptocurrency is a specific type of virtual currency that uses “cryptography” to validate and secure transactions that are digitally recorded on a distributed ledger or record keeper. A “blockchain” is a chain or blocks that store digital information in a public database, that functions similar to a ledger. The individual blocks making up the chain contain information about transactions including the date, time, and dollar amount of a transaction. The individual block also contains information about the parties participating in a transaction (via unique digital signatures) as well as a unique “hash,” or string of text and numbers, updated for each transaction.

Cryptocurrency transactions are generally pseudonymous as accounts and transactions are not connected to individual identities. As a result, individuals cannot easily connect the identity of a user with an address or transaction. Each transaction on a network must be confirmed by a miner, and once a

transaction is confirmed, it cannot be reversed. Bitcoin is the first and most well-known cryptocurrency, although there are several other cryptocurrencies available.

Nonfungible tokens (NFTs) are a type of digital asset that represents a “real-world” physical asset such as artwork, a musical composition, memorabilia, or film/video.

NFTs have gained popularity in recent years due to many factors, including:

- a. Blockchain Technology;
- b. Digital Ownership;
- c. Metaverse; and
- d. Speculation/Investment.

One fascinating aspect regarding NFTs is that purchasing or owning an NFT does not automatically grant the purchaser copyright or reproduction rights to the underlying digital asset, instead the purchaser only acquires ownership rights to the specific NFT. For example, only one person owns an original Van Gogh piece, but many people can buy print copies of the same piece. Often, the real “value” provided by an NFT is the satisfaction of ownership and the perceived rarity or uniqueness of the asset. Like traditional art, the value of an NFT is determined by what an individual is willing to pay for those ownership rights, making it largely subjective and market-driven.

Similar to cryptocurrencies, NFTs are stored on a blockchain and can be traded or sold. Unlike cryptocurrency, NFTs are non-fungible (hence the name), as they are unique and cannot be exchanged on a one-to-one basis. Each NFT has distinct attributes, whether in the form of art, music, video clips, or other digital content, that makes it different from every other NFT. On the other hand, cryptocurrency is fungible, like fiat currency, as it can be traded interchangeably, and the value is easily determinable.

Metadata associated with the NFT plays a critical role in providing essential information about the token and underlying asset it represents, including but not limited to:

- **Description** – A description of the NFT, including creator details, any historical/contextual information, as well as any details about the edition or specific features of the NFT;
- **Contractual terms** – Any contractual terms/conditions that govern the use, ownership, and transfer of the NFT;
- **Links** – Any links to digital or media files related to the NFT;
- **Ownership history** – Records about the NFT’s previous owners; and
- **Blockchain information** – Information about the blockchain (to verify authenticity of the NFT).

NFT contractual metadata is a key aspect of the NFT ecosystem that provides content creators with the ability to establish specific terms and conditions associated with their digital assets, including ongoing compensation or royalties for secondary sales. To facilitate this, many NFTs are linked to smart contracts that contain metadata that outlines important details about the NFT, such as the creator’s name, a description of the digital asset, and other relevant information.

One of the most valuable aspects of NFTs is that creators and artists are able to receive ongoing royalties as their work appreciates in value. When an NFT is resold in a secondary market, contractual metadata embedded within the smart contract automatically ensures that the original creator receives a percentage of the sale.

Traditionally, in the physical world, once a creator or artist initially sells their content, they are unable to benefit from any further future appreciation in value. With NFTs, creators can program royalties directly into the smart contract, allowing them to automatically receive a percentage of the sale price whenever the NFT is resold on the secondary market. The smart contract ensures that the royalty payment is distributed instantly to the creator's wallet, providing them with a continuous stream of income as the value of their work appreciates over time. This innovative feature can serve as a strong incentive for creators and artists to keep producing high-quality content, knowing that they will continue to benefit financially from their creations long after the initial sale. It is important to note that not all NFT marketplaces support royalties. As such, creators should carefully research platforms that offer this feature to ensure they can take full advantage of ongoing compensation if it is a priority for them.

After years of silence, in March 2023, the IRS announced its intent to issue guidance on the tax treatment of certain nonfungible tokens (NFTs). Notice 2023-27 defines a nonfungible token (NFT) as a unique digital identifier that is recorded using distributed ledger technology and may be used to certify authenticity and ownership of an associated right or asset. When an individual has ownership of an NFT, they hold the right to a digital asset that represents a "real-world" physical asset such as artwork, a musical composition, memorabilia, or film/video. As such, the IRS classifies NFTs as having two parts: the digital file/identifier and the underlying right/asset. NFT ownership may also provide the holder a right with respect to an asset that is not a digital file, such as a right to attend an event/concert or certify ownership of a physical item.

Notice 2023-27 states that the IRS and Department of the Treasury intend to issue guidance related to the treatment of certain NFTs as collectibles under IRC §408(m). Per §408(m)(2), the term "collectible" means:

- a. Any work of art;
- b. Any rug or antique;
- c. Any metal or gem;
- d. Any stamp or coin;
- e. Any alcoholic beverage; or
- f. Any other tangible personal property specified by the Secretary for purposes of this subsection.

**Note:**

Section 408(m)(3) provides that certain coins and bullion are excluded from the definition of collectible.

The IRS intends to determine whether an NFT is a §408(m) collectible by conducting look-through analysis, meaning they will analyze whether the NFT's associated right or asset is a §408(m) collectible. Using look-through analysis methodology, an NFT constitutes a §408(m) collectible if the NFT's associated right or asset is a §408(m) collectible. Utilizing look-through analysis to an NFT to determine if its associated right or asset is a digital file raises the question as to whether the digital file constitutes a "work of art" under §408(m)(2)(A). If considered a "work of art" under §408(m)(2)(A), the NFT would be a §408(m) collectible. The Treasury Department and IRS are currently considering the extent to which a digital file may constitute a "work of art" under §408(m)(2)(A).

As a result of the guidance provided in Notice 2023-27, individuals who sell collectible NFTs could potentially be subject to higher tax rates than individuals who sell non-collectible NFTs. The sale or

exchange of a §408(m) collectible that is a capital asset held for more than one year is subject to a maximum 28 percent capital gains tax rate, whereas other long-term capital assets held for more than one year are subject to a maximum 20 percent capital gains tax rate. Another important consideration is that IRAs are generally prohibited from directly holding certain types of collectibles, which could include NFTs, pending look-through analysis.

## B. Taxable/nontaxable events

While Notice 2023-27 sheds light on the potential tax implications of nonfungible tokens (NFTs), particularly in how they may be classified as collectibles, it's essential to recognize that the IRS has already established general principles for the taxation of digital assets as a whole. Notice 2014-21, later confirmed by Notice 2023-34, establishes that for U.S. federal tax purposes, virtual currency, including digital assets, is considered property rather than currency. As a result, digital assets are subject to general tax principles applicable to property transactions. It is critical for individuals to track the underlying basis of each unit of cryptocurrency in order to correctly calculate any potential gain or loss triggered upon sale or transfer. In a broad sense, cryptocurrency can be taxed as either capital gain/loss or ordinary income/loss.

# DIGITAL ASSET EVENTS

## TAXABLE/(DEDUCTIBLE) EVENTS

- ✓ Receiving compensation
- ✓ Mining income
- ✓ Rewards
- ✓ Air drops
- ✓ Interest income
- ✓ Hard forks
- ✓ Sales/Purchases
- ✓ Charitable donations (deductible)

## NONTAXABLE EVENTS

- ✗ Receipt of digital assets after purchase from exchange
- ✗ Receiving digital assets as a bona fide gift
- ✗ Gifting digital assets
- ✗ Self-transactions (transfer between wallets or accounts)
- ✗ Receipt of digital assets after coin swap/migration
- ✗ Soft forks

### 1. Compensation

As with any other form of compensation, digital assets received as payment for services must be reported as income on Form 1040 and taxed at ordinary income tax rates. This requirement applies to all individuals receiving compensation, including:

- a. Employees (reported on Form W-2);
- b. Independent contractors (reported on Form 1099); and

- c. Others providing services who may not receive a formal tax form.

**Note:**

Even if no Form W-2 or 1099 is issued, the individual is still responsible for reporting the income received (FMV at time of receipt).

## **2. Mining income**

Cryptocurrency miners verify and authenticate cryptocurrency transactions in exchange for cryptocurrency. Professional miners conduct mining activity as part of a §162 trade or business. Professional miners include the FMV of the mined cryptocurrency as ordinary income at the time it is received.

Like any other §162 trade or business, professional miners can deduct mining-related expenses on Schedule C. Hobby miners mine cryptocurrency on a casual basis, and the activity does not rise to the level of a §162 trade or business. Hobby miners must still include the FMV of mined cryptocurrency in their gross income. However, mining-related expenses are not deductible, as the activity does not meet the requirements of a §162 business.

## **3. Rewards**

Unless specifically exempted, the FMV of the digital asset reward at the time of receipt must be included in taxable income. If an individual receives a reward in the form of a digital asset while shopping on an online platform, the individual should err on the side of caution (no clear IRS guidance exists) and include the FMV of the digital asset reward received in taxable income.

## **4. Airdrops**

Airdrops occur when a company distributes a digital asset (most likely cryptocurrency) to an individual's wallet, usually free of charge, and often as a promotional strategy for launching a new cryptocurrency or raising awareness. Sometimes airdrops are unsolicited, and other times individuals may complete small tasks (like sending a tweet) in exchange for the airdrop.

The IRS defines an airdrop as “a means of distributing units of a cryptocurrency to the distributed ledger addresses of multiple taxpayers.” The IRS guidance (Rev. Rul. 2019-24) confirms that individuals are liable for taxes on cryptocurrencies resulting from an airdrop, regardless of whether the cryptocurrency is actually received. Individuals should recognize ordinary income at the FMV of the airdropped cryptocurrency at time of receipt.

## **5. Interest income**

Certain platforms offer users the ability to earn interest on their digital asset holdings. Individuals receiving interest income should report the amount as interest income on Form 1040. If the platform provides a Form 1099-INT or Form 1099-MISC, it can assist with accurate reporting, but even if no form is issued, taxpayers are still responsible for reporting the income.

## **6. Hard forks**

Similar to how computers require software updates or phones require app updates, cryptocurrency networks also require updates in order to improve performance and resolve any known issues. This “update” is often referred to as a “fork” in the cryptocurrency community. Forks arise when there are two different blocks in the same blockchain that have an identical set of blocks preceding it.

In Rev. Rul. 2019-24, the IRS defines a “hard fork” as “unique to distributed ledger technology and occurs when a cryptocurrency on a distributed ledger undergoes a protocol change resulting in a permanent diversion from the legacy or existing distributed ledger. A hard fork may result in the creation of a new cryptocurrency on a new distributed ledger in addition to the legacy cryptocurrency on the legacy distributed ledger. Following a hard fork, transactions involving the new cryptocurrency are recorded on the new distributed ledger and transactions involving the legacy cryptocurrency continue to be recorded on the legacy distributed ledger.”

Sometimes an airdrop occurs after the hard fork, distributing the new cryptocurrency to the individual who owned the original (“legacy”) cryptocurrency. The IRS clarifies that if an individual receives an airdrop of new cryptocurrency resulting from a hard fork and has complete control over the new cryptocurrency, the individual must include the FMV of the new cryptocurrency in ordinary income. If an individual does not receive units of a new cryptocurrency through an airdrop following a hard fork, there is no taxable event.

## **7. Sales/purchases**

As digital assets become more widely accepted, individuals increasingly use them not just as investments, but also for everyday transactions, such as sales and purchases. It is important to understand that both sales and purchases involving digital assets can be taxable events.

When an individual sells digital assets, whether for currency or in exchange for another cryptocurrency, they must recognize a capital gain or loss based on the difference between the FMV at the time of sale and their adjusted basis. This applies whether the digital asset was held as a short-term or long-term investment.

Many people assume that spending digital assets (such as buying coffee with Bitcoin) is not taxable, but that is incorrect. The IRS treats the use of digital assets to buy goods or services as a form of disposal, similar to a sale. As a result, taxpayers must calculate a capital gain or loss based on the difference between the FMV at the time of sale and their adjusted basis.

Currently, no de minimis exception exists for small personal transactions involving digital assets. This means that even minor purchases, like a coffee or a sandwich, purchased using digital assets, must be reported if they result in a gain or loss.

## **8. Charitable donations (deductible)**

When a taxpayer donates digital assets directly to a qualified 501(c)(3) organization, they do not recognize income, gain, or loss on the donation, rather they may take a deduction as follows:

- a. If the individual held the digital assets for **more than a year**, the amount of the charitable deduction is equal to the FMV of the digital assets at the time of donation; or
- b. If the individual held the digital assets for **less than a year**, the amount of the charitable deduction is equal to the lesser of the basis in the digital assets or the FMV of the digital assets at the time of donation.

## **9. Receipt of digital assets after purchase from an exchange**

When an individual purchases a digital asset through an exchange, the receipt of that asset is **not** a taxable event. While no tax is due at the time of purchase, the transaction plays a critical role in tax reporting because it establishes the individual’s cost basis in the digital asset. It is best practice to keep

records of purchase date, amount paid, any exchange/transaction fees, and the wallet/exchange where the asset is stored.

### **10. Receiving digital assets as a bona fide gift**

The receipt of digital assets as a bona fide gift is not considered taxable income to the recipient under §102(a). A bona fide gift is a gift given without the expectation of receiving anything in return. While the gift itself is nontaxable upon receipt, the recipient should carefully document the donor's basis and the FMV at the time of the gift. If the recipient later disposes of the digital asset, either by selling, exchanging, or using it, they may incur a capital gain or loss.

### **11. Gifting digital assets**

The gift of a digital asset is generally not a taxable event for the donor at the time the gift is made. However, if the value of the digital asset gift exceeds the annual gift exclusion limit (\$19,000 for 2025), the donor may be required to file Form 709.

### **12. Self-transactions (transfers between wallets or accounts)**

In the context of digital assets, a self-transaction refers to the act of transferring assets between two wallets or accounts. A self-transaction is not a taxable event, as the individual is still the same beneficial owner of the digital asset.

### **13. Receipt of digital assets after coin swap/migration**

Coin swaps function similarly to stock splits (shareholders receive additional shares, but the overall value of their holdings remains the same), and thus, are not considered a taxable event. However, the individual should allocate basis among the new coins in order to properly calculate basis going forward.

### **14. Soft forks**

A soft fork in the context of digital assets refers to a type of blockchain protocol upgrade or modification that is backward-compatible. A soft fork introduces changes to the protocol that do not invalidate or split the existing blockchain, but rather, update it in a way that does not require all participants to upgrade their software. A soft fork makes the protocol change less disruptive than a hard fork, which often results in the creation of an entirely new blockchain and a new digital asset (coin). A soft fork is generally not taxable because it does not result in the creation of a new asset, nor does it lead to any transfer of ownership or realization of gain.

## **C. Reporting**

As of tax year 2019, taxpayers are required to answer whether, at any time during the tax year, they received, sold, sent, exchanged, or otherwise disposed of any financial interest in virtual currency. Taxpayers who do not properly report the income tax consequences of virtual currency transactions are, when appropriate, liable for tax, penalties and interest. In some cases, taxpayers could be subject to criminal prosecution.

<b>Digital Assets</b>	At any time during 2024, did you: (a) receive (as a reward, award, or payment for property or services); or (b) sell, exchange, or otherwise dispose of a digital asset (or a financial interest in a digital asset)? (See instructions.)	<input type="checkbox"/> Yes	<input type="checkbox"/> No
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As discussed, taxpayers should check “yes” to the digital asset question on Form 1040 if:

- a. They received digital assets for:
  - (i) Payment for property or services provided;
  - (ii) A reward or award;
  - (iii) Mining, staking and similar activities; or
  - (iv) An airdrop as it relates to a hard fork.
- b. They disposed, sold, exchanged, or transferred ownership of digital assets:
  - (i) For another digital asset;
  - (ii) For U.S. dollars or other currency;
  - (iii) In exchange or trade for property, goods or services in any amount;
  - (iv) By paying a transfer fee with digital assets; or
  - (v) By a transfer of ownership or financial interest.
- c. They had a financial interest in a digital asset for which:
  - (i) They are recorded as the owner of a digital asset;
  - (ii) They have an ownership stake in an account that holds one or more digital assets, including the rights and obligations to acquire a financial interest; or
  - (iii) They own a wallet that holds digital assets.

As discussed, taxpayers should check “no” to the digital asset question on Form 1040 if:

- a. They did not own any digital assets;
- b. Only owned or held digital assets in a wallet or account, but did not engage in any digital asset transactions during the year;
- c. Purchased, but did not sell, digital assets using U.S. or other real currency, including through electronic platforms; or
- d. Transferred digital assets from one wallet or account they owned or controlled to another wallet or account they owned or controlled.

**Note:**

An exception applies if a transaction fee was paid with digital assets. This is considered a digital asset transaction.

If the “Yes” box is selected, taxpayers are instructed to report all income related to their digital asset transactions using Form 8949 to calculate their capital gain or loss. Then, taxpayers are to report such income on Form 1040, Schedule D, Schedule 1 if ordinary income, Schedules C, F, or E if the transaction is business related, or Form 709 in the case of gifts.

In addition to checking the “Yes” box, taxpayers must report all income related to their digital asset transactions:

- a. If an investor held a digital asset as a capital asset and sold, exchanged, or transferred it during the tax year, they must use Form 8949, “Sales and other Dispositions of Capital Assets,” to figure their capital gain or loss on the transaction and then report it on Schedule D (Form 1040), “Capital Gains and Losses.”
- b. Similarly, a taxpayer who disposed of any digital asset by gift may be required to file Form 709, “United States Gift (and Generation-Skipping Transfer) Tax Return.”
- c. If an employee was paid with digital assets, they must report the value of assets received as wages.

- d. If an individual worked as an independent contractor and was paid with digital assets, they must report that income on Schedule C (Form 1040), "Profit or Loss from Business (Sole Proprietorship)."
- e. Schedule C is also used by any taxpayer who sold, exchanged, or transferred digital assets to customers in connection with a trade or business.

Below is a table summarizing some of the forms and schedules that taxpayers involved with cryptocurrency should consider when reviewing digital asset reporting obligations.

Digital Asset Compliance						
Form 1040	Schedule 1	Schedule A	Schedule B	Schedule C	Schedule D	Form 8949
<ul style="list-style-type: none"> <li>• "Check the box" question on page 1 of Form 1040</li> <li>• Report Ordinary Income (Wages / Compensation)               <ul style="list-style-type: none"> <li>• Line 1a</li> </ul> </li> <li>• Report Capital Gains / Losses               <ul style="list-style-type: none"> <li>• Line 7</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Report Ordinary Income (Other Income)               <ul style="list-style-type: none"> <li>• Line 8z</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Report Charitable Deductions of Digital Asset donations               <ul style="list-style-type: none"> <li>• Line 12</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Report Interest Income               <ul style="list-style-type: none"> <li>• Part I</li> </ul> </li> <li>• Report Rewards               <ul style="list-style-type: none"> <li>• Part I</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Report income generated as part of §162 trade or business               <ul style="list-style-type: none"> <li>• Line 1</li> </ul> </li> <li>• Deduct any expenses associated with §162 trade or business               <ul style="list-style-type: none"> <li>• Part 2</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Summarize Digital Asset Capital Gains / Losses from Form 8949</li> </ul>	<ul style="list-style-type: none"> <li>• Report Digital Asset gains and losses</li> </ul>

In order to properly report digital asset transactions, taxpayers should maintain adequate records, including, but not limited to:

- a. Adjusted basis in the assets sold;
- b. Description of the asset;
- c. FMV at the time of transaction;
- d. Date/time of transaction;
- e. Type of transaction;
- f. Amount transacted; and
- g. Any transaction fees.

**Example:** John purchased 2 ETH for \$4,000 (\$2,000 per unit) on May 21, 2022. He sold both units for \$8,000 (\$4,000 per unit) on March 9, 2024. John paid \$0.50 in transaction fees.

John's adjusted amount realized is \$7,999.50 (\$8,000 amount realized - \$0.50 transaction fee). John's capital gain is \$3,999.50 (\$7,999.50 adjusted amount realized - \$4,000 basis).

## D. Form 1099-DA and broker reporting

In July 2024, TIGTA released a report regarding virtual currency tax compliance.<sup>1</sup> From April 2020 through July 2023, the number of types of virtual currency has grown from 5,000 to over 26,000. Without information reporting documents, the IRS has been unable to use some of its enforcement tools to match reported virtual currency-related income to taxpayers' tax returns to ensure that taxpayers are accurately reporting their income generated from virtual currencies and other digital assets.

Form 1099-DA, "Digital Asset Proceeds From Broker Transactions," is an IRS tax form introduced to enhance transparency and compliance in the reporting of digital asset transactions, including cryptocurrencies and nonfungible tokens (NFTs). This form is part of a broader effort to standardize tax reporting for digital assets.

<sup>1</sup> TIGTA Virtual Currency Tax Compliance Enforcement Can Be Improved. July 10, 2024. Report Number: 2024-300-030.

Prior to the introduction of Form 1099-DA, digital asset transactions lacked standardized reporting. Some exchanges issued Form 1099-MISC, others issued Form 1099-B, and others did not issue any tax forms. Form 1099-DA requires digital asset brokers to report key details of digital asset transactions, such as proceeds, cost basis, and acquisition/sale date. A U.S. digital asset broker (broker) is a U.S. person (other than a foreign branch or office of such person), or a U.S. branch described in Regulations Section 1.1441-1(b)(2)(iv) that is treated as a U.S. person (excluding a territory financial institution) that effects sales of digital assets on behalf of others.

On November 15, 2021, former President Biden signed into law The Infrastructure Investment and Jobs Act (IIJA), containing provisions that significantly expand cryptocurrency reporting requirements for digital asset transactions. Section 80603 of the IIJA made significant changes to the broker reporting provisions under §6045 to clarify the rules regarding how certain digital asset transactions should be reported by brokers, and to expand the categories of assets for which basis reporting is required to include all digital assets.

Notably, the IIJA included a provision related to broker reporting of digital asset transactions. The IIJA intended to expand the reporting requirements to cover cryptocurrency and other digital assets to enhance tax compliance and improve the ability of the IRS to track and collect taxes on transactions involving these assets. Brokers are required to report to the IRS and furnish statements to customers detailing gross proceeds from digital asset sales, adjusted basis, and whether gains or losses are long-term or short-term. The reporting of cost basis and holding period information is mandated for transactions occurring on or after January 1, 2026.

In late 2024, the U.S. Treasury Department finalized regulations implementing broker reporting requirements. The final rules clarified that the reporting obligations would apply to custodial brokers and certain decentralized finance (DeFi) platforms that provide trading front-end services. Under the final rules, these brokers were to report digital asset transactions starting in 2025, with the reporting of cost basis and holding period information commencing in 2026.

However, in April 2025, President Trump signed a bill nullifying a revised IRS rule that sought to classify decentralized cryptocurrency exchanges (DeFi) as brokers. The amendment, finalized in late 2024, aimed to increase tax compliance among crypto users by expanding the IIJA provisions. The cryptocurrency industry opposed the IRS revision, arguing that DeFi platforms, which enable peer-to-peer transactions without intermediaries, lack the necessary user data to meet reporting requirements.

In January 2025, the IRS released the final version of Form 1099-DA and accompanying instructions which provide information for brokers to use to complete Form 1099-DA for each sale a broker has effected in 2025. As discussed, brokers are not required to report basis information with respect to sales effected in 2025. The broker may voluntarily report basis information. For any basis information voluntarily reported by the broker, the broker will not be subject to penalties under §6721 or 6722 for failure to report or furnish the information correctly. For each sale a broker has effected for customers on or after January 1, 2026, of digital assets that are covered securities, the broker must complete Form 1099-DA.

CORRECTED (if checked)

FILER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.		Applicable checkbox on Form 8949	OMB No. 1545-2330  <div style="text-align: center; font-size: 24pt; font-weight: bold;">2025</div> Form 1099-DA	<b>Digital Asset Proceeds From Broker Transactions</b>
FILER'S TIN                      RECIPIENT'S TIN		1a Code for digital asset		
RECIPIENT'S name		1b Name of digital asset		
Street address (including apt. no.)		1c Number of units		<b>Copy B For Recipient</b>
City or town, state or province, country, and ZIP or foreign postal code		1d Date acquired	1e Date sold or disposed	
Account number		1f Proceeds \$	1g Cost or other basis \$	
CUSIP number		1h Accrued market discount \$	1i Wash sales loss disallowed \$	
5 Check if loss is not allowed based on amount in 1f <input type="checkbox"/>	6 Gain or loss: <input type="checkbox"/> Short-term <input type="checkbox"/> Ordinary <input type="checkbox"/> Long-term	2 Check if basis reported to IRS <input type="checkbox"/>	3a Reported to IRS: <input type="checkbox"/> Gross proceeds <input type="checkbox"/> Net proceeds	
9 Check if digital asset is a noncovered security <input type="checkbox"/>		3b Check if proceeds from: <input type="checkbox"/> Reserved for future use <input type="checkbox"/> QOF		
10		4 Federal income tax withheld \$	8 Check if broker relied on customer-provided acquisition information <input type="checkbox"/>	
11b If 11a checked, number of transactions	11c For aggregate reporting of specified NFTs, aggregate gross proceeds reported in 1f that are attributable to first sales by creator or minter \$	7 Check if 1f is only cash <input type="checkbox"/>	11a Check if gross proceeds reported in 1f is an aggregate amount for: <input type="checkbox"/> Qualifying stablecoins <input type="checkbox"/> Specified NFTs	
14 State name		12a Number of units transferred in		
15 State identification no.		12b If transferred in, provide transfer-in date		
16 State tax withheld \$		13		

Form **1099-DA**                      (Keep for your records)                      www.irs.gov/Form1099DA                      Department of the Treasury - Internal Revenue Service

Per form instructions, a broker includes “any person who, in the ordinary course of a trade or business, stands ready to effect sales of digital assets to be made by others.” An individual/entity is considered a broker with respect to sales of digital assets if:

- a. They are a person that regularly offers to redeem digital assets that were created or issued by them; or
- b. They effect dispositions of customers’ digital assets as an agent, a dealer, or digital asset middleman.

Generally, only a U.S. digital asset broker is required to report on Form 1099-DA. Typically, each transaction is reported on a separate Form 1099-DA. Brokers have an option to report on an aggregated annual basis rather than on a transactional basis for certain stablecoins and NFTs.

Form 1099-DA instructions specifically state that the sales of each of the following types of digital assets should be reported on a separate Form 1099-DA, even if all four types were sold in a single transaction:

- a. Covered securities with short-term gain or loss.
- b. Covered securities with long-term gain or loss.
- c. Noncovered securities if box 9 is checked when reporting their sale. If box 9 was not checked, the sale is reported as the sale of a covered security.
- d. First sales by a creator or minter if the sales of specified NFTs are reported using the optional reporting method for specified NFTs.

The Form 1099-DA instructions clarify that if a broker effected a sale of a digital asset that is also a security for which the Form 1099-B would be required (otherwise known as a dual classification asset), the broker should generally file Form 1099-DA and not Form 1099-B. The instructions also clarify that rewards and staking payments should not be reported on Form 1099-DA.

## **E. Digital asset scrutiny**

Although Form 1099-DA streamlines reporting, taxpayers should keep their own detailed records of digital asset transactions to resolve any discrepancies that may arise during tax reporting. The IRS has significantly intensified its scrutiny of digital asset transactions in recent years, implementing various measures to enhance tax compliance and reporting accuracy.

As discussed, as of 2019, the IRS added a question about virtual currency to Form 1040, Schedule 1, asking whether taxpayers had received, sold, sent, exchanged, or acquired virtual currency. Per a recent TIGTA report, from TYs 2019 to 2022, the IRS processed over 662 million Form 1040s, with nearly 12.6 million taxpayers self-reporting digital asset activity. The number of taxpayers answering “Yes” increased significantly, increasing 649 percent from 2019 to 2021, then dropping to 2.7 million in 2022, but still representing a 202 percent increase over 2019.<sup>2</sup>

Some IRS business units use the digital asset question in combination with other data to identify compliance risks, especially during audits. Incorrect answers (e.g., saying “No” while evidence shows digital asset use) raise red flags, but are difficult to act on without being able to validate external data sources. In 2023, the IRS expanded the digital asset question to other tax forms, including Form 1065, Form 1120, Form 1120-S, and Form 709. This expansion is meant to improve compliance and enforcement in digital asset reporting by collecting more information from different types of entities.

In 2021, the IRS launched “Operation Hidden Treasure,” a joint effort between the IRS Criminal Investigation Division and the IRS Office of Fraud Enforcement (OFE). The main goal of this initiative is to seek out fraud and uncover omitted income related to cryptocurrency. The IRS trained 200 employees across all business divisions to address noncompliance related to cryptocurrency. Through this training, the employees became knowledgeable about cryptocurrency and how to spot issues when examining returns. These employees were in addition to the in-house experts in the OFE and IRS Criminal Investigation Division.

One goal of the Operation Hidden Treasure initiative was to determine whether there is a common, recognizable tax evasion pattern amongst digital asset holders. An example of this is structuring a series of transactions, each under \$10,000, to avoid reporting requirements. The OFE planned to create a virtual

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<sup>2</sup> TIGTA Virtual Currency Tax Compliance Enforcement Can Be Improved. July 10, 2024. Report Number: 2024-300-030.

currency network to assist with tracking cryptocurrency basis and computing gain. This network would not only help train IRS employees but also generate insightful data about cryptocurrency transactions.

Although initially criticized for lack of direct enforcement, this initiative laid the groundwork for future enforcement by:

- a. Acquiring forensic tools;
- b. Training IRS agents; and
- c. Building internal expertise in blockchain auditing.

The IRS Criminal Investigation (CI) has opened hundreds of crypto-related investigations, targeting unreported gains, mixing service, wash trading, and offshore wallets. Additionally, in recent years, the IRS ramped up their cryptocurrency compliance efforts through the use of “John Doe” summonses. The IRS has used this tool to demand records from exchanges like Coinbase, Kraken, and Poloniex. This allows the IRS to identify individuals who failed to report taxable crypto income. More summonses are likely as the IRS seeks to validate data with taxpayer filings.

In summary, the IRS’s scrutiny of digital assets is not a passing phase, rather it is a long-term strategic initiative. It is essential for taxpayers to:

- a. Keep accurate records;
- b. Understand new reporting requirements; and
- c. Stay informed about IRS guidance and enforcement trends.

Taxpayers who do not properly report the income tax consequences of virtual currency transactions are, when appropriate, liable for tax, penalties, and interest. In some cases, taxpayers could be subject to criminal prosecution.

Not to insinuate all cases qualify; however, practitioners must remember virtual currency is an ongoing focus area for IRS Criminal Investigation. **Should practitioners find themselves dealing with a Criminal Investigation case, they should seek proper legal counsel**

## ***II. Artificial intelligence***

### **A. Overview**

Artificial Intelligence tools are revolutionizing the tax industry, transforming the way tax professionals manage compliance, planning, and advisory services. As AI technology continues to evolve, it presents both opportunities and challenges for tax professionals looking to stay ahead in a rapidly changing regulatory environment.

Artificial Intelligence (AI) attempts to simulate human intelligence in machines that are designed to think, learn, and solve problems like a human. AI is the umbrella term that covers all tools, technologies, and systems designed to simulate human intelligence. Generative AI (GenAI) emulates the structure and characteristics of input data to generate derived synthetic content, such as images, video, audio, text, and other digital content. A popular and commonly used example of GenAI is ChatGPT.

Machine Learning (ML) is a subset of AI where computers learn from data, improve over time through experience, and make predictions without being explicitly programmed. A widely known example of ML is the Netflix recommendation system. Robotic Process Automation (RPA) involves automating repetitive, rule-based tasks through AI-powered bots, increasing efficiency in data entry and task management. RPA often works “behind the scenes,” but many individuals unknowingly use RPA when using an auto-pay feature. RPA can check due dates and schedule/confirm payment.

Optical Character Recognition (OCR) is a technology that converts different types of documents, such as scanned paper documents, PDFs, or images captured by a digital camera, into editable and searchable data. Individuals use OCR when scanning receipts or documents using their phone’s camera. Natural Language Processing (NLP) allows computers to understand, interpret, and generate human language. It is commonly utilized in tools such as chatbots, translation tools, and speech recognition systems. Individuals use NLP when using voice assistants like Siri or Alexa.

## **B. Automated data entry and categorization**

As Artificial Intelligence technology rapidly evolves, it offers significant opportunities to enhance compliance, planning, and advisory services while also posing unique challenges. Automated data entry and categorization tools will become increasingly essential tools for tax professionals, helping streamline workflows, reduce manual errors, and improve efficiency. By utilizing various AI tools, one can automatically extract, classify, and organize financial data from various sources, such as receipts, invoices, tax forms, and bank statements.

Common Uses of Automated Data Entry and Categorization include:

- a. Income and Expense Tracking;
- b. Bank and Credit Card Reconciliation;
- c. Data Extraction;
- d. Tax Form Population;
- e. Client Data Management; and
- f. Multi-State Tax Compliance.

### **1. Income and expense tracking**

OCR can assist in converting paper receipts, scanned invoices, and bank statements into digital, searchable data. RPA can assist in automating data entry and categorization into tools such as QuickBooks or Excel. For example, an RPA bot could log into a bank portal, download statements, import transactions, and apply preset rules (i.e. rent deposits are categorized as “rental income”). NLP can assist in understanding descriptions or notes in emails and classifying the notes into income/expenses. Lastly, ML can learn from patterns to automate future categorization. For example, ML may learn over time how a client typically categorizes meals vs. entertainment.

AI tools can also automatically analyze and categorize transactions, as well as distinguish between tax-deductible and non-deductible expenses. AI not only analyzes the transaction amount; it also processes contextual information, such as the descriptions in transaction details or notes, to ensure each entry is classified correctly. AI tools can even assist in mapping different income streams to the correct tax reporting forms (like Schedule C, Schedule E, or 1099 forms).

## **2. Bank and credit card reconciliation**

OCR can extract data from bank and credit card statements that are in PDF or image formats. OCR scans these statements, extracts key details like transaction date, amount, and merchant/vendor, and converts it into a structured, usable format. RPA bots automate the data transfer from bank and credit card accounts to the accounting or tax software. RPA can also automatically match transactions from bank and credit card statements with existing records in the accounting system (e.g., invoices, receipts), streamlining the reconciliation process.

NLP can help interpret and categorize transactions that have descriptive text in bank and credit card statements, such as merchant names or descriptions. For example, NLP may learn from past patterns and tag “Uber” as business travel. ML models improve the accuracy of bank and credit card reconciliations over time by learning from past transactions. As more data is processed, ML algorithms can auto-categorize transactions and flag anomalies or duplicates.

## **3. Data extraction**

OCR can extract data from scanned or image-based documents like W-2s or 1099s. OCR can extract the payer’s name, amount paid, and tax withheld, making it ready for tax prep software. Similarly, RPA bots can download forms such as W-2s, extract the key fields, and import them into a tax preparation platform. ML improves the accuracy of extraction over time by learning from past documents and corrections. It can recognize patterns in tax forms (like box numbers and expected values) and flag any anomalies.

## **4. Tax form population**

Similar to extraction tools, RPA can automatically fill out fields in tax forms such as 1099s, W-2s, and other IRS forms based on financial data for tax professionals. OCR can extract data from scanned or paper-based documents like W-2s or 1099s and use such data to auto-fill tax forms. RPA bots can take extracted data and populate the correct lines in various tax forms. ML improves the form population process by learning from past returns, identifying patterns in how specific clients’ data is mapped, and predicting where new data should go, even when information is less structured or incomplete.

## **5. Client data management**

OCR enables professionals to digitize paper records, such as tax forms or signed engagement letters, by extracting relevant client information and converting it into searchable, editable formats. This helps build and update client profiles without manual data entry. RPA can automate routine admin tasks like importing client data from emails or portals and updating client records across systems. NLP helps extract data from unstructured sources, such as emails, and turn these notes into actionable info that can update client profiles. For example, a client sends an email saying, “I got married in September and changed my last name.” NLP recognizes the life event and flags the profile for a filing status update. ML helps identify data patterns and gaps in client files. It can suggest missing documents, predict which forms a client may need based on past returns, and personalize document requests or checklists based on past behavior.

## **6. Multi-state compliance**

OCR helps digitize and extract relevant data from state-specific tax documents, such as sales tax reports. This ensures accurate capture of location-specific data. NLP reads and understands unstructured data such as client notes or emails that mention new business activities, remote employees, or out-of-state sales. It helps flag potential nexus events that trigger tax obligations in new states. ML learns from previous filing patterns and client behavior to anticipate new filing requirements or recognize missing

state forms. It may also help with threshold tracking, such as monitoring sales levels that trigger economic nexus in specific states.

## 7. *Benefits*

Implementing automation offers numerous advantages to tax professionals and firms, including:

- a. **Increased efficiency**, which:
  - (i) Significantly reduces the time spent on manual data entry and categorization; and
  - (ii) Frees up focus for strategic advisory work.
- b. **Improved accuracy**, which:
  - (i) Minimizes human error and ensures precise tax calculations; and
  - (ii) Reduces the likelihood of compliance issues due to misclassifications.
- c. **Cost savings**, which:
  - (i) Decrease administrative costs and improves overall profitability; and
  - (ii) Allows firms to scale operations without increasing headcount decision-making.
- d. **Compliance and audit readiness**, which:
  - (i) Ensures proper documentation and categorization for tax audits; and
  - (ii) Facilitates easy retrieval of financial records during audits.

## C. **Predictive analytics for tax planning**

Predictive analytics is transforming tax planning by enabling professionals to analyze historical data, identify trends, and forecast future tax liabilities with greater accuracy. By leveraging ML algorithms, AI, and big data analytics, predictive models can help tax professionals and businesses make informed decisions, optimize tax strategies, and improve compliance.

Predictive analytics can be applied in various aspects of tax planning to improve efficiency and decision-making. Some common use cases include:

- a. Forecasting tax liabilities;
- b. Identifying tax-saving opportunities;
- c. Compliance risk assessment;
- d. Scenario planning and simulations;
- e. Cash flow optimization; and
- f. Multi-jurisdictional tax planning.

### 1. *Forecasting tax liabilities*

Predictive analytics can analyze past tax returns for historical income, deductions, and credits to project future tax obligations. Additionally, it can help businesses and individuals estimate quarterly and year-end tax payments to avoid penalties and assist in business cash flow forecasting. Predictive analytics can also provide scenario modeling based on changes in income, deductions, or tax law updates. Overall, predictive analytics helps provide year-round visibility, enabling proactive adjustments.

Some benefits of forecasting tax liabilities with predictive analytics include:

- a. Providing clients with a more accurate forecast of taxes owed;
- b. Identifying any potential issues/surprises early;
- c. Having additional time to plan strategies to mitigate potential liabilities; and
- d. Enabling better cash flow management by planning for tax payments.

## **2. Identifying tax saving opportunities**

Machine learning models can review past returns to detect patterns of underutilized deductions (e.g., credits for research and development, state tax credits, or charitable contributions). Modeling can demonstrate the impact of potential tax law changes, such as new credits or deductions, to taxpayers.

Some benefits of identifying tax-saving opportunities with predictive analytics include:

- a. Alerting taxpayers to overlooked deductions;
- b. Suggesting timing strategies, such as accelerating or deferring income/expenses for tax optimization; and
- c. Recommending proactive changes based on prior year filings, industry benchmarks, or recent tax law changes.

## **3. Compliance risk assessment**

Predictive analytics can assess the risk of non-compliance with tax regulations by analyzing past tax filings and identifying patterns that could trigger audits or scrutiny from the IRS. Specifically, AI can analyze previous tax filings for errors, inconsistencies, or unusual tax positions to identify areas where tax compliance could be at risk. Utilizing AI can reduce audit risk by identifying and addressing potential red flags prior to submission.

## **4. Scenario planning**

Practitioners can utilize AI to simulate the potential impact of different tax strategies (e.g., deferring income or accelerating deductions). What-if scenarios allow taxpayers to see how changes in factors like income levels, tax rates, or business deductions will impact their tax burden. Scenario planning brings value to taxpayers by helping them make informed decisions through understanding the tax impact of each potential strategy.

Taxpayers often appreciate scenario planning, especially visual tools and reports, to help understand the impact of major decisions.

**Example:** A client asks whether to sell an investment property this year or next. The CPA runs simulations for both years and shows how deferring the sale could reduce their tax liability due to an expected drop in income.

## **5. Cash flow optimization**

Predictive analytics can play a role in optimizing cash flow by forecasting when tax payments will be due, based on projected profits, tax liabilities, and anticipated expenses. AI models analyze cash inflows and outflows, factoring in revenue forecasts, seasonal fluctuations, and tax obligations. By forecasting future tax liabilities, businesses can optimize their financial decisions, ensuring they have sufficient cash reserves when estimated payments are due.

## **6. Multi-jurisdictional tax planning**

Predictive analytics evaluates the tax impact of operating in different jurisdictions, while considering state and local tax laws. AI and machine learning models can analyze the tax implications of different business structures (e.g., subsidiaries, partnerships, etc.) and help determine the most tax-efficient way to operate in each jurisdiction. AI can also assist remote workers with residency-based tax impacts, as well as support business taxpayers with state apportionment and sales tax forecasting.

## D. Risks

While there are many benefits to utilizing AI technology, certain risks exist, including:

- **Data privacy and security concerns** – AI systems rely on sensitive financial and personal data. Inadequate data protection or third-party tool vulnerabilities can expose sensitive information to breaches.
- **Overreliance on automation** – Relying too heavily on AI without human oversight can lead to missed errors, overlooked nuances, or improper tax treatment in complex scenarios.
- **Inaccurate or biased outputs** – AI and ML models are only as good as the data they're trained on. Incomplete or biased data can lead to incorrect predictions or recommendations.
- **Regulatory and compliance risks** – Tax laws change frequently, and if AI tools aren't properly updated or monitored, they may apply outdated rules, leading to compliance issues or incorrect filings.
- **Lack of transparency** – Some AI tools offer limited insight into how conclusions are reached, making it difficult to validate or explain decisions to taxpayers or auditors.
- **Ethical and professional liability** – Even when using AI, tax professionals remain ethically and legally responsible for filings.

## E. Use of AI in the IRS

While it's important for tax professionals to understand the risks of using AI in practice, it's equally important to recognize that AI isn't just a tool for tax preparers; it is also being adopted by the IRS itself. In recent years, the IRS has significantly expanded its use of AI and advanced data analytics to detect tax fraud, identify high-risk returns, and prioritize audits more effectively.

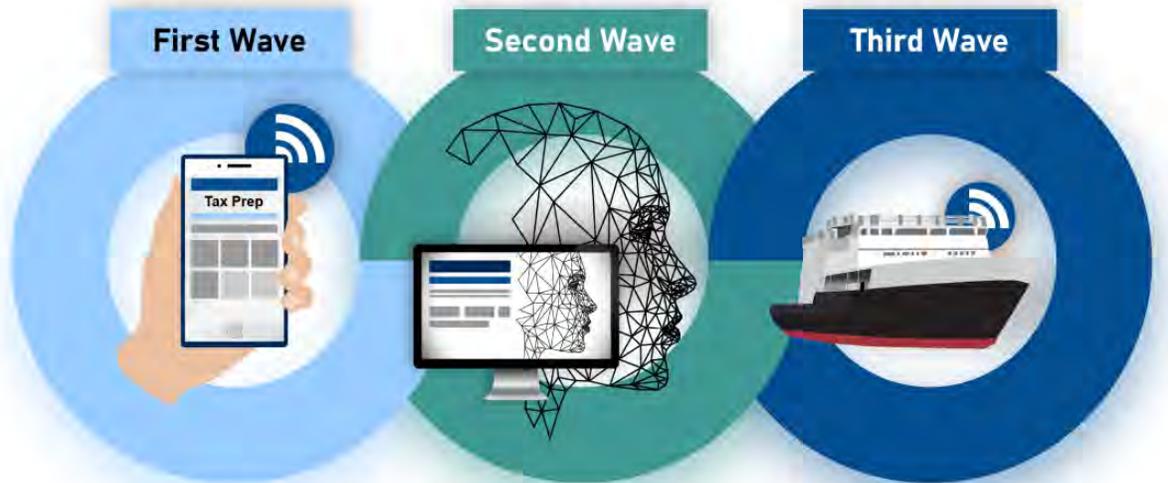
In a December 2023 report, the GAO reviewed the implementation of AI at major federal agencies, including the Department of the Treasury.<sup>3</sup> Per the GAO, there are three distinct "waves" of AI:

1. **First wave of AI systems** – These are rules-based systems whereby a computer was programmed based on expert knowledge and logical reasoning, as well as produced outputs consistent with its programming.
2. **Second/current wave of AI systems** – These are systems based on machine/statistical learning that begins with data and infers rules or decision procedures to predict specified outcomes.
3. **Third wave of AI systems** – These are the future systems of AI that will combine the strengths of the first and second waves, while also being capable of contextual adaptation with sophistication, abstraction, and explanation.

Third-wave AI systems will not only be capable of adapting to new situations but will also explain to users the reasoning behind these decisions.

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<sup>3</sup> GAO-24-105980.



**First Wave**  
**Expert knowledge or criteria and logical reasoning**

The first wave of artificial intelligence (AI) is represented by expert knowledge or criteria developed in law or other authoritative sources and encoded into a computer program in the form of an expert system.

**Example: Online tax preparation**

**Second Wave**  
**Machine/statistical learning**

Second-wave AI technology is based on machine learning, or statistical learning, and includes voice recognition, natural language processing, and computer-vision technologies, among others.

**Example: Face recognition technology**

**Third Wave**  
**Contextual adaptation**

Third-wave AI technology combines the strengths of first-and second-wave AI, and is also capable of contextual sophistication, abstraction, and explanation.

**Example: Autonomous ships**

Sources: The Defense Advanced Research Projects Agency Information, GAO (monitor, hand, ship), lidia/stock.adobe.com (wireframe). | GAO-24-105980

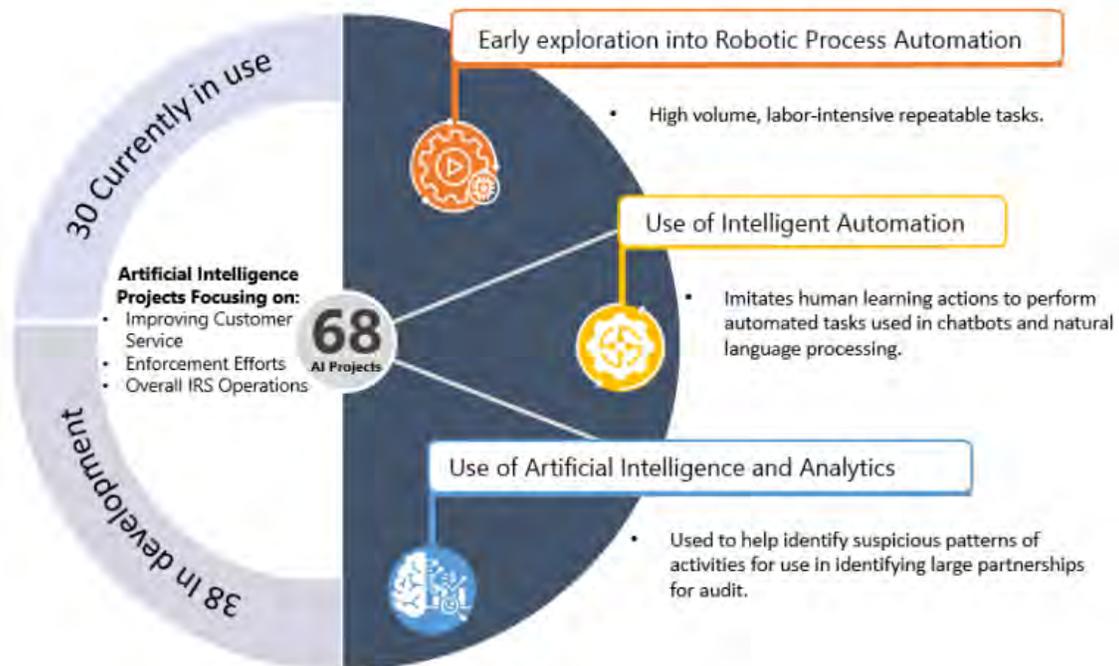
4

The IRS has been working with AI-like technology since as early as 2008 and continues to expand on its use of AI in recent years. Specifically, the IRS has been leveraging AI-related technology in the following ways:

- **Robotic process automation** – The IRS uses RPA software to perform high-volume, labor-intensive, repeatable tasks.
  - Utilizing RPA technology allows employees to focus on higher value-added work while the software performs the repetitive work.
  - RPA can increase quality, reduce human error, increase compliance, and strengthen control environments.
- **Use of intelligent automation** – This technology imitates human learning actions to perform automated tasks used in chatbots and natural language processing.
  - As an example, the IRS developed a Collection chatbot (that has since handled over 450,000 interactions) that was launched in 2021 to provide taxpayers with self-service assistance for common questions, such as payment information.
- **Use of AI and analytics** – The IRS uses AI and analytics to identify patterns and trends in the nation’s largest partnerships, and open examinations on large hedge funds, private equity groups, real estate investors, and law firms.

4 GAO-24-105980.

As of February 2, 2024, the IRS reported 68 projects involving AI:<sup>5</sup>



Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of IRS AI projects.

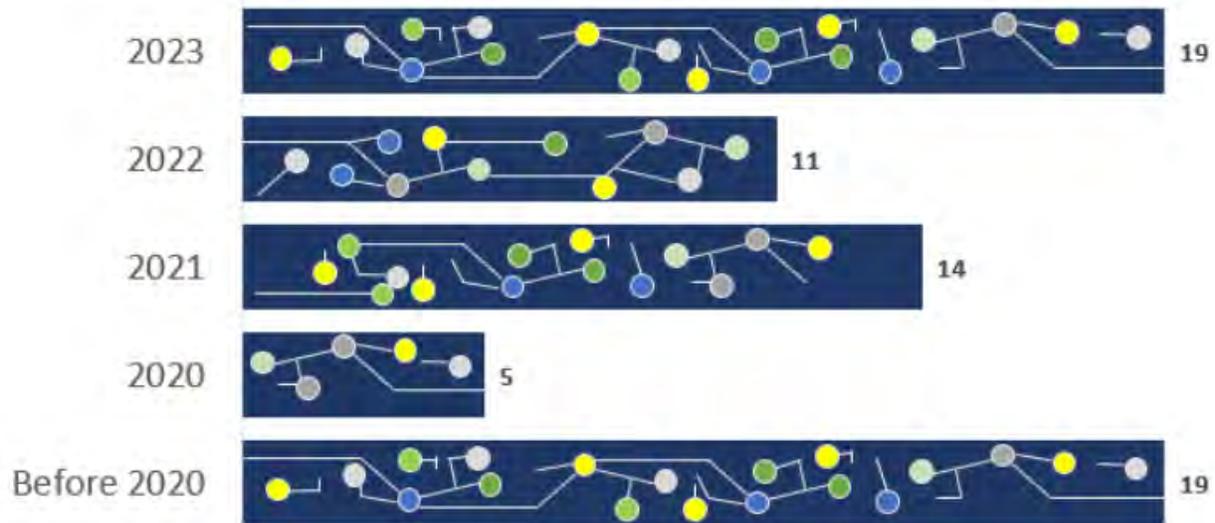
These 68 projects that involve the use of AI models to improve IRS operations can be broken into the following categories:

- **Customer Service (12 projects)** – These projects focus on tools like chatbots to assist taxpayers with FAQs.
- **Enforcement (27 projects)** – These projects focus on IRS enforcement initiatives.
  - An example of an enforcement project is the Issue Recommender F1040 Classification Model that automates the identification of anomalous line items of Form 1040 returns and recommends an appropriate grade level examiner to audit the return.
- **Operations (29 projects)** – These projects focus on improving overall IRS operations, such as gaining insights to improve future examinations and outcomes.

Many of the 68 projects have been initiated since 2020, with the most projects to date initiated in 2023.<sup>6</sup>

<sup>5</sup> TIGTA Report Number: 2025-IE-R003.

<sup>6</sup> TIGTA Report Number: 2025-IE-R003.



Source: TIGTA analysis of IRS AI projects.

All 68 projects fall within the GAO’s first and second “waves” of AI development. While many IRS projects involve systems that can train themselves after an initial dataset, they are not able to explain the reasoning behind outputs of the process. Many of the projects are focused on tax compliance initiatives for high-income earners, partnerships, large corporations, and promoters. Further, 82 percent of the projects are internal projects supporting IRS operations, while 18 percent of the projects support taxpayers.

One example of an IRS project is the IRS Large Partnership Compliance Model. The IRS developed this model in response to the growing number of large, complex partnership returns. This model prioritizes returns for classification and provides information to audit teams about the potential noncompliance risks identified in the returns. The Large Partnership Compliance Model uses multiple indicators of risk for noncompliance that are based on accounting rules, tax law, and a machine learning algorithm. The return scores are then weighted according to the degree of importance assigned to each metric by IRS’s subject matter experts. The results are combined and used to classify the risk of noncompliance for each return as very low, low, medium, high, or very high. In April 2023, the IRS utilized the Large Partnership Compliance Model for the first time to identify 150 large partnership returns from tax year 2021 for additional review by classifiers.

### III. The Gig Economy

#### A. Introduction

The gig economy represents a labor market characterized by short-term, flexible, and freelance work arrangements. Within the gig economy, jobs are typically temporary or project-based, with individuals offering services or completing tasks for various clients or companies. Digital platforms and apps play a crucial role in facilitating work in the gig economy, connecting gig workers with potential clients or employers. Common examples of gig economy labor encompass roles such as ridesharing drivers, food delivery drivers, grocery shoppers, freelance writers, graphic designers, and other independent contractors. It is common for individuals to utilize multiple platforms to offer their services, contributing to the dynamic and ever-evolving nature of the gig economy.

The gig economy has grown significantly in recent years for several reasons, such as:

- **Technological Advancements:** The growth of digital technology and apps has made it easier for workers to connect with popular gig economy platforms.
- **Flexibility:** Gig work provides individuals with the flexibility of when and where they work, easily adapting to changing lifestyles and preferences.
- **Economic Circumstances:** For some individuals, gig work is a response to economic circumstances, providing a source of income in a challenging job market or an additional source of income to another job.

Common examples of gig economy work include:

- Driving a vehicle for scheduled rides;
- Driving a vehicle for scheduled deliveries of food or goods;
- Renting out property or a portion thereof;
- Completing errands or tasks for an individual;
- Renting equipment;
- Selling merchandise or other goods online;
- Providing professional or creative services; and
- Engaging in other temporary, on-demand, or freelance assignments.

The 2022 "Freelance Forward" report by Upwork reported that the freelance / gig economy workforce represented 39% of the total workforce, increased from 36% of the workforce in 2021. The same report highlighted that freelance/gig economy workers contributed \$1.35 trillion to the U.S. economy in annual earnings in 2022, a substantial increase from \$50 billion in 2021. According to the Statista Research Department, as of December 18, 2023, there were 57.3 million freelancers working in the U.S., with an average weekly workload ranging from 11 to 30 hours. These statistics underscore the rising prominence of gig work, reflecting its popularity as a flexible and accessible form of employment.

Gig Economy Platforms provide a digital marketplace where individuals can offer their services (such as driving, delivering food, or grocery shopping), to users seeking those services. Examples of popular Gig Economy Platforms include Uber, Lyft, DoorDash, Instacart, AirBnB, and TaskRabbit. Acting as intermediaries, these platforms connect gig economy workers with consumers seeking specific services. Gig Economy Platforms typically do not directly employ gig workers but rather act as facilitators of transactions between the gig workers and consumers. As a result, individuals who work for these platforms are generally classified as independent contractors rather than traditional employees. This means they are not employees of the Gig Economy Platform provider, but instead work independently and have greater autonomy over their work schedules and operations.

With the expansion of the gig economy, it has become increasingly important for all small businesses to understand and correctly apply the rules related to classifying workers as either employees or independent contractors. Misclassifying an employee as an independent contractor can result in significant tax consequences, including penalties and interest, as well as legal liability for the employer. Workers who are misclassified may incur liability for self-employment taxes or denial of business-related deductions. As a result, understanding and accurately applying worker classification rules is crucial for both businesses and workers alike.

## B. Rev. Rul. 87-41

The determination of whether an individual is an independent contractor or employee is based on the facts and circumstances of his or her specific situation. In 1987, the IRS issued Rev. Rul. 87-41, providing guidance on the classification of workers as employees or independent contractors for federal employment tax purposes. This ruling outlines 20 factors that may be considered in determining worker classification. It is important to note that no single factor is determinative, and the entire working relationship must be considered.

The 20 factors outlined in Rev. Rul. 87-41 are as follows:

1. **Instructions:** A worker who is required to comply with instructions on when, where, and how to work is often considered an employee rather than an independent contractor.
2. **Training:** If the business provides training to the worker on how to perform a service in a particular method or manner, this suggests an employment relationship.
3. **Integration:** If the worker's services are integrated into the business's operations (i.e., the success of the business is dependent upon the performance of the worker's services), this generally indicates an employment relationship.
4. **Services Rendered Personally:** If the services must be rendered personally and the business has the right to control the details of the work, the worker is typically classified as an employee.
5. **Hiring, Supervising, and Paying Assistants:** If the business hires, supervises, and pays the worker's assistants, it indicates control over workers on the job, suggesting an employment relationship.
6. **Continuing Relationship:** A continuous or ongoing relationship generally indicates an employment relationship.
7. **Set Hours of Work:** If the worker has set hours of work established by the business, this generally suggests employee status. Independent contractors typically choose their own hours of work.
8. **Full-Time Required:** If the worker is required to work full-time for the business, this indicates a stronger likelihood of employee status as they are restricted from completing other gainful work.
9. **Work Performed on Employer's Premises:** If the work is performed on the employer's premises, it is generally indicative of an employment relationship.
10. **Order or Sequence Set:** If the worker must perform services in the order or sequence set by the business or follow the established routines or schedules of the business, this suggests an employment relationship, since the worker is not free to follow his or her own pattern of work.
11. **Oral or Written Reports:** If the worker must submit regular reports to the business, it may indicate an employment relationship.
12. **Payment by Hour, Week, Month:** Payment on an hourly, weekly, or monthly basis is more characteristic of an employment relationship than an independent contractor relationship.
13. **Payment of Business or Travel Expenses:** If the business pays the worker's business or travel expenses, it typically suggests employee status.
14. **Furnishing of Tools and Materials:** If the business provides tools and materials to the worker, this suggests an employment relationship.
15. **Significant Investment:** If the worker has a significant investment in facilities used to perform services, this suggests independent contractor status. Lack of investment in

facilities indicates dependence on the individual(s) for whom the services are performed, indicating an employee-employer relationship.

16. **Realization of Profit or Loss:** The worker's potential for profit or loss based on managerial skill suggests an independent contractor relationship.
17. **Working for More Than One Firm at a Time:** Working for multiple businesses at the same time typically indicates independent contractor status.
18. **Making Services Available to the General Public:** If the worker makes their services available to the general public, this suggests independent contractor status.
19. **Right to Discharge:** The right to discharge the worker suggests an employer-employee relationship.
20. **Right to Terminate:** The right to terminate the worker at will suggests an employer-employee relationship.

Many of the factors outlined in Rev. Rul. 87-41 center around the degree of control a business has over its workers. The classification of gig workers as independent contractors or employees has been an ongoing subject of legal and regulatory scrutiny. Both companies operating in the gig economy and gig workers alike should be aware of the factors delineated in Rev. Rul. 87-41 when evaluating worker classification for tax compliance.

### C. Three-factor test

In addition to the 20 factors outlined in Rev. Rul. 87-41, the IRS utilizes a three-factor test to determine whether a worker is an independent contractor or an employee:

1. Behavioral control;
2. Financial control; and
3. The relationship between the parties.

Behavioral Control is the extent to which the individual receiving services has the right to direct or control what the worker does and how the worker performs his or her services. Factors to consider when determining behavioral control include:

- Type of instructions given;
- Degree of instruction;
- Evaluation systems; and
- Training.

Financial Control is the extent to which the individual receiving services has the right to control the economic aspects of the worker's job. Factors to consider when determining financial control include:

- Significant investment;
- Unreimbursed expenses;
- Opportunity for profit or loss;
- Services available to the market; and
- Method of payment.

The relationship between the parties refers to the extent to which the worker and individual for whom the services are provided see their relationship with each other. Factors to consider when determining the relationship between the parties include:

- Written contracts;
- Employee benefits (pension plan, insurance, vacation pay, etc.);

- Permanency of the relationship; and
- Services provided as key activity of the business.

If after analyzing all factors a business is unable to determine a worker's classification, they may file Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*, to request a determination of the status of a worker. A Form SS-8 determination may be requested only in order to resolve federal tax matters. The IRS will not issue a determination letter for a tax year for which the statute of limitations on the tax return has expired. Additionally, the IRS will not issue a determination letter for proposed transactions, hypothetical situations, cases involving current worker classification litigation, cases involving state or local government workers who may be performing services under an agreement entered into pursuant to Section 218 of the Social Security Act, or business-to-business transactions, or for other reasons not in the best interests of tax administration.

**Determination of Worker Status for Purposes  
of Federal Employment Taxes and  
Income Tax Withholding**

Go to [www.irs.gov/FormSS8](http://www.irs.gov/FormSS8) for instructions and the latest information.

For IRS Use Only:  
Case Number:

Earliest Receipt Date:

**Disclosure of Information**

The information provided on Form SS-8 may be disclosed to the firm, worker, or payer named below to assist the IRS in the determination process. For example, if you are a worker, we may disclose the information you provide on Form SS-8 to the firm or payer named below. The information can only be disclosed to assist with the determination process. See *Privacy Act and Paperwork Reduction Act Notice* in the separate instructions for more information. **If you do not want this information disclosed to other parties, do not file Form SS-8.**

**IMPORTANT THINGS YOU SHOULD KNOW**

- **The Form SS-8 must be fully completed. If you provide incomplete information, we may not be able to process your request.**
- All questions in Parts I through IV must be explained with clear concise answers.
- Part V must be completed if the worker provides a service directly to customers or is a salesperson.
- If you cannot answer a question, enter "Unknown" or "Does not apply."
- If you need more space for a question, attach another sheet with the part and question number clearly identified. Write your firm's name (or worker's name) and employer identification number (or social security number) at the top of each additional sheet attached to this form.
- You **MUST** include copies of the Forms W-2, 1099-MISC, and/or 1099-NEC for each year you are contesting. See instructions.

Name of firm (or person) for whom the worker performed services		Worker's name	
Firm's mailing address (include street address, apt. or suite no., city, state, and ZIP code)		Worker's mailing address (include street address, apt. or suite no., city, state, and ZIP code)	
Trade name		Worker's daytime telephone number	Worker's alternate telephone number
Firm's fax number	Firm's website	Worker's fax number	Worker's social security number
Firm's telephone number (include area code)	Firm's employer identification number	Worker's employer identification number (if any)	

**Note:** If the worker is paid for services performed for a business or individual not listed above, enter the name, address, and taxpayer identification number of that business/individual who paid the worker, if known. Explain the relationship between the firm and the business/individual who paid the worker.

**Part I General Information**

1 This form is being completed by:  Firm  Worker  
for services performed from beginning date           MM/YYYY           to ending date           MM/YYYY          .

**Caution:** Filing Form SS-8 does not prevent the expiration of the time in which a claim for refund must be filed.

2 Explain your reason(s) for filing this form.  
 You received a bill from the IRS  You believe you erroneously received a Form 1099 or Form W-2  
 You are unable to get workers' compensation benefits  You were audited or are being audited by the IRS  
 Other (specify) \_\_\_\_\_

 Don't complete this form if payment was received for reasons unrelated to Form SS-8. See instructions.

**Did you remember to answer all questions and refer to the Instructions for Form SS-8 at [www.irs.gov/pub/irs-pdf/iss8.pdf](http://www.irs.gov/pub/irs-pdf/iss8.pdf)?**

For Privacy Act and Paperwork Reduction Act Notice, see the separate instructions.

Cat. No. 16106T

Form **SS-8** (Rev. 12-2023)

**Part I General Information** (continued)

- 3 Total number of workers who performed or are performing the same or similar services: \_\_\_\_\_
- 4 How did the worker obtain the job? Attach any advertisement.  
 Application     Bid     Employment agency     Other (specify) \_\_\_\_\_
- 5 **Attach copies of all supporting documentation (for example, contracts; invoices; memos; Forms W-2, Forms 1099-MISC, or Forms 1099-NEC issued or received; IRS closing agreements; or IRS rulings).**
  - a Inform us of any current or past litigation concerning the worker's status. \_\_\_\_\_
  - b If no income reporting forms (Form 1099-MISC, 1099-NEC, or W-2) were furnished to the worker, enter the amount of income earned for the year(s) at issue \$ \_\_\_\_\_
  - c If both Form W-2 and Form 1099-MISC, or both Form W-2 and Form 1099-NEC, were issued or received, explain why.  
 \_\_\_\_\_
- 6 Describe the firm's business. \_\_\_\_\_  
 \_\_\_\_\_
- 7 Did the worker receive pay from more than one entity (for example, two or more entities with different taxpayer identification numbers) because of a business sale, merger, acquisition, or reorganization?  No. Skip to line 8.     Yes. Complete the rest of line 7.  
 Name of the firm's previous owner: \_\_\_\_\_  
 Previous owner's taxpayer identification number: \_\_\_\_\_ Change was a:  Sale     Merger     Acquisition     Reorganization  
 Other (specify) \_\_\_\_\_  
 Description of above change: \_\_\_\_\_  
 Date of change (MM/DD/YY): \_\_\_\_\_
- 8 What is the worker's job title? \_\_\_\_\_  
 Describe the worker's duties. \_\_\_\_\_  
 \_\_\_\_\_
- 9 Which do you believe the worker is? Check only one.     Employee     Independent contractor  
 Explain. \_\_\_\_\_  
 \_\_\_\_\_
- 10 Did the worker perform any services for the firm before or after the dates entered on line 1 on page 1 of this form?     Yes     No  
 If "Yes," what were the dates of service? \_\_\_\_\_  
 If "Yes," explain any differences between the services provided. \_\_\_\_\_  
 \_\_\_\_\_
- 11a Is the work done under a written agreement between the firm and the worker?     Yes     No  
 If "Yes," attach a copy (preferably signed by both parties).  
 If "Yes," describe the terms and conditions of the work arrangement. \_\_\_\_\_  
 \_\_\_\_\_
- b Is the work done under an oral agreement?     Yes     No  
 If "Yes," describe the details of the agreement. \_\_\_\_\_  
 \_\_\_\_\_

**Part II Behavioral Control** (Provide names and titles of specific individuals, if applicable.)

- 1 What specific training and/or instruction is the worker given by the firm? \_\_\_\_\_  
 \_\_\_\_\_
- 2 Who gives the worker work assignments?  
 How are the assignments received?     In person     Phone     Email     Text message  
 Other (specify) \_\_\_\_\_
- 3 Who determines the methods by which the assignments are performed? \_\_\_\_\_
- 4 If problems or complaints arise, who is contacted? \_\_\_\_\_  
 Who is responsible for their resolution? \_\_\_\_\_

**Did you remember to answer all questions and refer to the Instructions for Form SS-8 at [www.irs.gov/pub/irs-pdf/iss8.pdf](http://www.irs.gov/pub/irs-pdf/iss8.pdf)?**

**Part II Behavioral Control** (Provide names and titles of specific individuals, if applicable.) (continued)

- 5 Is the worker required to complete reports?  Yes  No  
If "Yes," attach examples.
- 6a How frequently does the worker perform services?  As scheduled  As needed  As available  
 Other (specify) \_\_\_\_\_
- b Describe the worker's primary services.  Sales  Timesheets  Patient logs  
 Other (specify) \_\_\_\_\_
- 7 Where are the services performed? If more than one location, what percentage of the worker's time is spent at each location?  
 Firm premises \_\_\_\_\_ %  
 Worker's office or shop \_\_\_\_\_ %  
 Customer's location \_\_\_\_\_ %  
 Other (specify) \_\_\_\_\_ %
- 8a Is the worker required to attend meetings?  Yes  No  
If "Yes," what type of meetings?  Sales  Staff  Other (specify) \_\_\_\_\_
- b Is the worker penalized if unable to attend a meeting?  Yes  No  
If "Yes," what is the penalty? \_\_\_\_\_
- 9 Is the worker required to provide the services personally?  Yes  No
- 10 Can the worker hire substitutes or helpers?  Yes  No
- 11 If the worker hires the substitutes or helpers, is approval required?  Yes  No  
If "Yes," who approves the hiring?  Firm  Other (specify) \_\_\_\_\_
- 12 Does the worker pay substitutes or helpers?  Yes  No  
If "Yes," is the worker reimbursed?  Yes  No  
If the worker is reimbursed, explain who reimburses them. \_\_\_\_\_

**Part III Financial Control** (Provide names and titles of specific individuals, if applicable.)

- 1a List the supplies, equipment, materials, and property provided by  
The firm: \_\_\_\_\_  
The worker: \_\_\_\_\_
- b Are supplies, equipment, materials, or property provided by another party?  Yes  No  
If "Yes," explain. \_\_\_\_\_
- 2 Does the worker lease equipment, space, or a facility?  Yes  No  
If "Yes," what are the terms of the lease? (Attach a copy or explanatory statement.) \_\_\_\_\_
- 3 Are expenses incurred by the worker in the performance of services for the firm?  Yes  No  
If "Yes," explain. \_\_\_\_\_
- 4a Are expenses reimbursed by the firm?  Yes  No  
If "Yes," provide the frequency and amount. \_\_\_\_\_
- b Are expenses reimbursed by another party?  Yes  No  
If "Yes," explain. \_\_\_\_\_
- 5a What type of pay does the worker receive?  Salary  Commission  Hourly wage  Piece work  Lump sum  
 Other (specify) \_\_\_\_\_
- b If paid commission, does the firm guarantee a minimum amount of pay?  Yes  No  
If "Yes," explain. \_\_\_\_\_
- 6 Can the worker request advance pay?  Yes  No  
If "Yes," how often?  Daily  Weekly  Monthly  Other (specify) \_\_\_\_\_
- 7 Whom does the customer pay?  Firm  Worker  
If worker, does the worker pay the total amount to the firm?  Yes  No If "No," explain. \_\_\_\_\_
- 8 Does the firm carry workers' compensation insurance on the worker?  Yes  No

**Did you remember to answer all questions and refer to the Instructions for Form SS-8 at [www.irs.gov/pub/irs-pdf/iss8.pdf](http://www.irs.gov/pub/irs-pdf/iss8.pdf)?**

**Part III Financial Control** (Provide names and titles of specific individuals, if applicable.) (continued)

- 9a Does the worker take a financial risk by performing services?  Yes  No  
If "Yes," explain. \_\_\_\_\_
- b Can the worker suffer a financial loss by performing services?  Yes  No  
If "Yes," explain. \_\_\_\_\_
- 10a Who sets the rate of pay for the services performed?  Firm  Worker  Other (specify) \_\_\_\_\_
- b If products are sold, who sets the product price?  Firm  Worker  Other (specify) \_\_\_\_\_

**Part IV Relationship of the Worker and Firm**

- 1 Are benefits made available to the worker?  Yes  No  
If "Yes," which benefits are available?  Paid vacations  Sick pay  Paid holidays  
 Personal days  Pensions  Insurance benefits  Bonuses  
 Other (specify) \_\_\_\_\_
- 2 Can the firm or worker end the work relationship without penalty?  Yes  No  
If "No," explain. \_\_\_\_\_
- 3 Did the worker perform similar services for others during the time period entered in Part I, line 1?  Yes  No  
If "Yes," is the worker required to get approval from the firm?  Yes  No
- 4 Is there an agreement prohibiting competition between the firm and the worker?  Yes  No  
If "Yes," explain or attach available documentation. \_\_\_\_\_
- 5 Reserved for future use.
- 6 Does the worker advertise?  Yes  No  
If "Yes," what type of advertising does the worker do? Provide copies, if available. \_\_\_\_\_
- 7 Does the worker assemble or process a product at home?  Yes  No  
If "Yes," who provides the materials and instructions or patterns?  
If "Yes," what does the worker do with the finished product?  Return to the firm  Provide to another party  Sell it  
 Other (specify) \_\_\_\_\_
- 8a Does the firm introduce the worker to its customers?  Yes  No  
If "Yes," how is the worker introduced?  Employee  Partner  Representative  Contractor  
 Other (specify) \_\_\_\_\_
- b Under whose name are services performed?  Firm  Worker  
 Other (specify) \_\_\_\_\_
- 9 Does the worker still perform services for the firm?  Yes  No  
If "No," how did the work relationship end?  Firm ended the work relationship  Worker ended the work relationship  
 Job completed  Contract ended  Firm or worker went out of business  
 Other (specify) \_\_\_\_\_

**Part V For Service Providers or Salespersons.** You must complete this part if the worker provided a service directly to customers or is a salesperson.

- 1 Is the worker responsible for contacting potential new customers?  Yes  No  
If "Yes," what are the worker's specific responsibilities? \_\_\_\_\_
- 2 Is the worker provided leads (names and contact information) for potential new customers?  Yes  No  
If "Yes," who provides the leads? \_\_\_\_\_
- 3 Is the worker required to report on potential new customers contacted?  Yes  No  
If "Yes," what are the reporting requirements? \_\_\_\_\_
- 4 Does the firm set terms and conditions of sale?  Yes  No  
If "Yes," explain. \_\_\_\_\_
- 5 Are orders submitted and subject to the firm's approval?  Yes  No
- 6 Who determines the worker's sales territory?  Firm  Worker  
 Other (specify) \_\_\_\_\_

**Did you remember to answer all questions and refer to the Instructions for Form SS-8 at [www.irs.gov/pub/irs-pdf/iss8.pdf](http://www.irs.gov/pub/irs-pdf/iss8.pdf)?**

**Part V For Service Providers or Salespersons.** You must complete this part if the worker provided a service directly to customers or is a salesperson. (continued)

7 Did the worker pay for the privilege of serving customers on the route or in the territory?  Yes  No  
 If "Yes," whom did the worker pay? \_\_\_\_\_  
 If "Yes," how much did the worker pay? \_\_\_\_\_ \$

8 Where does the worker sell the product?  Home  Retail establishment  Online  
 Other (specify) \_\_\_\_\_

9 List the product and/or services distributed by the worker (for example, meat, vegetables, fruit, bakery products, beverages, or laundry or dry cleaning services). If more than one type of product and/or service is distributed, specify the principal one. \_\_\_\_\_

10 Does the worker sell life insurance full time?  Yes  No

11 Does the worker sell other types of insurance for the firm?  Yes  No  
 If "Yes," enter the percentage of the worker's total working time spent in selling other types of insurance \_\_\_\_\_ %

12 Does the worker solicit orders from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments?  Yes  No  
 If "Yes," what percentage of the worker's time is spent in solicitation? \_\_\_\_\_ %

13 Is the merchandise purchased by the customers for resale or use in their business operations?  Yes  No  
 Describe the merchandise and state whether it is equipment installed on the customers' premises. \_\_\_\_\_

**Sign Here** Under penalties of perjury, I declare that I have examined this request, including accompanying documents, and to the best of my knowledge and belief, the facts presented are true, correct, and complete.

\_\_\_\_\_ Print your name \_\_\_\_\_ Signature \_\_\_\_\_ Date

**Did you remember to answer all questions and refer to the Instructions for Form SS-8 at [www.irs.gov/pub/irs-pdf/iss8.pdf](http://www.irs.gov/pub/irs-pdf/iss8.pdf)?**  
**Did you sign Form SS-8?**  
**Did you attach copies of your Form W-2 or Form 1099 for each year contested?**

When Form SS-8 is filed, the IRS generally tries to get information from all parties involved (typically two or more), by sending those parties blank Forms SS-8 to complete. An IRS technician will review the facts, potentially request additional information from the requestor or other parties and render a decision on the matter. Then, the IRS will typically issue a formal determination to the firm and send a copy to the worker. Any Form SS-8 determination only applies to the worker or class of workers requesting it, and the decision is binding on the IRS if there is no change in the facts or law that formed the basis for the ruling.

**D. DOL worker classification**

It is important to acknowledge that while the IRS primarily utilizes Rev. Rul. 87-41 and the three-factor test to determine whether a worker is an employee or independent contractor, the Department of Labor (DOL) utilizes different criteria to determine worker classification. Additionally, state laws governing worker classification may vary.

The Fair Labor Standards Act (FLSA), enacted in 1938, was enacted to safeguard workers' rights by establishing minimum wage, overtime pay eligibility, and protection against exploitation in the workplace. Notably, these protections do not apply to independent contractors. Since the 1940s, both the Department of Labor (DOL) and courts have utilized an economic reality test to discern a worker's classification under the FLSA, whether as an employee or an independent contractor. The economic reality test is a framework used to determine whether a worker is considered an employee or an independent contractor. It assesses various factors to determine the extent of economic dependence between the worker and the employer. When assessing economic dependence, the DOL and courts have historically conducted a totality-of-the-circumstances analysis, considering multiple factors to determine whether a worker is an employee or an independent contractor, with no factor or factors carrying predetermined weight.

On January 7, 2021, the DOL introduced a final rule known as the "2021 IC Rule," marking a departure from the historical approach utilized by both courts and the DOL in applying the economic reality test to determine a worker's status under the FLSA. The 2021 IC Rule outlined two "core" factors for assessing worker classification:

- 1) The nature and degree of the worker's control over the work; and
- 2) The worker's opportunity for profit or loss.

Additionally, the 2021 IC rule introduced three additional factors that were given less weight in the analysis of determining worker status:

- 3) Amount of skill required for the work;
- 4) Permanence of the working relationship; and
- 5) Whether the work is part of an integrated unit of production.

Per the 2021 IC Rule, if the two "core" factors aligned in their classification of the worker, their combined weight would typically outweigh the significance of the remaining three factors of lesser importance. However, if the core factors produced differing classification outcomes, the remaining factors could assist in determining the appropriate worker classification.

The 2021 IC Rule was originally scheduled to take effect on March 8, 2021. However, on March 4, 2021, the DOL issued a rule postponing the effective date of the 2021 IC Rule, followed shortly by another rule on May 6, 2021, withdrawing the 2021 IC Rule entirely. On October 13, 2022, the DOL introduced a Notice of Proposed Rulemaking (NPRM), proposing the rescission and replacement of the 2021 IC Rule. The DOL cited concerns that maintaining the 2021 IC Rule would create confusion and disruption for both workers and businesses, as it departed from established case law applying the multifactor economic reality test as a totality-of-the-circumstances test.

On January 10, 2024, the Department of Labor (DOL) issued a final rule, which further revises the definition of employee under the Fair Labor Standards Act (FLSA) as it relates to independent contractors. This 2024 final rule rescinds and replaces the 2021 final rule and provides an analysis for determining employee or independent contractor status that aligns more closely with the FLSA as interpreted by longstanding judicial precedent. The DOL highlighted concerns with the 2021 final rule, stating it placed undue weight on "core factors" and was problematic due to limited and narrow consideration of other factors. According to the DOL, "leaving the 2021 Independent Contractor Rule in place would have a confusing and disruptive effect on workers and businesses alike due to its departure from decades of case law describing and applying the multifactor economic reality test as a totality-of-the-circumstances test."<sup>7</sup> The 2024 final rule relies on the longstanding multifactor "economic reality" test used by courts to determine worker classification status. This test relies on the totality of the circumstances where no one factor is determinative. Effective March 11, 2024, the 2024 final rule aims to address these issues and provide clearer guidelines for worker classification.

Consistent with the DOL and judicial precedent, the 2024 final rule applies the following six factors to analyze employee or independent contractor status under the FLSA:

- **Factor 1 - Opportunity for profit or loss depending on managerial skill:** This factor evaluates whether the worker exercises managerial skill, such as initiative, business acumen, or judgment, that impacts the worker's economic success or failure in

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<sup>7</sup> DOL Frequently Asked Questions - Final Rule: Employee or Independent Contractor Classification Under the FLSA

performing the work. Relevant considerations when analyzing this factor include, but are not limited to:

- Whether the worker determines or negotiates the pay for the work provided;
- Whether the worker accepts or declines jobs or chooses the order and/or time in which the jobs are performed;
- Whether the worker engages in marketing, advertising, or other efforts to expand their business or secure more work; and
- Whether the worker makes decisions to hire others, purchase materials and equipment, and/or rent space.

If a worker lacks the opportunity for profit or loss, it indicates that they are likely an employee rather than an independent contractor.

**Example 1:** A worker for a landscaping company performs assignments only as determined by the company for its corporate clientele. The worker does not independently select assignments, solicit additional work from other clients, advertise the landscaping services, or attempt to minimize costs. Additionally, the worker regularly agrees to work additional hours in order to increase their earnings.

In this scenario, the worker does not exercise managerial skill that affects their profit or loss. Rather, their earnings depend primarily on the availability of work and their willingness to work additional hours.

The absence of managerial skill affecting opportunity for profit or loss suggests that the worker is more likely to be classified as an employee rather than an independent contractor under the opportunity for profit or loss factor.

**Example 2:** A worker provides landscaping services directly to corporate clients, taking charge of various aspects of the business operations.

The worker produces their own advertising, negotiates contracts, decides which jobs to undertake and schedules when to perform them, and makes decisions regarding whether to hire additional assistance.

By exercising such managerial autonomy, this worker significantly influences their potential for profit or loss.

Based on these circumstances, the worker's exercise of managerial skill points towards their classification as an independent contractor under the opportunity for profit or loss factor.

- **Factor 2 - Investments by the worker and the potential employer:** This factor evaluates whether a worker's investments are of a capital or entrepreneurial nature.
  - The DOL emphasizes that costs unilaterally imposed by an employer on a worker are not capital or entrepreneurial in nature.
  - The DOL notes that a capital or entrepreneurial investment signifies that the worker is operating as an independent business.
  - Additionally, the DOL highlights that capital or entrepreneurial investments tend to enhance a worker's ability to work for multiple companies, further reflecting the characteristics of an independent business.
  - Finally, the DOL affirms that the worker's investments need not be equal to the potential employer's investments and should not be compared only in terms of the dollar values of investments or the sizes of the worker and the potential

employer. Instead, the focus should be on comparing the investments to determine whether the worker is making similar types of investments as the potential employer. Even if on a smaller scale, similarities in the nature of investments suggest that the worker is operating independently, thus supporting their classification as an independent contractor.

**Example 1:** A graphic designer provides design services for a commercial design firm.

The firm provides essential resources such as software, a computer, office space, and all necessary equipment and supplies for the worker.

The company invests in marketing efforts and client acquisition, maintaining a central office from which to manage services.

The worker occasionally uses their own preferred drafting tools for certain jobs.

These circumstances suggest that the worker's relatively minor investment in supplies is not capital in nature and does little to further a business beyond completing specific jobs. As a result, these facts indicate employee status under the investment factor.

**Example 2:** A graphic designer occasionally completes specialty design projects for the same commercial design firm.

The graphic designer purchases their own design software, computer, drafting tools, and rents an office in a shared workspace. Additionally, the graphic designer spends money on marketing their services.

These types of investments are indicative of an independent business and are capital in nature, enabling the worker to complete more work and extend their market reach.

Consequently, these facts suggest independent contractor status under the investment factor.

- **Factor 3 - Degree of permanence of the work relationship:** This factor states that the degree of permanence of the work relationship would weigh in favor of the worker being an employee when the work relationship is indefinite in duration or continuous, but would weigh in favor of the worker being an independent contractor when the work relationship is definite in duration, non-exclusive, project-based, or sporadic based on the worker being in business for themselves and marketing their services or labor to multiple entities.
  - The DOL clarifies that independent contractors may have regularly occurring fixed periods of work, but the seasonal or temporary nature of work alone does not necessarily indicate independent contractor classification.
  - Further, the DOL acknowledges that independent contractors often rely on repeat business and long-term clients or customers in order to sustain the economic viability and success of their business.

**Example 1:** A cook has been consistently preparing meals for an entertainment venue over the course of several years.

The cook prepares meals as directed by the venue, depending on the size and specifics of the event. The cook only prepares food for the entertainment venue, which has regularly scheduled events each week.

The relationship between the cook and the venue is characterized by a high degree of permanence and exclusivity.

These facts indicate employee status under the permanence factor.

**Example 2:** A cook has prepared specialty meals intermittently for an entertainment venue over the past 3 years for certain events.

The cook promotes their meal preparation services to multiple venues and private individuals, exercising discretion in accepting or declining work based on availability, including instances where they are occupied with other meal preparation assignments.

The cook has a sporadic or project-based nonexclusive relationship with the entertainment venue.

These facts indicate independent contractor status under the permanence factor.

- **Factor 4 – Nature and degree of control:** This factor evaluates the worker's substantial control over key aspects of the performance and supervision of the work, including scheduling, price or rate determination for goods or services, project selection, workload management, and limitations on the worker's ability to work for others. The DOL also states that an employer's compliance with legal obligations, safety or health standards, or requirements to meet contractual or quality control obligations, for example, may indicate that the employer is exerting control, suggesting that the worker is economically dependent on the employer.

**Example 1:** A registered nurse provides nursing care for Alpha House, a nursing home. The nursing home sets the work schedule with input from staff regarding their preferences and determines where each nurse will work in the nursing home.

Alpha House's internal policies prohibit nurses from working for other nursing homes while employed with Alpha House in order to protect its residents. In addition, the nursing staff are supervised by regular check-ins with managers, although nurses typically carry out their duties without direct supervision.

Despite nurses having some autonomy in their work and schedule preferences, Alpha House retains control over the timing and location of nurse assignments, as well as their ability to work elsewhere.

These facts indicate employee status under the control factor.

**Example 2:** A registered nurse provides specialty movement therapy to residents at Beta House.

The nurse maintains a website and was contacted by Beta House to assist its residents.

The nurse provides the movement therapy for residents on a schedule agreed upon between the nurse and the resident, without direction or supervision from Beta House, and sets the price for services on the website. In addition, the nurse simultaneously provides therapy sessions to residents at Beta House as well as other nursing homes in the community.

The facts—that the nurse markets their specialized services to obtain work for multiple clients, is not supervised by Beta House, sets their own prices, and has

the flexibility to select a work schedule—indicate independent contractor status under the control factor.

- **Factor 5 – Extent to which the work performed is an integral part of the potential employer’s business:** This factor analyzes whether the work performed is an integral part of the employer’s business. The DOL emphasizes that this factor must consider whether the work is critical, necessary, or central to the employer’s principal business in order to better reflect the economic reality case law and to be more consistent with the totality-of-the-circumstances approach when determining whether a worker is an employee or an independent contractor.

**Example 1:** A large farm grows tomatoes that it sells to distributors. During the harvest season, the farm hires workers to pick the tomatoes.

Since picking tomatoes is an integral part of farming tomatoes, and the company is in the business of farming tomatoes, the role of tomato pickers is integral to the farm’s operations.

These circumstances indicate employee status under the integral factor.

**Example 2:** The same farm pays an accountant to provide non-payroll accounting support, including filing its annual tax return. His accounting support, while important, does not constitute a critical, necessary, or central function of the farm’s principal business of tomato farming.

As the accountant’s work is not integral to the business, these facts indicate independent contractor status under the integral factor.

- **Factor 6 – Skill and Initiative:** This factor considers whether the worker uses specialized skills when performing their work and whether those skills contribute to business-like initiative. According to the DOL, employee status is indicated when the worker does not use specialized skills in performing their work or when the worker is dependent upon training from the employer to perform the work. Conversely, when the worker brings specialized skills to the work relationship, it is the worker’s use of those specialized skills in connection with business-like initiative that indicates that the worker is an independent contractor.

**Example 1:** A highly skilled welder provides welding services for a construction firm.

The welder does not make any independent judgments at the job site beyond the decisions necessary to do the work assigned. The welder does not determine the sequence of work, order additional materials, think about bidding the next job, or use those skills to obtain additional jobs, and is told what work to perform and where to do it.

In this example, the welder, despite possessing considerable technical proficiency, is not using those skills in a manner that evidences business-like initiative.

These facts indicate employee status under the skill and initiative factor.

**Example 2:** A highly skilled welder provides a specialty welding service, such as custom aluminum welding, for a variety of area construction companies.

Leveraging these specialized skills, the welder actively markets their services to attract new clients and secure work from multiple companies. Their approach not only demonstrates technical proficiency but also exhibits a proactive business-like initiative in utilizing and promoting their skills.

These facts indicate independent contractor status under the skill and initiative factor.

Below summarizes key similarities between the 2021 IC Rule and 2024 Final Rule:

- Both rules define independent contractors as workers who are in business for themselves, while FLSA-covered employees are those who are, as a matter of economic reality, economically dependent on their employer.
- Economic dependence is considered the "ultimate inquiry" in both rules' analyses.
- Each rule provides a non-exhaustive list of factors to evaluate economic dependence, emphasizing that no single factor is determinative in the analysis.
- Both rules stress that economic dependence does not hinge on the amount of income earned by the worker or whether the worker has other income sources.

Below summarizes key differences between the 2021 IC Rule and 2024 Final Rule:

- The 2024 final rule returns to a totality-of-the-circumstances economic reality test, where no single factor or group of factors is assigned any predetermined weight;
- The 2024 final rule considers six factors (instead of five), including the investments made by the worker and the potential employer;
- The 2024 final rule provides additional analysis of the control factor, including a detailed discussion of how scheduling, supervision, price-setting, and the ability to work for others should be considered when analyzing the nature and degree of control over a worker;
- The 2024 final rule returns to the DOL's historical consideration of whether the work is integral to the employer's business, rather than whether it is exclusively part of an "integrated unit of production";
- The 2024 final rule provides additional context to some factors, such as the permanence and skill factors; and
- The 2024 final rule omits a provision from the 2021 IC Rule which minimized the relevance of an employer's reserved but unexercised rights to control a worker.

Again, the 2024 final rule emphasizes that no factor or set of factors among the list of six factors has a predetermined weight, and additional factors may be relevant if such factors in some way indicate whether the worker is in business for themselves (i.e., an independent contractor), as opposed to being economically dependent on the employer for work (i.e., an employee under the FLSA). Under the economic reality test, no single factor singlehandedly determines a worker's status; rather, the economic reality factors are all weighed to assess whether a worker is economically dependent on a potential employer for work, according to the totality of the circumstances. Lastly, the 2024 final rule provides that different factors may be more or less important in different circumstances depending on the facts of each individual case. It is important for businesses and individuals alike to familiarize themselves with the new DOL 2024 final rule when determining worker classification.

## **E. Tax implications**

The tax implications for gig economy work vary for both the platform and the independent contractor providing services through the platform.

Tax considerations for gig economy platforms include:

- Information reporting:
  - Gig economy platforms are required to report payments made to independent contractors to the IRS, typically using Form 1099-NEC, if they issued payments totaling \$600 or more.
- Compliance:
  - Gig economy platforms need to ensure compliance with regulations, including accurately reporting payments, providing necessary forms to contractors, and adhering to any applicable state or federal laws.
- State and local taxes:
  - Platforms should consider state and local tax implications, as tax rules can vary by jurisdiction.

Tax considerations for gig economy independent contractors include reporting income, self-employment taxes, quarterly estimated taxes, and deductions.

### **1. Reporting income**

Gig economy workers must report income earned from any gig work on their tax return, including:

- Income from part-time or temporary work;
- Income not reported on an information return such as Form 1099-K, Form 1099-MISC, Form 1099-NEC, etc.;;
  - Note: Generally, gig economy workers receive Form 1099-NEC if they received payments of more than \$600 per year. Gig economy workers earning less than \$600 from a platform must still report their earnings on their tax return.
- Income paid in forms other than cash, such as property, goods, or virtual currency/digital assets; and
- Income derived from gig economy work outside of a platform.

Failure to report income on a tax return can result in penalties, such as:

- **A negligence or disregard of the rules or regulations penalty** applies when a taxpayer does not make reasonable attempts to follow the tax laws when preparing their tax return (negligence) or when they carelessly, recklessly, or intentionally ignore tax rules or regulations (disregard).
  - In the case of negligence or disregard of the rules or regulations, an accuracy-related penalty of 20% is applied to the portion of the underpayment of tax that happened because of negligence or disregard.
  - In the case of substantial understatement, an accuracy-related penalty of 20% of the portion of the underpayment of tax that was understated on the return applies.
  - **A substantial understatement of income tax penalty** applies if a taxpayer understates their tax liability by 10% of the tax required to be shown on their tax return or \$5,000, whichever is greater.
- Additional penalties may exist, and interest is charged on such penalties.

As discussed, the OBBBA introduces a tax deduction of up to \$25,000 annually for qualified tips earned, with phaseouts for higher incomes. Gig economy workers who earn tips, such as delivery drivers, rideshare operators, hair stylists, freelance servers, and personal care providers, are explicitly included in

a targeted federal tax deduction for tipped income. This deduction applies to gig workers who receive tips (e.g., delivery workers, hair stylists), provided:

- They are in an occupation that customarily receives tips; and
- Their income from that tipped activity exceeds the total of allowable deductions for that trade.

The deduction is available starting in tax year 2026 and applies to taxpayers who receive tips as a customary part of their work.

To qualify for the deduction, three main conditions must be satisfied:

1. **Customary Tipping Occupation:** The taxpayer must work in an occupation recognized as one in which tipping is customary. This includes gig workers (e.g., Uber Eats, DoorDash, Instacart) as well as traditional service jobs.
2. **Net Income Threshold:** The individual's total income from the tipped trade or business must exceed the amount of their deductions (expenses) related to that trade.
3. **Annual Deduction Limit:** The deduction is capped at \$25,000 per year, with a phaseout for higher-income taxpayers.

Gig workers in service roles who regularly receive tips will now be eligible for a federal tax deduction that directly lowers their taxable income, reducing both income tax liabilities. This includes:

- **Food delivery drivers** who receive cash or digital tips;
- **Rideshare drivers** who earn post-trip gratuities;
- **Freelance** barbers, beauticians, or massage therapists operating via platforms or independently; and
- **Other app-based or informal service providers** (e.g., movers, furniture assemblers, dog groomers) in tipping-enabled roles.

Prior to the OBBBA, tips were fully taxable with no specific deduction.

## **2. Self-employment taxes**

Employers are not required to withhold taxes or pay Social Security and Medicare tax on independent contractors. Consequently, independent contractors are responsible for the full 15.3% Social Security and Medicare taxes, referred to as the self-employment tax, comprised of 12.4% for Social Security (old-age, survivors, and disability insurance) and 2.9% for Medicare (hospital insurance). Conversely, employers are required to withhold income taxes and pay Social Security, Medicare, and unemployment tax on wages paid to employees. Employers generally withhold 6.2% for Social Security tax and 1.45% for Medicare tax (for a total of 7.65%) from wages paid to an employee. Employers are also required to pay the employer share of Social Security and Medicare taxes, which is also 7.65% of wages paid to an employee.

Misclassifying workers as independent contractors negatively impacts employees because the employer's share of taxes is not paid, and the employee's share is not withheld. If a business misclassifies an employee, the business can be held liable for employment taxes for that worker.

Individuals generally must pay self-employment tax and file Schedule SE if their net earnings from self-employment were \$400 or more. Generally, net earnings from self-employment are subject to the self-employment tax. Schedule C is typically used to figure net earnings from self-employment.

For 2025, the first \$176,100 of a taxpayer's combined wages, tips, and net earnings is subject to any combination of the Social Security part of self-employment tax. All of a taxpayer's combined wages, tips, and net earnings in the current year are subject to the 2.9% Medicare part of the self-employment tax. Taxpayers are liable for an additional 0.9% Medicare Tax if their wages, compensation, or self-employment income (together with that of their spouse if filing a joint return) exceed the threshold amount for their filing status:

Filing Status	Threshold Amount
Married filing jointly	\$250,000
Married filing separate	\$125,000
Single	\$200,000
Head of Household	\$200,000
Qualifying Surviving Spouse	\$200,000

Taxpayers may use Form 8919, *Uncollected Social Security and Medicare Tax on Wages*, to figure and report their share of the uncollected Social Security and Medicare taxes due on their compensation if they were an employee but were treated as an independent contractor by their employer. By utilizing this form, the taxpayer's Social Security earnings will be credited to their Social Security record.

**Practice Note - Voluntary Classification Settlement Program**

- The Voluntary Classification Settlement Program is an optional program that provides businesses with an opportunity to reclassify their workers as employees for future employment tax purposes.
- This program offers partial relief from federal employment taxes for eligible businesses who agree to prospectively treat their workers as employees.
- Businesses must meet certain eligibility requirements and apply by filing Form 8952, *Application for Voluntary Classification Settlement Program (VCSP)*, and enter into a closing agreement with the IRS.

**3. Quarterly estimated taxes**

If a taxpayer does not pay enough tax during the year either through withholding or by making estimated tax payments, they may have to pay a penalty. Since gig workers do not have taxes withheld from their paychecks, they are often required to make quarterly estimated tax payments to cover their tax liabilities throughout the year. Taxpayers who work as an employee and do gig economy work on the side may be able to avoid making estimated tax payments on their gig income by withholding more tax from their employee paycheck.

Estimated tax payments are generally due four times a year:

- April 15 for payment period January 1–March 31.
- June 15 for payment period April 1–May 31.
- September 15 for payment period June 1–August 31.
- January 15 for payment period September 1–December 31.

If a due date falls on a Saturday, Sunday or legal holiday, payment is due the next business day.

#### **4. Deductions**

Unlike employees, independent contractors may qualify for various tax deductions related to their business expenditures, including mileage, phone bills, tools/equipment, or other costs directly associated with their work. Generally, taxpayers may deduct ordinary and necessary expenses incurred in conducting a trade or business. Ordinary expenses are expenses that are common and accepted in the taxpayer's trade or business, while necessary expenses are expenses that are appropriate for the business. Additionally, independent contractors also may deduct the employer-equivalent portion of their self-employment tax when calculating their adjusted gross income.

It is pivotal for gig economy workers to maintain meticulous and accurate records in order to keep track of deductible expenses. By keeping accurate records, gig economy workers can ensure they do not miss out on any eligible deductions, thereby maximizing their tax savings. Certain expenses, such as those associated with mixed-use assets like vehicles used in ridesharing, may need to be allocated between business and personal use, adding a layer of complexity. The IRS requires taxpayers to maintain adequate records to substantiate the deductions claimed on their tax returns. Keeping detailed records demonstrates compliance with tax laws and can help substantiate deductions in the event of an audit.

#### **5. Other considerations**

To summarize, gig workers who are independent contractors share many of the filing obligations of small business owners, even if they earn relatively modest amounts:

- Gig workers who are independent contractors generally must report their income and expenses on Schedule C;
- Gig workers who are independent contractors must file Schedule SE if their net earnings from self-employment are \$400 or more;
- Gig workers who are independent contractors may be required to make estimated payments and file Form 1040-ES; and
- Gig workers who are independent contractors may have additional state and local tax obligations.

It is essential to understand worker classification rules within the gig economy. Adhering to classification rules ensures compliance with labor laws and tax regulations, mitigating the risk of legal issues. Lastly, being aware of the classification rules helps prevent misclassification errors that could lead to penalties.

# Numbers Applicable to Rulings

<b>Learning objectives</b>	<b>1</b>
<b>I. Tax rates and other information for 2025</b>	<b>1</b>
<b>A. Tax rates for the individual</b>	<b>1</b>
<b>B. Standard deduction</b>	<b>3</b>
<b>C. Qualified Business Income deduction</b>	<b>3</b>
<b>D. Personal exemptions</b>	<b>3</b>
<b>E. Gift/Estate Exemptions</b>	<b>4</b>
<b>F. Alternative Minimum Tax Exemption</b>	<b>4</b>
<b>G. Pease Limitation</b>	<b>4</b>
<b>H. Earned income tax credit (EITC)</b>	<b>5</b>
1. <i>Earned income and AGI limits</i>	5
2. <i>Investment income limit</i>	5
3. <i>Maximum credit amounts</i>	6
<b>I. Exclusion from income for certain redemptions of bonds</b>	<b>6</b>
<b>J. Dependent-care credit</b>	<b>7</b>
1. <i>In general</i>	7
2. <i>Exclusion</i>	7
3. <i>Planning notes</i>	7
<b>K. Dependent Care FSA</b>	<b>8</b>
<b>L. Adoption expenses</b>	<b>8</b>
<b>M. Education benefits</b>	<b>12</b>
1. <i>Education credits</i>	12
2. <i>Qualified tuition expenses</i>	16
3. <i>Coverdell education savings accounts (CESAs)</i>	18
4. <i>Qualified Tuition programs (§529 plans)</i>	20
5. <i>SECURE Act update: Section 529 plans</i>	24
6. <i>Student loan interest</i>	24
<b>N. Transportation</b>	<b>25</b>
1. <i>Mileage</i>	25
2. <i>Lease-deduction reduction</i>	25
3. <i>Depreciation</i>	26
4. <i>Qualified transportation expenses</i>	28
5. <i>Federal per-diem rates</i>	29
6. <i>SIFL rates</i>	34
<b>O. Social Security adjustments</b>	<b>35</b>
1. <i>Wage base</i>	35
2. <i>Excess earnings</i>	35
3. <i>Full retirement age</i>	36
4. <i>Medicare</i>	39
5. <i>Premiums for prescription drugs</i>	40
<b>P. Medical expenses</b>	<b>41</b>
1. <i>Long-term-care insurance</i>	41
2. <i>Health savings accounts</i>	42
<b>Q. Other</b>	<b>44</b>
1. <i>Tax benefits effective for individuals</i>	44
2. <i>Interest rates for third quarter of 2025</i>	45
3. <i>FUTA surtax reduced</i>	46
4. <i>Section 448(c)(1) gross receipts limitation</i>	46
5. <i>Educator expense deduction</i>	46
6. <i>Excess Business Loss Threshold</i>	47
<b>R. Retirement plan 2025 numbers</b>	<b>47</b>
1. <i>Maximum annual benefit</i>	47
2. <i>Maximum annual addition</i>	47
3. <i>Maximum compensation considered</i>	47
4. <i>SIMPLE deferral maximum</i>	48
5. <i>SEP minimum compensation</i>	49

6. <i>Maximum elective deferral</i>	50
7. <i>Highly compensated employee</i>	51
8. <i>Self-employed persons</i>	51
9. <i>IRAs</i>	52

TREASURY/IRS AND OMB USE ONLY DRAFT

Form 1040 Department of the Treasury—Internal Revenue Service U.S. Individual Income Tax Return 2025 OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2025, or other tax year beginning , 2025, ending , 20 See separate instructions.

Filed pursuant to section 301.9100-2 Combat zone Deceased MM / DD / YYYY Spouse MM / DD / YYYY

Other Your first name and middle initial Last name Your social security number

If joint return, spouse's first name and middle initial Last name Spouse's social security number

Home address (number and street). If you have a P.O. box, see instructions. Apt. no. Check here if your main home, and your spouse's if filing a joint return, was in the U.S. for more than half of 2025.

City, town, or post office. If you have a foreign address, also complete spaces below. State ZIP code Presidential Election Campaign

Foreign country name Foreign province/state/county Foreign postal code Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund.

Foreign country name Foreign province/state/county Foreign postal code You Spouse

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

Married filing separately (MFS). Enter spouse's SSN above and full name here: If you checked the HOH or QSS box, enter the child's name if the qualifying person is a child but not your dependent:

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

Digital Assets At any time during 2025, did you: (a) receive (as a reward, award, or payment for property or services); or (b) sell, exchange, or otherwise dispose of a digital asset (or a financial interest in a digital asset)? Yes No

Dependents (see instructions) (1) First name (2) Last name (3) SSN (4) Relationship

(5) Check if lived with you more than half of 2025 (a) Yes (b) And in the U.S.

(6) Check if Full-time student Permanently and totally disabled (a) Yes (b) And in the U.S.

(7) Credits Child tax credit Credit for other dependents (a) Yes (b) And in the U.S.

Check if your filing status is MFS or HOH and you lived apart from your spouse for the last 6 months of 2025, or you are legally separated according to your state law under a written separation agreement or a decree of separate maintenance and you did not live in the same household as your spouse at the end of 2025.

Income 1a Total amount from Form(s) W-2, box 1 (see instructions) 1a

b Household employee wages not reported on Form(s) W-2 1b

c Tip income not reported on line 1a (see instructions) 1c

d Medicaid waiver payments not reported on Form(s) W-2 (see instructions) 1d

e Taxable dependent care benefits from Form 2441, line 26 1e

f Employer-provided adoption benefits from Form 8839, line 31 1f

g Wages from Form 8919, line 6 1g

h Other earned income (see instructions). Enter type and amount: 1h

i Nontaxable combat pay election (see instructions) 1i

z Add lines 1a through 1h 1z

2a Tax-exempt interest 2a

3a Qualified dividends 3a

c Check if your child's dividends are included in 1 Line 3a 2 Line 3b

4a IRA distributions 4a

c Check if (see instructions) 1 Rollover 2 QCD 3

5a Pensions and annuities 5a

c Check if (see instructions) 1 Rollover 2 PSO 3

6a Social security benefits 6a

c If you elect to use the lump-sum election method, check here (see instructions)

d If you are married filing separately and lived apart from your spouse the entire year (see inst.), check here

7a Capital gain or (loss). Attach Schedule D if required 7a

b Check if: Schedule D not required Includes child's capital gain or (loss)

8 Additional income from Schedule 1, line 10 8

9 Add lines 1z, 2b, 3b, 4b, 5b, 6b, 7a, and 8. This is your total income 9

10 Adjustments to income from Schedule 1, line 26 10

11a Subtract line 10 from line 9. This is your adjusted gross income 11a

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**Tax and Credits**

**11b** Amount from line 11a (adjusted gross income) . . . . . **11b**

**12a** Someone can claim  You as a dependent  Your spouse as a dependent

**b**  Spouse itemizes on a separate return **c**  You were a dual-status alien

**d** **You:**  Were born before January 2, 1961  Are blind

**Spouse:**  Was born before January 2, 1961  Is blind

**e** **Standard deduction or itemized deductions** (from Schedule A) . . . . . **12e**

**13a** Qualified business income deduction from Form 8995 or Form 8995-A . . . . . **13a**

**b** Additional deductions from Schedule 1-A, line 38 . . . . . **13b**

**14** Add lines 12e, 13a, and 13b . . . . . **14**

**15** Subtract line 14 from line 11b. If zero or less, enter -0-. This is your **taxable income** . . . . . **15**

**16** **Tax** (see instructions). Check if any from Form(s): **1**  8814 **2**  4972 **3**  . . . . . **16**

**17** Amount from Schedule 2, line 3 . . . . . **17**

**18** Add lines 16 and 17 . . . . . **18**

**19** Child tax credit or credit for other dependents from Schedule 8812 . . . . . **19**

**20** Amount from Schedule 3, line 8 . . . . . **20**

**21** Add lines 19 and 20 . . . . . **21**

**22** Subtract line 21 from line 18. If zero or less, enter -0- . . . . . **22**

**23** Other taxes, including self-employment tax, from Schedule 2, line 21 . . . . . **23**

**24** Add lines 22 and 23. This is your **total tax** . . . . . **24**

**Standard deduction for—**

- Single or Married filing separately, \$15,750
- Married filing jointly or Qualifying surviving spouse, \$31,500
- Head of household, \$23,625
- If you checked a box on line 12a, 12b, 12c, or 12d, see inst.

**Payments and Refundable Credits**

**25** Federal income tax withheld from:

**a** Form(s) W-2 . . . . . **25a**

**b** Form(s) 1099 . . . . . **25b**

**c** Other forms (see instructions) . . . . . **25c**

**d** Add lines 25a through 25c . . . . . **25d**

**26** 2025 estimated tax payments and amount applied from 2024 return . . . . . **26**

If you made estimated tax payments with your former spouse in 2025, enter their SSN (see instructions): \_\_\_\_\_

**27a** Earned income credit (EIC) . . . . . **27a**

**b** Clergy filing Schedule SE (see instructions) . . . . .

**c** If you do not want to claim the EIC, check here . . . . .

**28** Additional child tax credit (ACTC) from Schedule 8812. If you do not want to claim the ACTC, check here . . . . .  **28**

**29** American opportunity credit from Form 8863, line 8 . . . . . **29**

**30** Refundable adoption credit from Form 8839, line 13 . . . . . **30**

**31** Amount from Schedule 3, line 15 . . . . . **31**

**32** Add lines 27a, 28, 29, 30, and 31. These are your **total other payments and refundable credits** . . . . . **32**

**33** Add lines 25d, 26, and 32. These are your **total payments** . . . . . **33**

If you have a qualifying child, you may need to attach Sch. EIC.

**Refund**

**34** If line 33 is more than line 24, subtract line 24 from line 33. This is the amount you **overpaid** . . . . . **34**

**35a** Amount of line 34 you want **refunded to you**. If Form 8888 is attached, check here . . . . .  **35a**

**b** Routing number \_\_\_\_\_ **c** Type:  Checking  Savings

**d** Account number \_\_\_\_\_

**36** Amount of line 34 you want **applied to your 2026 estimated tax** . . . . . **36**

**Amount You Owe**

**37** Subtract line 33 from line 24. This is the **amount you owe**. For details on how to pay, go to [www.irs.gov/Payments](http://www.irs.gov/Payments) or see instructions . . . . . **37**

**38** Estimated tax penalty (see instructions) . . . . . **38**

**Third Party Designee**

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

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

**Sign Here**

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

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

**Paid Preparer Use Only**

Preparer's name	Preparer's signature	Date	PTIN	Check if: <input type="checkbox"/> Self-employed
Firm's name	Phone no.			
Firm's address	Firm's EIN			

Go to [www.irs.gov/Form1040](http://www.irs.gov/Form1040) for instructions and the latest information. Form **1040** (2025)

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**SCHEDULE 1-A  
(Form 1040)**

Department of the Treasury  
Internal Revenue Service

**Additional Deductions**

Attach to Form 1040, 1040-SR, or 1040-NR.  
Go to [www.irs.gov/Form1040](http://www.irs.gov/Form1040) for instructions and the latest information.

OMB No. 1545-0074

**2025**  
Attachment  
Sequence No. **1A**

Name(s) shown on Form 1040, 1040-SR, or 1040-NR

Your social security number

**Part I Modified Adjusted Gross Income (MAGI) Amount**

<b>1</b>	Enter the amount from Form 1040, 1040-SR, or 1040-NR, line 11b		<b>1</b>
<b>2a</b>	Enter any income from Puerto Rico that you excluded	<b>2a</b>	
<b>b</b>	Enter the amount from Form 2555, line 45	<b>2b</b>	
<b>c</b>	Enter the amount from Form 2555, line 50	<b>2c</b>	
<b>d</b>	Enter the amount from Form 4563, line 15	<b>2d</b>	
<b>e</b>	Add lines 2a, 2b, 2c, and 2d		<b>2e</b>
<b>3</b>	Add lines 1 and 2e		<b>3</b>

**Part II No Tax on Tips**

**Caution:** Fill out Part II only if you received qualified tips. You and/or your spouse who received qualified tips must have a valid social security number to claim the deduction. If married, you must file jointly to claim this deduction. See instructions.

<b>4</b>	Qualified tips received as an employee.		
<b>a</b>	If Form W-2, box 5, is \$176,100 or less, enter qualified tips included in Form W-2, box 7. Otherwise, see instructions	<b>4a</b>	
<b>b</b>	Qualified tips included on Form 4137, line 1(c). If Form 4137 is not filed, enter -0-	<b>4b</b>	
<b>c</b>	If you only received qualified tips from one employer, enter the larger of line 4a or line 4b. Otherwise, see instructions		<b>4c</b>
<b>5</b>	Qualified tips received in the course of a trade or business. Qualified tip amount included in Form 1099-NEC, box 1; Form 1099-MISC, box 3; or Form 1099-K, box 1a. Do not enter more than the net profit from the trade or business. If you received qualified tips in the course of more than one trade or business, see instructions		<b>5</b>
<b>6</b>	Add lines 4c and 5		<b>6</b>
<b>7</b>	Enter the smaller of the amount on line 6 or \$25,000		<b>7</b>
<b>8</b>	Enter the amount from line 3		<b>8</b>
<b>9</b>	Enter \$150,000 (\$300,000 if married filing jointly)		<b>9</b>
<b>10</b>	Subtract line 9 from line 8. If zero or less, enter the amount from line 7 on line 13		<b>10</b>
<b>11</b>	Divide line 10 by \$1,000. If the resulting number isn't a whole number, decrease the result to the next lower whole number. (For example, decrease 1.5 to 1, and decrease 0.05 to 0.)		<b>11</b>
<b>12</b>	Multiply line 11 by \$100		<b>12</b>
<b>13</b>	<b>Qualified tips deduction.</b> Subtract line 12 from line 7. If zero or less, enter -0-		<b>13</b>

**Part III No Tax on Overtime**

**Caution:** Fill out Part III only if you received qualified overtime compensation. You and/or your spouse who received the qualified overtime compensation must have a valid social security number to claim this deduction. If married, you must file jointly to claim this deduction. See instructions.

<b>14a</b>	Qualified overtime compensation included on Form W-2, box 1 (see instructions)	<b>14a</b>	
<b>b</b>	Qualified overtime compensation included on Form 1099-NEC, box 1 or Form 1099-MISC, box 3 (see instructions)	<b>14b</b>	
<b>c</b>	Add lines 14a and 14b		<b>14c</b>
<b>15</b>	Enter the smaller of the amount on line 14c or \$12,500 (\$25,000 if married filing jointly)		<b>15</b>
<b>16</b>	Enter the amount from line 3		<b>16</b>
<b>17</b>	Enter \$150,000 (\$300,000 if married filing jointly)		<b>17</b>
<b>18</b>	Subtract line 17 from line 16. If zero or less, enter the amount from line 15 on line 21		<b>18</b>
<b>19</b>	Divide line 18 by \$1,000. If the resulting number isn't a whole number, decrease the result to the next lower whole number. (For example, decrease 1.5 to 1, and decrease 0.05 to 0.)		<b>19</b>
<b>20</b>	Multiply line 19 by \$100		<b>20</b>
<b>21</b>	<b>Qualified overtime compensation deduction.</b> Subtract line 20 from line 15. If zero or less, enter -0-		<b>21</b>

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 95872Q

Schedule 1-A (Form 1040) 2025 Created 9/4/25

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**Part IV No Tax on Car Loan Interest**

**Caution:** Fill out Part IV only if you paid or accrued qualified passenger vehicle loan interest. See instructions to learn more about what is an applicable passenger vehicle.

**22** Applicable passenger vehicle (see instructions). If more than two VINs, see instructions.

		Interest for this loan:	
		(ii) Deducted on Schedule C, Schedule E, or Schedule F	(iii) Schedule 1-A
(i) Vehicle identification number (VIN)			
a	<input type="text"/>		
b	<input type="text"/>		
<b>23</b>	Add lines 22a and 22b, column (iii)		<b>23</b>
<b>24</b>	Enter the smaller of the amount on line 23 or \$10,000		<b>24</b>
<b>25</b>	Enter the amount from line 3		<b>25</b>
<b>26</b>	Enter \$100,000 (\$200,000 if married filing jointly)		<b>26</b>
<b>27</b>	Subtract line 26 from line 25. If zero or less, enter the amount from line 24 on line 30		<b>27</b>
<b>28</b>	Divide line 27 by \$1,000. If the resulting number isn't a whole number, increase the result to the next higher whole number. (For example, increase 1.5 to 2, and increase 0.05 to 1.)		<b>28</b>
<b>29</b>	Multiply line 28 by \$200		<b>29</b>
<b>30</b>	<b>Qualified car loan interest deduction.</b> Subtract line 29 from line 24. If zero or less, enter -0-		<b>30</b>

**Part V Enhanced Deduction for Seniors**

**Caution:** You and/or your spouse must have a valid social security number. If married, you must file jointly to claim this deduction. See instructions.

<b>31</b>	Enter the amount from line 3	<b>31</b>
<b>32</b>	Enter \$75,000 (\$150,000 if married filing jointly)	<b>32</b>
<b>33</b>	Subtract line 32 from line 31. If zero or less, enter \$6,000 on line 35	<b>33</b>
<b>34</b>	Multiply line 33 by 6% (0.06)	<b>34</b>
<b>35</b>	Subtract line 34 from \$6,000. If zero or less, enter -0-	<b>35</b>
<b>36a</b>	If you have a valid social security number (see instructions) and were born before January 2, 1961, enter the amount from line 35	<b>36a</b>
<b>b</b>	If you are married filing jointly, your spouse has a valid social security number (see instructions), and your spouse was born before January 2, 1961, enter the amount from line 35	<b>36b</b>
<b>37</b>	<b>Enhanced deduction for seniors.</b> Add lines 36a and 36b	<b>37</b>

**Part VI Total Additional Deductions**

<b>38</b>	Add lines 13, 21, 30, and 37. Enter here and on Form 1040 or 1040-SR, line 13b, or on Form 1040-NR, line 13c	<b>38</b>
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# Numbers Applicable to Rulings

## Learning objectives

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

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

## I. Tax rates and other information for 2025

### A. Tax rates for the individual

The tax rate brackets for 2025 are as follows.<sup>1</sup>

Single:

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

Head of Household:

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

<sup>1</sup> Rev. Proc. 2024-40.

### Married Filing Jointly and Surviving Spouse:

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

### Married Filing Separately:

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

### Estates and Trusts:

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

### Capital Gains Rate:

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

#### 2025 Capital Gains Rates

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

## B. Standard deduction<sup>2</sup>

As discussed, the OBBBA increases the standard deduction amounts in 2025. The standard deduction in 2025 is as follows:

<b>Filing status:</b>	<b>2025</b>
Married filing jointly and Surviving spouses (§1(a))	\$31,500
Heads of Households (§1(b))	\$23,625
Unmarried (§1(c))	\$15,750
Married filing separately (§1(d))	\$15,750

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

### Additional standard deductions for the elderly and blind in 2025:<sup>3</sup>

<b>Taxpayer</b>	<b>Either</b>	<b>Both</b>
Unmarried	\$2,000	\$4,000
Married	\$1,600	\$3,200

## C. Qualified Business Income deduction

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

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

## D. Personal exemptions

The personal exemption amount under §151(d) is \$5,200.<sup>4</sup> As discussed, the OBBBA permanently sets the personal exemption amount to zero.

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

**Example:** Bob and Mary are married and file a joint return for 2025. Their son, Jay, is 20 years old. Jay graduated from college in 2024 but cannot find a job that utilizes his education. The family decided it would be better for Jay to live at home and

<sup>2</sup> Rev. Proc. 2024-40.

<sup>3</sup> Rev. Proc. 2024-40.

<sup>4</sup> Rev. Proc. 2023-34.

<sup>5</sup> I.R.C. §151(d), created by the TCJA.

not seek other full-time employment so that he can continue to seek employment in his chosen field. Jay worked at a local store part-time and earned \$4,000.

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

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

## E. Gift/Estate Exemptions

Tax year 2025 allows for a \$19,000 annual exclusion for gifts to any person (other than gifts in future interests in property). If spouses splitting gifts, the annual exemption is doubled to \$38,000. For tax year 2025, the first \$190,000 of gifts to a non-US citizen spouse (other than gifts of future interests in property) are not considered taxable gifts. The lifetime gift exemption in 2025 increases to \$13.99 million from \$13.61 million in 2024. The OBBBA permanently increases the exemption amount to \$15 million (\$30 million for married couples) for gifts made and decedents dying in 2026 and beyond.

## F. Alternative Minimum Tax Exemption

For 2025, the AMT exemption is:

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

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

## G. Pease Limitation

Under the OBBBA, the Pease limitation is permanently repealed and replaced with a new overall limitation on the tax benefit of itemized deductions, applicable to individuals, estates, and trusts. Beginning in tax years after December 31, 2025, this limitation applies to taxpayers whose taxable income (prior to reduction for itemized deductions) exceeds the threshold for the 37% marginal rate bracket. For these taxpayers, the value of itemized deductions is effectively limited to 35%. In other words, each dollar of otherwise allowable itemized deductions may reduce tax liability by no more than 35 cents.

<sup>6</sup> T.D. 9913.

## H. Earned income tax credit (EITC)<sup>7</sup>

### 1. Earned income and AGI limits

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

ARPA permanently modified the EITC as follows:

- a. **Qualifying Child Requirement** -- In prior years, to qualify for the EITC with qualifying children, taxpayers typically had to provide information about the qualifying child, including name, age, and TIN/SSN. ARPA removed this requirement, essentially allowing individuals who have qualifying children to claim the EITC, despite not being able to provide proper documentation.
- b. **Joint Return Requirement** – Prior to ARPA, individuals who were married were required to file a joint return in order to be eligible to claim the EITC. ARPA modified this requirement and provides that certain separated married individuals are not required to file jointly in order to claim the EITC. For EITC purposes, an individual will not be treated as “married” if the individual:
  - Is considered married per §7703(a).
  - Lives with his or her qualifying child for more than half of the tax year.
  - Does not file a joint return for the tax year.
  - Does not have the same principal place of abode as his or her spouse during the last six months of the tax year or has a decree, instrument, or agreement with regard to his or her spouse and is not a member of the same household with his or her spouse by the end of the tax year.

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

- c. **Investment Income Requirement** – Prior to ARPA, individuals with certain types of investment over \$3,650 were unable to claim the EITC. ARPA increased the threshold amount to \$10,000 for tax years beginning after December 31, 2020. The \$10,000 threshold will be indexed for inflation for tax years beginning after 2021 (\$11,950 in 2025).
- d. **Identification Requirement** -- Prior to ARPA, a taxpayer was required to provide a qualifying child’s name, age, and taxpayer identification number in order to claim the qualifying child when determining the amount of the EITC. If the taxpayer was unable to provide the qualifying child’s name, age, and taxpayer identification number, he or she was ineligible to claim the EITC as an eligible individual with no qualifying children. ARPA removed this requirement and allows an eligible individual who has qualifying children, but cannot provide the necessary identification for such children, to claim the EITC as an eligible individual with no qualifying children. This provision is effective for tax years beginning after December 31, 2020.

### 2. Investment income limit

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

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<sup>7</sup> All numbers from section E. are from Rev. Proc. 2023-34.

### 3. Maximum credit amounts

Below are the following figures applicable to the 2025 tax year:<sup>8</sup>

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

**Note:**

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

### I. Exclusion from income for certain redemptions of bonds

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

The Service has announced that for 2025:<sup>9</sup>

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

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

<sup>8</sup> Rev. Proc. 2024-40.  
<sup>9</sup> Rev. Proc. 2024-40.

## **J. Dependent-care credit**

### **1. In general**

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

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

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

### **2. Exclusion**

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

### **3. Planning notes**

- a. In 2025, the dependent-care credit is nonrefundable.
- b. Many taxpayers and accountants wrongly assume that the \$6,000 must be prorated between the two qualifying individuals. This is untrue. If \$5,900 is paid on behalf of one qualifying individual and \$100 on the other, the full \$6,000 is taken into account in computing the credit.
- c. Another often overlooked area is a non-child individual can be a qualifying individual. An individual who is incapable of self-care, such as one of the parents following certain surgical procedures after returning home for a few days, can be a qualifying individual.
- d. Payments to a non-dependent parent of the taxpayer for the care of the taxpayer's child qualify as payments for dependent care.
- e. Carryovers of unused dependent care assistance program amounts are generally not permitted (other than a 2 ½ month grace period). However, in 2021 and 2022, the CAA 2021 temporarily provided that employers could amend their plans to permit the carryover

of unused dependent care assistance program amounts to plan years ending in 2021 and 2022, or to extend the permissible period for incurring claims to plan years over the same period.

- f. In 2026, OBBBA changes to the child and dependent care credit take effect.

## K. Dependent Care FSA

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

## L. Adoption expenses

A tax credit is allowed for **qualified adoption expenses** paid or incurred by a taxpayer. In 2025 the maximum credit is \$17,280<sup>10</sup> per eligible child, including special-needs children. A \$17,280 credit is provided in the year a special-needs adoption is finalized, regardless of whether the taxpayer has qualified adoption expenses.

- a. Qualified adoption expenses are reasonable and necessary adoption fees, court costs, attorneys' fees, and other expenses that are: (i) directly related to, and the principal purpose of which is for, the legal adoption of an eligible child by the taxpayer; (ii) not incurred in violation of state or federal law, or in carrying out any surrogate parenting arrangement; (iii) not for the adoption of the child of the taxpayer's spouse; and (iv) not reimbursed (e.g., by an employer).
- b. A taxpayer may exclude up to \$17,280 in 2025 per eligible child, including special-needs children, for employer-provided adoption assistance to reimburse qualified adoption expenses. In the case of a special-needs adoption, the exclusion is provided regardless of whether the taxpayer has qualified adoption expenses. The exclusion does not apply for purposes of payroll taxes.

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<sup>10</sup> Rev. Proc. 2024-40.

**Note:**

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

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

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

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

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

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

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

- c. The adoption credit (and the employer-provided adoption assistance exclusion) is phased out ratably for taxpayers with modified adjusted gross income between \$259,190 and \$299,190 in 2025.<sup>11</sup> The dollar/credit limitation must be reduced for a particular year for credits claimed in a prior year for the same adoption effort.

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

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

**Example:** Jennifer claimed \$8,000 of qualified adoption expenses credit in 2023 related to an unsuccessful adoption. In 2024 and 2025, she spent an additional \$10,000 for qualified adoption expenses in connection with successful adoptions finalized in

<sup>11</sup> Adoption credit amounts and limitations updated by Rev. Proc. 2024-40.

2025. The maximum allowable credit in 2025 is \$9,280 (\$17,280 credit limitation less \$8,000 previously claimed).

**Note:**

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

- e. An eligible child is an individual who: (i) has not attained age 18; or (ii) is physically or mentally incapable of caring for himself or herself. A special-needs child is an eligible child who is a citizen or resident of the United States who a state has determined: (i) cannot or should not be returned to the home of the birth parents; and (ii) will not be adopted unless special assistance is provided to the adoptive parents. Factors include whether the child has a specific factor or condition (such as the child's ethnic background, age, or membership in a minority or sibling group), and whether the child has a medical condition, or a physical, mental, or emotional handicap.
- f. Generally, both domestic and foreign adoptions qualify for the credit, however, there are differing timing rules for when the credit can be claimed based on the type of adoption.
- Qualified expenses related to a domestic adoption become creditable in the tax year following the payment. This is the case even if the adoption is never finalized or the eligible child is yet to be identified.
  - Qualified expenses related to a foreign adoption become creditable in the tax year the adoption is finalized. Once the adoption is finalized, all qualified expenses from prior years and the year the adoption becomes final are available for the credit.
  - Whether domestic or foreign, adoption expenses paid after the year the adoption becomes final are available for credit in the year of payment.

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

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

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

- The \$12,000 (\$3,000 from 2023 + \$4,000 from 2024 + \$5,000 from 2025) becomes creditable on the 2025 tax return as this is the year the adoption becomes final.

- Any excess credits would be available for a carryforward of up to five years.
  - Whether domestic or foreign, any additional expenses paid in 2026 would be creditable in 2026 as the adoption has been finalized.
- g. The adoption credit is generally available to all filing statuses except married filing separately. Married taxpayers filing separately may still be able to claim the credit if the filer is considered unmarried because of legal separation or living apart from spouse.

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

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

- When claiming the qualified adoption expenses in 2025, only \$9,000 (\$5,000 from 2024 and \$4,000 from 2025) will be creditable in 2025.
  - Because the taxpayers filed separately in 2024 when the first \$2,000 of expenses became creditable, those adoption expenses may not be claimed in 2025.
  - If claiming the credit is a priority, amended returns could be filed for 2024 within the appropriate period of limitations to change the filing status and claim \$2,000 qualified expenses for purposes of the adoption credit.
- h. The adoption credit and exclusion are both claimed on Form 8839, *Qualified Adoption Expenses*, which is attached to a filed individual income tax return. Creditable expenses should be tracked and provided by the taxpayer, and employer-provided adoption assistance should be reported on the employee's Form W-2, box 12, code T. Adoption documentation is no longer required to be attached to the filed return, though documentation should be retained as part of accurate record keeping.
- i. The SECURE Act contains favorable updates for both **qualified adoption expenses** and **qualified births**. The SECURE Act allows for penalty-free withdrawals from retirement plans of up to \$5,000 per individual in the event of a qualified birth of a child or adoption for distributions made after December 31, 2019. This provision is a new exemption from the 10% penalty tax of §72(t) for early withdrawals from qualified plans and IRAs.

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

**Note:**

As discussed, prior to the OBBBA, the Adoption Tax Credit was nonrefundable. The OBBBA enhances the existing adoption credit by making up to \$5,000 (adjusted for inflation) of the credit refundable beginning in tax year 2025. The refundable portion of the credit is not eligible for carryforward. The remaining portion of the credit (up to the total limit) remains nonrefundable and continues to be subject to five-year carryforward rules.

## M. Education benefits

**Note:**

For taxable years beginning after December 31, 2025, in the case of an American Opportunity Tax Credit or Lifetime Learning Credit with respect to qualified tuition and related expenses of an individual other than the taxpayer or the taxpayer's spouse (for example, the dependent child of the taxpayer), the taxpayer is allowed the credit only if the taxpayer includes on the return the SSN of both the individual and the taxpayer.

### 1. Education credits

An individual taxpayer is allowed a nonrefundable education tax credit against income tax for the taxable year. The amount of the education tax credit is the total of the Hope Scholarship credit plus the Lifetime Learning credit.<sup>12</sup>

- a. In the same taxable year, a taxpayer may claim a Hope Scholarship credit for each eligible student's **qualified tuition and related expenses** and a Lifetime Learning credit for one or more other students' qualified tuition and related expenses. However, a taxpayer may not claim both a Hope Scholarship credit and a Lifetime Learning credit with respect to the same student in the same taxable year.<sup>13</sup>
- b. Subject to certain limitations, a Hope Scholarship credit may be claimed for the qualified tuition and related expenses paid during a taxable year with respect to each eligible student. Qualified tuition and related expenses paid during a taxable year with respect to one student may not be taken into account in computing the amount of the Hope Scholarship credit with respect to any other student. In addition, qualified tuition and related expenses paid during a taxable year with respect to any student for whom a Hope Scholarship credit is claimed may not be taken into account in computing the amount of the Lifetime Learning credit.<sup>14</sup>
- c. Subject to certain limitations, a Lifetime Learning credit may be claimed for the aggregate amount of qualified tuition and related expenses paid during a taxable year with respect to students for whom no Hope Scholarship credit is claimed.<sup>15</sup>
- d. As a result of the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (TCDTRA), for tax years beginning in 2021, the Lifetime Learning tax credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified adjusted gross income between \$80,000 and \$90,000 (\$160,000 and \$180,000 for married individuals who file a joint return). Thus, taxpayers with modified adjusted gross income above \$90,000 (or \$180,000 for joint filers) may not claim an education tax credit.

<sup>12</sup> Treas. Regs. §1.25A-1(a).

<sup>13</sup> Treas. Regs. §1.25A-1(b)(1).

<sup>14</sup> Treas. Regs. §1.25A-1(b)(2).

<sup>15</sup> Treas. Regs. §1.25A-1(b)(3).

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

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

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

- e. Subject to the phaseout of the education tax credit described above, the Lifetime Learning credit amount is 20 percent of up to \$10,000 of qualified tuition and related expenses paid during the taxable year for education furnished to the taxpayer, the taxpayer's spouse, and any claimed dependent during any academic period beginning in the taxable year (or treated as beginning in the taxable year).<sup>16</sup> Those expenses paid with respect to a student for whom the Hope Scholarship credit is claimed are not eligible for the Lifetime Learning credit.<sup>17</sup> Thus, in 2025, the maximum Lifetime Learning credit is \$2,000.

**Note:**

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

- f. For any taxable year beginning after 2008, the Hope Scholarship is redesignated as the American Opportunity credit.<sup>18</sup> For 2025, the American Opportunity credit is an amount equal to the sum of <sup>19</sup> 100 percent of so much of the qualified tuition and related expenses paid by the taxpayer during the taxable year (for education furnished to the eligible student during any academic period beginning in such taxable year) as does not exceed \$2,000,<sup>20</sup> plus 25 percent of such expenses so paid as exceeds \$2,000 but does not exceed \$4,000.<sup>21</sup> For 2025, the maximum American Opportunity credit is \$2,500.

<sup>16</sup> Treas. Regs. §1.25A-4(a)(2).

<sup>17</sup> Treas. Regs. §1.25A-4(a)(3).

<sup>18</sup> The American Recovery and Reinvestment Act of 2009.

<sup>19</sup> I.R.C. §25A(i)(1).

<sup>20</sup> I.R.C. §25A(i)(1)(A).

<sup>21</sup> I.R.C. §25A(i)(1)(B).

The change generally increases the credit:

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

- (i) The Act extends the period during which the credit applies. It not only applies to as many as four years of post-secondary education (provided that the student has not completed the first four years of post-secondary education before the beginning of the fourth taxable year),<sup>22</sup> but also to all four years of post-secondary education.<sup>23</sup>

**Planning point:**

Looking at the above table, the American Opportunity tax credit exceeds the Lifetime Learning credit at all levels of qualified expense. Formerly, one could squeeze an additional \$200 (.20 x \$10,000) at expense levels of or more than \$10,000. The Lifetime Learning credit was larger for qualified expenses above \$9,000. The effect of the provision is to limit Lifetime Learning credits to situations in which the taxpayer (or taxpayer's dependent) is a less-than-half-time student or has been convicted of a federal or state felony offense consisting of the possession or distribution of a controlled substance before the end of the taxable year within which such period ends, since in either case an individual does not qualify for the Hope Scholarship (or its surrogate, the American Opportunity, for 2009 through 2025) credit.<sup>24</sup>

- (ii) In general, the personal credits are applicable only to the excess of the regular tax liability over the tentative tax; it is not applicable against any AMT, i.e., the excess of the tentative tax over the regular tax liability as reduced by the personal nonrefundable credits.<sup>25</sup> However, since 2000, Congress has enabled this and other such nonrefundable personal credits to be applied against the sum of the regular tax liability (reduced by the foreign tax credit) and the AMT (essentially the tentative tax).<sup>26</sup> This was made permanent by the 2012 ATRA legislation. That, in effect, permits this credit to offset and reduce an AMT liability.
- (iii) The Hope credit is a nonrefundable personal credit. However, the Act treats 40 percent of so much of the education credit allowed as is attributable to the Hope Scholarship (American Opportunity) credit (after taking into account the income

<sup>22</sup> I.R.C. §25A(b)(2)(A). I.R.C. §25A(i)(2).

<sup>23</sup> I.R.C. §25A(b)(2)(C). I.R.C. §25A(i)(2).

<sup>24</sup> I.R.C. §25A(b)(2)(B) and §25A(b)(2)(D).

<sup>25</sup> I.R.C. §26(a)(1).

<sup>26</sup> I.R.C. §26(a)(2).

phase out, but without regard to the limitation of the credit against the AMT or regular tax liability, as the case may be) as a refundable credit.<sup>27</sup>

**Note:**

This means that the American Opportunity tax credit must be bifurcated into the refundable and nonrefundable portions after computing the aggregate amount after income phase out, then the nonrefundable portion of the credit must be applied against the AMT or the regular tax liability in excess of tentative tax<sup>28</sup> and then the refundable portion must be applied as other refundable credits are.

**Caution:**

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

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

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

**Comparison of American Opportunity Tax Credit and Lifetime Learning Credit**

Credit	Maximum Amount	Refundability	Qualifying Expenses	Education Level	MAGI Phaseout
<b>American Opportunity Tax Credit (AOTC)</b>	\$2,500 per student	40% Refundable	<ul style="list-style-type: none"> <li>• Tuition and Enrollment Fees</li> <li>• Required Books, supplies, and course materials</li> </ul>	<ul style="list-style-type: none"> <li>• Maximum 4 years of post-secondary education</li> <li>• Must pursue degree</li> </ul>	Single: \$80,000-\$90,000  MFJ: \$160,000 - \$180,000
<b>Lifetime Learning Credit</b>	\$2,000 per return	Nonrefundable	<ul style="list-style-type: none"> <li>• Tuition and Enrollment Fees</li> </ul>	<ul style="list-style-type: none"> <li>• Unlimited years</li> <li>• All levels of post-secondary education or courses to improve job skills</li> </ul>	Single: \$80,000-\$90,000  MFJ: \$160,000 - \$180,000

<sup>27</sup> I.R.C. §25A(i)(6). It is not treated as a Hope credit, so the limitations (other than the income phase out) of §25A do not apply.

<sup>28</sup> Any reference in §25A or §§24, 25, 26, 25B, 904, or 1400C to a credit allowable under this subsection shall be treated as a reference to so much of the credit allowable as is attributable to the Hope Scholarship Credit.

**Planning point:**

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

**Example 1:** In 2025, Client pays qualified tuition and related expenses for Client's dependent, Child, to attend Ole Alma Mater during 2025. Client claims Child as a dependent on Client's federal income tax return. Therefore, assuming all other relevant requirements are met, Client is allowed an education credit on Client's federal income tax return, and Child is **not** allowed an education credit on Child's federal income tax return. The result would be the same if Child paid the qualified tuition and related expenses.<sup>29</sup>

**Example 2:** In 2025, Client has one dependent, Child. In 2025, Child pays qualified tuition and related expenses to attend Ole Alma Mater during 2025. Although Client is eligible to claim Child as a dependent on Client's federal income tax return, Client does not do so. Therefore, assuming all other relevant requirements are met, Child is allowed an education credit on Child's federal income tax return, and Client is not allowed an education credit on Client's federal income tax return with respect to Child's education expenses. The result would be the same if Client paid the qualified tuition and related expenses on behalf of Child.<sup>30</sup>

The new tax structure may suggest higher wages to be paid to certain children, since now the kiddie tax applies to a student who has not attained age 24 or a child who has not attained age 19 unless, in either case, the child has earned income in excess of one-half of the child's support. This means that a child, assuming all other conditions are met, may earn up to \$37,800 of earned income and pay no income tax if eligible for the American Opportunity credit or \$33,200 if eligible for the Lifetime Learning credit.

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

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

**2. Qualified tuition expenses**

For taxable years through 2017, taxpayers were allowed an above-the-line deduction for qualified tuition and related expenses paid by the taxpayer during a taxable year. The deduction was not allowed if the

<sup>29</sup> See Treas. Regs. §1.25A-1(f)(2), Ex. 1.

<sup>30</sup> See Treas. Regs. §1.25A-1(f)(2), Ex. 2.

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

<b>Form 8917</b> (Rev. January 2020) Department of the Treasury Internal Revenue Service		<b>Tuition and Fees Deduction</b> ▶ Attach to Form 1040 or 1040-SR. ▶ Go to <a href="http://www.irs.gov/Form8917">www.irs.gov/Form8917</a> for the latest information.		OMB No. 1545-0074
Name(s) shown on return			Your social security number	
 <p>Use this form for qualified tuition and fees paid in 2018, 2019, or 2020, and later years if legislation extends the deduction (see instructions). File a separate Form 8917 for each year after 2017 for which you qualify to take the deduction.</p> <p>You can't take both an education credit from Form 8863 and the tuition and fees deduction from this form for the same student for the same tax year.</p>				
<b>Before you begin:</b> <ul style="list-style-type: none"> <li>✓ To see if you qualify for this deduction, see <i>Who Can Take the Deduction</i> in the instructions below.</li> <li>✓ If you file Form 1040 or 1040-SR, figure any write-in adjustments.           <ul style="list-style-type: none"> <li>• For 2018: Figure any write-in adjustments to be entered on the dotted line next to Schedule 1 (Form 1040), line 36.</li> <li>• For 2019: Figure any write-in adjustments to be entered on the dotted line next to Schedule 1 (Form 1040 or 1040-SR), line 22.</li> <li>• For 2020 and later years: Figure any write-in adjustments for Schedule 1 (Form 1040 or 1040-SR); see the instructions for Forms 1040 and 1040-SR.</li> </ul> </li> </ul>				
1		(a) Student's name (as shown on page 1 of your tax return)	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Adjusted qualified expenses (see instructions)
		First name	Last name	
2		Add the amounts on line 1, column (c), and enter the total		2
3		Enter the amount from your "total income" line of Form 1040 or 1040-SR		3
4		<ul style="list-style-type: none"> <li>• For 2018: Enter the total of the amounts on your 2018 Schedule 1 (Form 1040), lines 23 through 33, plus any write-in adjustments you entered on the dotted line next to Schedule 1 (Form 1040), line 36.</li> <li>• For 2019 and 2020: Enter the total of the amounts on your 2019 Schedule 1 (Form 1040 or 1040-SR), lines 10 through 20, plus any write-in adjustments you entered on the dotted line next to Schedule 1 (Form 1040 or 1040-SR), line 22.</li> <li>• For later years: See <a href="http://www.irs.gov/Form8917">www.irs.gov/Form8917</a> to find out if the line references above for 2019 have changed.</li> </ul>		4
5		Subtract line 4 from line 3.* If the result is more than \$60,000 (\$160,000 if married filing jointly), stop; you can't take the deduction for tuition and fees. * If you're filing Form 2555, 2555-EZ, or 4563, or you're excluding income from Puerto Rico, see <i>Effect of the Amount of Your Income on the Amount of Your Deduction</i> in Pub. 970 to figure the amount to enter on line 5.		5
6		<b>Tuition and fees deduction.</b> Is the amount on line 5 more than \$65,000 (\$130,000 if married filing jointly)?		6
		<input type="checkbox"/> Yes. Enter the smaller of line 2, or \$2,000.		
		<input type="checkbox"/> No. Enter the smaller of line 2, or \$4,000.		
Also enter this amount on line 21 of the 2019 and 2020 Schedule 1 (Form 1040 or 1040-SR), or line 34 of the 2018 Schedule 1 (Form 1040). See <a href="http://www.irs.gov/Form8917">www.irs.gov/Form8917</a> to find out if the line references above for 2019 have changed.				

<sup>31</sup> The Consolidated Appropriations Act, 2021.

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

### 3. Coverdell education savings accounts (CESAs)

A Coverdell education savings account (CESA), a product of the Taxpayer Relief Act of 1997, is a tax-free savings account for educational expenses. A CESA is a trust or custodial account that is created or organized in the United States exclusively for the purpose of paying the qualified higher-education expenses of the designated beneficiary of the account. The account must be designated as a Coverdell education savings account when it is created in order to be treated as a Coverdell savings account for tax purposes.<sup>32</sup>

- a. Taxpayers may deposit up to \$2,000 per year into a CESA for a child younger than age 18. Parents, grandparents, other family members, friends, and the child may contribute to the child's CESA, provided that the total contributions for the child during the taxable year do not exceed the \$2,000 limit. Amounts deposited in the account grow tax-free until distributed, and the child will not owe tax on any withdrawal from the account if the child's qualified higher-education expenses at an eligible educational institution for the year equal or exceed the amount of the withdrawal.
- b. Any individual, again including the beneficiary, can contribute to a CESA if their modified adjusted gross income is under \$110,000 (\$220,000 for joint returns).
- c. Distributions from a CESA are not included in the gross income of the distributee to the extent of the beneficiary's qualified higher-education expenses during the taxable year.<sup>33</sup> "Qualified higher-education expenses" are defined as tuition, fees, books, supplies, and equipment required for the enrollment or attendance at a college or university (or certain vocational schools). They now include reasonable costs for room and board incurred by the designated beneficiary who is an eligible student for any academic period while attending such institution.<sup>34</sup> Unique to a CESA is the inclusion as qualified higher-education expenses "qualified elementary and secondary school expenses,"<sup>35</sup> meaning expenses for:
  - (i) Tuition, fees, academic tutoring, special-needs services, books, supplies, and other equipment incurred in connection with the enrollment or attendance of the beneficiary at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12) as determined under state law;
  - (ii) Room and board, uniforms, transportation, and supplementary items or services (including extended day programs) required or provided by such a school in connection with such enrollment or attendance of the beneficiary; and
  - (iii) The purchase of any computer technology, equipment, or Internet access and related services, if such technology, equipment, or services are to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in school. Computer software primarily involving sports, games, or hobbies is not considered a qualified elementary and secondary school expense unless the software is educational in nature.

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<sup>32</sup> Notice 97-60, 1997-46 I.R.B. 8, §3, Q&A-1.

<sup>33</sup> I.R.C. §530(d)(2)(A).

<sup>34</sup> I.R.C. §529(e)(3)(B)(i).

<sup>35</sup> I.R.C. §530(b)(4)(A).

- d. A distribution otherwise taxable from a CESA to the extent that the amount received is paid into another CESA for the benefit of the same beneficiary or a **member of the family** of such beneficiary not later than the sixtieth day after the date of such payment or distribution is not included in the gross income of the distributee.<sup>36</sup> A member of the family means: (i) the spouse of the beneficiary; (ii) a son or daughter of the beneficiary, or a descendant of either; (iii) a stepson or stepdaughter of the beneficiary; (iv) a brother, sister, stepbrother, or stepsister of the beneficiary; (v) the father or mother of the beneficiary, or an ancestor of either; (vi) a stepfather or stepmother of the beneficiary; (vii) a son or daughter of a brother or sister of the beneficiary; (viii) a brother or sister of the father or mother of the beneficiary; (ix) a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law of the beneficiary; (x) a first cousin of the beneficiary, but not the spouse of a first cousin; or (xi) any spouse of an individual named in (ii) - (ix).<sup>37</sup> However, the rollover does not avoid tax with respect to any payment or distribution if the rollover was applied to any prior payment or distribution during the 12-month period ending on the date of the payment or distribution.
- e. Tax-free transfers or rollovers of account balances may be made from one CESA benefiting one beneficiary to another CESA benefiting another beneficiary (as well as redesignations of the named beneficiary), provided that the new beneficiary is a **member of the family of the old beneficiary** and is under age 30. Any balance remaining in a CESA is deemed distributed within 30 days after the date that the beneficiary reaches age 30 (or, if earlier, within 30 days of the date that the beneficiary dies). The age limitations with respect to rollovers and required distributions are eliminated in the case of a beneficiary who is a special-needs beneficiary. Thus, a deemed distribution of any balance in a CESA does not occur when a special-needs beneficiary reaches age 30.
- f. Finally, the age-30 limitation does not apply in the case of a rollover contribution for the benefit of a special-needs beneficiary or a change in beneficiaries to a special-needs beneficiary.

**Note:**

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

**The Case to Kill the Coverdell:**

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

Consider the following:

- CESAs once had the advantage of allowing qualified withdrawals for K-12 expenses. The TCJA expanded §529 plans by allowing qualified withdrawals for K-12 expenses, eliminating that advantage of CESAs over §529 plans.
- The SECURE Act expanded §529 plans by allowing qualified withdrawals for student loan repayment (up to \$10,000) and apprenticeship programs. Student loan repayment and apprenticeship program expenses are not considered qualified withdrawals for CESAs.
- Combined contributions are capped at \$2,000 per beneficiary, per year, not indexed for inflation.

<sup>36</sup> I.R.C. §530(d)(5). This includes, besides the taxpayer and spouse, sons, daughters, brothers, sisters, nephews and nieces, certain in-laws, etc. and any spouse of such persons.

<sup>37</sup> I.R.C. §529(e)(2).

- Section 529 plans have an indefinite life and can last for generations, whereas CESAs must be disbursed for qualified education expenses or given to another family member under age 30 by the time the original beneficiary turns 30 years old.
- Section 529 plans can qualify for state tax deductions and credits, whereas CESAs do not.

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

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

Prior to 2002, a qualified tuition program (QTP) generally referred to a program established and maintained by a **state**. The basic thrust of the program was to permit persons to: (i) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher-education expenses of the beneficiary; or (ii) make contributions to an account that is established for the purpose of meeting qualified higher-education expenses of the designated beneficiary of the account (a “savings-account plan”). The terms and conditions of these programs vary from state to state.<sup>38</sup> However, there are some standard federal income-tax rules that apply to these programs.<sup>39</sup> The tax on earnings attributable to prepayments or contributions is deferred until the earnings are distributed from the QTP.

#### **Note:**

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

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

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

<sup>38</sup> Notice 97-60, 1997-46 I.R.B. 8, §6.

<sup>39</sup> I.R.C. §529.

- a. Under the 2001 Act, tax-exempt status is granted to a qualified tuition program, which includes both a qualified tuition program as before and prepaid tuition programs established and maintained by one or more eligible educational institutions (which may be private institutions) that satisfy the requirements under §529 (other than the state-sponsorship rule).<sup>40</sup> In the case of a qualified tuition program maintained by one or more **private eligible educational institutions**, persons are able to purchase tuition credits or certificates on behalf of a designated beneficiary, but would not be able to make contributions to a savings-account plan.<sup>41</sup> For these purposes, the term “eligible educational institution” means an institution that is described in §481 of the Higher Education Act of 1965,<sup>42</sup> as in effect on June 7, 2001 (the date of the enactment), and is eligible to participate in programs under Title IV of that Act.<sup>43</sup>
- b. The beneficiary pays tax on the earnings at the time of distribution. If amounts saved through a QTP are used to pay for college, the student or the student’s parents still may be eligible to claim either the Hope Scholarship credit or the Lifetime Learning credit.<sup>44</sup> However, an amount contributed to a Coverdell savings account on behalf of a designated beneficiary during any taxable year in which an amount is also contributed to a qualified tuition program on behalf of the same beneficiary will not be treated as an excess contribution to the CESA.<sup>45</sup> However, cash distributions made in taxable years beginning after December 31, 2001 from qualified tuition programs are excluded from gross income to the extent that the distribution is used to pay for qualified higher-education expenses (as reduced by any in-kind distributions). This exclusion from gross income is extended to distributions from qualified tuition programs established and maintained by an entity other than a state (or agency or instrumentality thereof) for distributions made in taxable years after December 31, 2003.
- c. Contributions by donors are eligible for the \$19,000 annual gift-tax exclusion (\$38,000 for “split” gifts by married couples). Therefore, for transfer-tax purposes such contributions are treated as a completed gift to the beneficiary.

**Questions to ponder:**

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

**Planning point:**

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

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

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<sup>40</sup> I.R.C. §529(b)(1).  
<sup>41</sup> I.R.C. §529(b)(1)(A)(i).  
<sup>42</sup> 20 U.S.C. 1088.  
<sup>43</sup> I.R.C. §529(e)(5).  
<sup>44</sup> Notice 97-60, 1997-46 I.R.B. 8, §6, Q&A-2.  
<sup>45</sup> Notice 97-60, 1997-46 I.R.B. 8, §6, Q&A-4.

The gift-tax annual exclusion increases to \$19,000 in 2025. Although the amount is indexed for inflation, it rounds down to the next lowest multiple of \$1,000.<sup>46</sup>

**Note:**

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

- d. PPA repealed the sunset provisions of Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) that would have expired at the end of 2010 and that relate to qualified tuition programs (§529 plans):
- (i) The provision that makes qualified withdrawals from qualified tuition accounts exempt from income tax;
  - (ii) The repeal of a pre-EGTRRA requirement that there be more than a de minimis penalty imposed on amounts not used for educational purposes and the imposition of the 10-percent additional tax on distributions not used for qualified higher education purposes;
  - (iii) A provision permitting certain private educational institutions to establish prepaid tuition programs that qualify under §529 if they receive a ruling or determination to that effect from the Internal Revenue Service, and if the assets are held in a trust created or organized for the exclusive benefit of designated beneficiaries;
  - (iv) Certain provisions permitting rollovers from one account to another account;
  - (v) Certain rules regarding the treatment of room and board as qualifying expenses;
  - (vi) Certain rules regarding coordination with Hope and Lifetime Learning credit provisions;
  - (vii) The provision that treats first cousins as members of the family for purposes of the rollover and change-in-beneficiary rules; and
  - (viii) Certain provisions regarding the education expenses of special-needs beneficiaries.
- e. Three significant changes have been made recently to the rules for §529 plans:
- (i) The PATH Act of 2015 expanded the definition of qualified expenses to include computers and peripheral equipment. This modernized the rules to be more in step with today's use of technology in education.
  - (ii) The TCJA added a provision to allow distributions to cover grades K-12, with an annual limit of \$10,000.
  - (iii) The SECURE Act expanded §529 education savings accounts coverage (discussed later).

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<sup>46</sup> I.R.C. §26(b)(2).

**Note:**

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

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

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

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

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

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

**Note:**

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

**5. SECURE Act update: Section 529 plans**

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

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

**6. Student loan interest**

As discussed, the OBBBA further expands §529 education savings accounts coverage to be used for additional educational expenses in connection with enrollment or attendance at an elementary or secondary school, as well as for additional qualified higher education expenses, including qualified postsecondary credentialing expenses. These provisions apply to distributions made after July 4, 2025.

There is an **above-the-line deduction for interest** paid on certain loans used to pay **qualified higher-education expenses**. This deduction applies to payments that would otherwise be treated as nondeductible personal interest except for the new special rules.<sup>47</sup> The amount allowable cannot exceed \$2,500. It is not indexed for inflation.

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

<sup>47</sup> I.R.C. §221.

**Note:**

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

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

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

## **N. Transportation**

### **1. Mileage**

- a. For automobiles first provided by employers to employees that meet certain requirements, the value to the employee of the use of the automobile may be determined under the vehicle cents-per-mile valuation rule,<sup>48</sup> but only if the fair market value of the automobile on the first date the automobile is made available to the employee does not exceed a “base value” amount. For years prior to 2018 this base value was \$16,000 (\$17,900 for vans and trucks). In IRS Notice 2019-08, the Treasury Department raised these amounts for 2018 significantly to \$50,000. The IRS Notice 2019-08 was issued to adjust the numbers because of the changes to the luxury automobile depreciation limits made by the Tax Cuts and Jobs Act of 2017. The \$50,000 limit for 2018 also applies for the fleet-average valuation rules. The 2025 figure is \$62,000.<sup>49</sup>

**Planning note:**

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

- b. For 2025, the standard mileage rate is the number of business miles driven multiplied by 70 cents.
- c. For 2025, the standard mileage rate for deductible medical or moving expenses (available for active-duty members of the military) is 21 cents per mile.
- d. The standard mileage rate for miles driven in connection with service of charitable organizations remains at 14 cents per mile.

### **2. Lease-deduction reduction**

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

<sup>48</sup> Treas. Regs. §1.61-21(e).

<sup>49</sup> Rev. Proc. 2025-16.

REV. PROC. 2025-16 TABLE 3

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

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

**3. Depreciation**

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

<sup>50</sup> Rev Proc. 2025-16.

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

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

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

**Note:**

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

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

**Autos (including trucks or vans):**

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

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

**Note:**

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

**Note:**

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

**Note:**

There is no AMT adjustment with respect to property expensed under §179.<sup>51</sup>

**Caution:**

Under the OBBBA, for tax years beginning in 2025, the maximum is \$2,500,000, phasing out for expenditures in excess of \$4,000,000.<sup>52</sup>

<sup>51</sup> S. Rept. (1986).  
<sup>52</sup> OBBBA.

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

- c. A sport-utility vehicle is a four-wheeled vehicle that:
- Is primarily designed or which can be used to carry passengers over public streets, roads, or highways (except any vehicle operated exclusively on a rail or rails);
  - Is not subject to §280F; and
  - Is rated at not more than 14,000 pounds gross vehicle weight.
- d. However, a sport-utility vehicle does **not** include any vehicle that:
- Is designed to have a seating capacity of more than nine persons behind the driver's seat;
  - Is equipped with a cargo area of at least six feet in interior length, which is an open area or is designed for use as an open area but is enclosed by a cap and is not readily accessible directly from the passenger compartment; or
  - Has an integral enclosure, fully enclosing the driver compartment and load carrying device, does not have seating rearward of the driver's seat, and has no body section protruding more than 30 inches ahead of the leading edge of the windshield.

**Note:**

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

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

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

#### 4. Qualified transportation expenses

Employees can exclude a limited amount of **qualified transportation fringe** benefits provided by the employer from gross income and wages for both income and payroll taxes within specific limitations, without regard to working-condition fringe benefits and de minimis fringe benefits.<sup>53</sup> However, for tax years beginning after December 31, 2017, the amounts are not deductible by the employer.<sup>54</sup>

- a. Qualified transportation fringe benefits include the following.
- (i) Transportation in a **commuter highway vehicle** is transportation provided by an employer to an employee in connection with travel between the employee's residence and place of employment.<sup>55</sup> A commuter highway vehicle is a highway vehicle with a seating capacity of at least six adults (excluding the driver) and with respect to which at least 80 percent of the vehicle's mileage is reasonably

<sup>53</sup> I.R.C. §132(a)(5).

<sup>54</sup> I.R.C. §274(a)(4), as amended by the TCJA.

<sup>55</sup> Treas. Regs. §1.132-9, A-2.

expected to be used for transporting employees in connection with travel between their residences and their place of employment and on trips during which the number of employees transported for commuting is at least one-half of the adult seating capacity of the vehicle (excluding the driver).<sup>56</sup> Transportation is considered provided by the employer if the transportation is furnished in a commuter highway vehicle operated by or for the employer.<sup>57</sup>

- (ii) Also included is any **transit pass**,<sup>58</sup> which is any pass, token, farecard, voucher, or similar item (including an item exchangeable for fare media) that entitles a person to transportation or transportation at a reduced price if such transportation is on mass-transit facilities (whether or not publicly owned), or is provided by any person in the business of transporting persons for compensation or hire in a highway vehicle with a seating capacity of at least six adults (excluding the driver).<sup>59</sup>
- (iii) Finally, any **qualified parking** that is parking provided to an employee by an employer:<sup>60</sup>
- On or near the employer's business premises; or
  - At a location from which the employee commutes to work by carpool, commuter highway vehicle, mass-transit facilities, transportation provided by any person in the business of transporting persons for compensation or hire, or by any other means.<sup>61</sup>
- b. The amount of the fringe benefits that are provided to any employee and that may be excluded in 2025 may not exceed \$325 per month in the aggregate for transportation in a commuter highway vehicle and transit passes,<sup>62</sup> and \$325 per month in the case of qualified parking.<sup>63</sup>
- c. Only employees are eligible for a qualified transportation fringe. For these purposes, an employee does not include a sole proprietor, a partner, or a more-than-two-percent shareholder of an S corporation.<sup>64</sup>
- d. Unlike the de minimis fringe benefits rule, under which \$1 above the facts-and-circumstances amount converts the entire benefit into a taxable benefit, the statute with respect to qualified transportation fringes merely places a limitation on the amount of the exclusion. Thus, the employer's payment of a \$326 monthly parking fee only subjects \$1 to tax in 2025.

## 5. Federal per-diem rates

The General Services Administration changed the COLI adjustment that affects the period October 1, 2025 through September 30, 2026. The per diem for 10/1/25 to 9/30/26 is \$319 for any high-cost locality, consisting of \$233 for lodging and \$86 for meals and incidentals. The 2026 per diem is \$225 for travel to any other locality, consisting of \$151 for lodging and \$74 for meals and incidentals.<sup>65</sup> Taxpayers may elect to treat this table as applicable to the calendar year 2026. The special M&IE rates for transportation

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<sup>56</sup> I.R.C. §132(f)(5)(B).

<sup>57</sup> I.R.C. §132(f)(5)(D).

<sup>58</sup> I.R.C. §132(f)(1)(B).

<sup>59</sup> Treas. Regs. §1.132-9, A-3.

<sup>60</sup> I.R.C. §132(f)(1)(C).

<sup>61</sup> Treas. Regs. §1.132-9, A-4(a).

<sup>62</sup> I.R.C. §132(f)(2)(A), Rev. Proc. 2023-34.

<sup>63</sup> I.R.C. §132(f)(2)(B). Both of these limitations will be adjusted to the nearest \$5 to account for inflation.

<sup>64</sup> I.R.C. §132(f)(7). A more-than-two-percent shareholder is treated the same as a partner for purposes of fringe benefits.

<sup>65</sup> Notice 2025-54.

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

- a. For travel away from home, the term “incidental expenses” has the meaning given to it in the Federal Travel Regulations.<sup>66</sup> For example, the term “incidental expenses” includes fees and tips given to porters, baggage carriers, bellhops, hotel maids, stewards or stewardesses and others on ships, and hotel servants in foreign countries but does not include expenses for laundry, cleaning and pressing of clothing, lodging taxes, or the costs of telegrams or telephone calls.
- b. In lieu of using actual expenses in computing the amount allowable as a deduction for ordinary and necessary incidental expenses paid or incurred for travel away from home, employees and self-employed individuals who do not pay or incur meal expenses for a calendar day (or partial day) of travel away from home may use an amount computed at the rate of \$5 per day for each calendar day (or partial day) the employee or self-employed individual is away from home.

**Note:**

In 2010, the Internal Revenue Service requested public comment on the continuing need for the high-low method for substantiating, under §274(d) of the Internal Revenue Code, lodging, meal, and incidental expenses incurred in traveling away from home. The Service received no comments.<sup>67</sup> Accordingly, the Service announced that it intended to **discontinue authorizing the high-low substantiation method**.<sup>68</sup> In 2011, the Service planned to publish a revenue procedure providing the general rules and procedures for substantiating lodging, meal, and incidental expenses incurred in traveling away from home (omitting the high-low substantiation method). However, based on comments received from tax professionals, the Service withdrew this guidance and reinstated the high-low method.

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<sup>66</sup> 41 C.F.R. Part 300 (2003).

<sup>67</sup> Rev. Proc. 2010-39, 2010-42 I.R.B. 459.

<sup>68</sup> Ann. 2011-42, 2011-32 I.R.B. 1.

<b>Localities eligible for \$319 (\$86 M &amp; IE) Per-Diem Under High-Low Substantiation Method in 2025-2026</b>		
<b>State</b>	<b>Key city</b>	<b>County or other defined location</b>
Alabama	Gulf Shores (June 1-July 31)	Baldwin
Arizona	Phoenix/Scottsdale (February 1-March 31)	Maricopa
	Sedona (October 1-December 31 and March 1-September 30)	City limits of Sedona
California	Los Angeles (October 1-September 30)	Los Angeles
	Mammoth Lakes (December 1-March 31)	Mono
	Monterey (June 1-August 31)	Monterey
	Napa (October 1-September 30)	Napa
	Palm Springs (October 1-April 30)	Riverside
	San Diego (October 1-September 30)	San Diego
	San Francisco (October 1-September 30)	San Francisco
	San Luis Obispo (June 1-July 31)	San Luis Obispo
	Santa Barbara (October 1-September 30)	Santa Barbara
	Santa Monica (October 1-September 30)	City limits of Santa Monica
	South Lake Tahoe (December 1-March 31)	El Dorado
	Sunnyvale/Palo Alto/San Jose (October 1-September 30)	Santa Clara
	Yosemite National Park (January 1-April 30)	Mariposa
Colorado	Aspen (October 1-September 30)	Pitkin
	Denver/Aurora (October 1-October 31 and April 1-September 30)	Denver, Adams, Arapahoe, and Jefferson
	Silverthorne/Breckenridge (December 1-March 31)	Summit
	Steamboat Springs (December 1-March 31)	Routt
	Telluride (October 1-September 30)	San Miguel
	Vail (October 1-September 30)	Eagle
Delaware	Lewes (June 1-August 31)	Sussex
District of Columbia	Washington D.C. (also the cities of Alexandria, Falls Church, and Fairfax, and the counties of Arlington and Fairfax, in Virginia; and the counties of Montgomery and Prince George's in Maryland) (See also Maryland and Virginia) (October 1-September 30)	
Florida	Boca Raton/Delray Beach/Jupiter (January 1-April 30)	Palm Beach and Hendry
	Bradenton (February 1-March 31)	Manatee
	Cocoa Beach (February 1-March 31)	Brevard
	Fort Lauderdale (January 1-April 30)	Broward

<sup>69</sup> Notice 2025-54.

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

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

## 6. SIFL rates

- a. The final regulations retain the aircraft travel valuation method based upon Standard Industry Fare Level (“SIFL”) statistics published semiannually by the Civil Aeronautics Board of the Department of Transportation (“CAB/DOT”). The regulations provide the applicable SIFL statistics for the first half of 1989; updates are provided unless or until such time as the CAB/DOT discontinues publication of these statistics.<sup>70</sup>

Rates for the second half of 2025 are as follows:

2025	Terminal Charge	Rate for Miles 0-500	Rate for Miles 501-1500	Rate for Miles Over 1,500
Jul. 1- Dec 31	\$53.62	\$0.2933	\$0.2237	\$0.2150

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

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

**Example:** An executive flies 1,000 miles on the corporate aircraft having 15,000 lbs. take-off weight in Oct 2025; the value of this trip is \$829.12  $((500 \times \$0.2933 + 500 \times \$0.2237) \times 3) + \$53.62$ ; for the noncontrol employee it is \$134.53  $((500 \times \$0.2933 + 500 \times \$0.2237) \times 0.313) + \$53.62$ .

<sup>70</sup> Treas. Regs. §§1.61-21(g)(5) and (6).

**Planning point:**

Under the special valuation rules, the value of a flight is determined by using the Standard Industry Fare Level (SIFL) formula, which involves multiplying the SIFL cents-per-mile rates applicable for the period during which the flight was taken by an appropriate aircraft multiple, and then adding an applicable terminal charge for the period in which the flight was taken. The value of personal flights provided to employees under these special rules does not correspond with the employer's actual costs in providing the flights. In a recent case, the employer was entitled to deduct the full costs of providing its executives with a company jet for vacation flights, even though those costs exceeded the compensation that the employees included in income because of the flights.<sup>71</sup> This ran contrary to the Service's position, which caps the employer's deduction for a noncash fringe benefit by the amount of the recipient's reported income from the benefit.<sup>72</sup>

## O. Social Security adjustments

### 1. Wage base

In 2025, the taxable wage base is \$176,100<sup>73</sup> resulting in a maximum OASDI tax of \$10,918.20 (employer's share), \$10,918.20 (employee's share), or \$21,836.40 (self-employed individual). The Medicare portion of the tax remains a combined 2.9 percent on all earned income.

**Note:**

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

### 2. Excess earnings

- a. Deductions are made from the monthly benefits payable to a worker who is under normal retirement age and to the worker's dependents for each month the worker is charged with earnings in excess of certain amounts. A similar deduction is made in the dependent's benefits when the dependent has excess earnings. These rates do not apply to Social Security benefits based on disability, to persons who are age 70 or older, or to work performed outside the United States not covered by Social Security. Likewise, a divorced spouse's benefits are not reduced because of the insured's excess earnings, provided the divorce has been in effect for two years.
- b. The maximum amount that a beneficiary, the year he or she reaches normal retirement age, might earn in 2025 without affecting the beneficiary's own benefit or those of dependents is \$62,160 (\$5,180 per month). Benefits are reduced by \$1 for every \$3 earned over the annual exempt amount. (Note that this limitation ends with the month in which the beneficiary attains full retirement age. Hereafter, a periodic cost-of-living increase in these benefits will be provided. There is no reduction for persons from full retirement age through age 69.)
- c. A lower number is used as a ceiling for those under the normal retirement age; this is \$23,400 (\$1,950 monthly) in 2025. Benefits are reduced \$1 for every \$2 if the individual is

<sup>71</sup> *Sutherland Lumber-Southwest, Inc. v. Commissioner*, 114 T.C. 14 (2000).

<sup>72</sup> TAM 9615002 and 9715001. The case was overturned by the enactment of I.R.C. §274(e)(2).

<sup>73</sup> SSA.gov *Update 2025*, <https://www.ssa.gov/OACT/COLA/cbb.html>.

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

**Planning point:**

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

**3. Full retirement age**

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

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

74

**Note:**

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

<sup>74</sup> SSA.gov 2025 Retirement Benefits, Securing Today and Tomorrow

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

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

## Full Retirement and Age 62 Benefit By Year Of Birth

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

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

75

<sup>75</sup> <https://www.ssa.gov/benefits/retirement/planner/whileworking.html>

**Note:**

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

**Note:**

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

#### **4. Medicare**

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 imposes a premium on high-income enrollees in Medicare Part B (physician services) that will vary based on the income reported by each enrollee to the IRS for federal income-tax purposes.<sup>76</sup> The premium is calculated based on the most-recently-available tax returns (usually a two-year look back). The 2025 premium is based on taxable income for 2023. Termed the "income-related reduction in Part B subsidy," the new premium will effectively constitute an income-tax surcharge. The premium will be in addition to the current flat Part B premium. The two premiums together will be capped at 85 percent of the per-enrollee Part B program costs.<sup>77</sup> The premium applies to individual seniors with adjusted gross income exceeding \$106,000 per year (adjusted for inflation) and to married couples with adjusted gross income exceeding \$212,000 per year (adjusted for inflation). Furthermore, the Act phases in the maximum premium, so that seniors with even the highest incomes will pay only a fraction of the amount of the Part B subsidy in the early years.<sup>78</sup>

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<sup>76</sup> 42 U.S.C. §1395r(i), I.R.C. §6103(l)(20).

<sup>77</sup> 42 U.S.C. §1395r(i)(3).

<sup>78</sup> The statute does not prescribe an explicit rate for the new premium. Rather, the rate will vary from year to year, based on the actuarial value of the Part B benefits for each year.

In 2025:<sup>79</sup>

2023† AGI more than:	2023† AGI less than:	Premium
Single		
\$0	\$106,000	\$185.00
\$106,000	\$133,000	\$259.00
\$133,000	\$167,000	\$370.00
\$167,000	\$200,000	\$480.90
\$200,000	\$500,000	\$591.90
\$500,000		\$628.90
Married filing jointly		
\$0	\$212,000	\$185.00
\$212,000	\$266,000	\$259.00
\$266,000	\$334,000	\$370.00
\$333,000	\$400,000	\$480.90
\$400,000	\$750,000	\$591.90
\$750,000		\$628.90

### 5. Premiums for prescription drugs

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

In 2025:

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

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

<sup>79</sup> Data for Medicare Parts B and D are available at Medicare.gov.

## P. Medical expenses

### 1. Long-term-care insurance

Under the law, medical care includes **eligible long-term care premiums** for **qualified long-term-care insurance contracts**.<sup>80</sup> A qualified long-term-care insurance contract means any insurance contract if the only insurance protection provided under such contract is coverage of **qualified long-term care services**, the contract does not pay or reimburse expenses incurred for services or items to the extent that such expenses are reimbursable under Title XVIII of the Social Security Act or would be so reimbursable, but for the application of a deductible or coinsurance amount, they are guaranteed renewable, the contract does not provide for a cash-surrender value or other money that can be paid, assigned, or pledged as collateral for a loan, or borrowed, and all refunds of premiums and all policyholder dividends or similar amounts under such contract are to be applied as a reduction in future premiums or to increase future benefits. They must also generally conform to the long-term-care insurance model act promulgated by the National Association of Insurance Commissioners (as adopted as of January 1993).

- a. For these purposes, **qualified long-term care services** means necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services, and **maintenance or personal care services**, which are required by a chronically ill individual, and are provided pursuant to a plan of care prescribed by a licensed health care practitioner.
  - (i) For these purposes, a chronically ill individual means any individual who has been certified by a licensed health care practitioner as:
    - Being unable to perform (without substantial assistance from another individual) at least two **activities of daily living** for a period of at least 90 days due to a loss of functional capacity;
    - Having a level of disability similar to the level of disability with respect to two activities of daily living; or
    - Requiring substantial supervision to protect such individual from threats to health and safety due to severe cognitive impairment.

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

- (ii) For these purposes, each of the following is an activity of daily living:
  - Eating;
  - Toileting;
  - Transferring;
  - Bathing;
  - Dressing; and
  - Continence.

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

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<sup>80</sup> I.R.C. §213(d)(1) [flush language].

- (iii) For these purposes, maintenance or personal care services means any care the primary purpose of which is the provision of needed assistance with any of the disabilities as a result of which the individual is a chronically ill individual (including the protection from threats to health and safety due to severe cognitive impairment).
- b. If the long-term-care insurance contract is an indemnity policy (one which reimburses actual long-term-care costs), all benefits received under the policy are tax-free. If, on the other hand, the long-term-care insurance contract is a per-diem policy (one which pays a set amount per day regardless of actual expenses), a taxpayer can exclude the greater of \$400 per day or actual daily expenses.<sup>81</sup>

**Planning point:**

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

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

**2. Health savings accounts**

The Medicare Act of 2003 established a new tax-favored vehicle, the **health savings account (HSA)**, which permits, effective for taxable years beginning after December 31, 2003, an eligible individual for any month during the taxable year to deduct for the taxable year an amount equal to the aggregate amount paid in cash during such taxable year by or on behalf of such individual to the HSA.<sup>82</sup> This deduction is taken above-the-line in determining adjusted gross income.<sup>83</sup>

- a. The amount allowable as a deduction to an individual for the taxable year may not exceed the sum of the **monthly limitations** for months during such taxable year that the individual is an eligible individual.<sup>84</sup>
  - (i) The monthly limitation for any month is one-twelfth of an amount that depends on the kind of coverage under a high-deductible health plan as of the first day of such month:<sup>85</sup>
    - In the case of an eligible individual who has self-only coverage, the amount of \$4,300 in 2025,<sup>86</sup> or

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<sup>81</sup> Per diem amount and maximum deductible premiums are from Rev. Proc. 2024-25.  
<sup>82</sup> I.R.C. §223(a).  
<sup>83</sup> I.R.C. §62(19).  
<sup>84</sup> I.R.C. §223(b)(1).  
<sup>85</sup> I.R.C. §223(b)(2).  
<sup>86</sup> Rev. Proc. 2024-25.

- In the case of an eligible individual who has family coverage, the amount of 8,550 in 2025.<sup>87</sup>
- (ii) In the case of an individual who has attained age 55 before the close of the taxable year, the applicable limitation is increased by the additional contribution amount.<sup>88</sup> The additional contribution amount is the amount determined in accordance with the following table.<sup>89</sup>

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

- (iii) The limitation that would otherwise apply to an individual for any taxable year is reduced (but not below zero) by the sum of:
  - The aggregate amount paid for such taxable year to Archer MSAs of such individual;<sup>90</sup> and
  - The aggregate amount contributed to health savings accounts of such individual, which is excludable from the taxpayer's gross income for such taxable year under §106(d) and such amount shall not be allowed as a deduction.<sup>91</sup> The aggregate amount paid for such taxable year to Archer MSAs of such individual is not a reduction with respect to any individual in the following paragraph.
- (iv) In the case of individuals who are married to each other, if either spouse has family coverage: both spouses are treated as having only such family coverage (and if such spouses each have family coverage under different plans, as having the family coverage with the lowest annual deductible)<sup>92</sup> and the monthly limitation (after the application of the reduction for aggregate contribution to Archer MSAs, and without regard to any additional contribution amount):
  - Shall be reduced by the aggregate amount paid to Archer MSAs of such spouses for the taxable year; and
  - After such reduction, shall be divided equally between them unless they agree on a different division.
- (v) No deduction is allowed to any individual with respect to whom a deduction under §151 is allowable to another taxpayer for a taxable year beginning in the calendar year in which such individual's taxable year begins.<sup>93</sup>

**Caution:**

The limitation for any month with respect to an individual is **zero** for the first month such individual is entitled to benefits under Title XVIII of the Social Security Act and for each month thereafter.<sup>94</sup>

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

<sup>87</sup> Rev. Proc. 2024-25.  
<sup>88</sup> I.R.C. §223(b)(3)(A).  
<sup>89</sup> I.R.C. §223(b)(3)(B).  
<sup>90</sup> I.R.C. §223(b)(4)(A).  
<sup>91</sup> I.R.C. §223(b)(4)(B).  
<sup>92</sup> I.R.C. §223(b)(5)(A).  
<sup>93</sup> I.R.C. §223(b)(6).  
<sup>94</sup> I.R.C. §223(b)(7).

benefit that is covered under the high-deductible health plan.<sup>95</sup> The term “high-deductible health plan” means a health plan:<sup>96</sup> (i) that has an annual deductible that is not less than \$1,650<sup>97</sup> for self-only coverage, and twice that dollar amount for family coverage; and (ii) the sum of the annual deductible and the other annual out-of-pocket expenses required to be paid under the plan (other than for premiums) for covered benefits does not exceed \$8,300<sup>98</sup> for self-only coverage, and twice that dollar amount for family coverage. Such term **does not** include a health plan if substantially all of its coverage is permitted insurance or coverage (whether through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care.<sup>99</sup> A plan does not fail to be treated as a high-deductible health plan by reason of failing to have a deductible for preventive care (within the meaning of §1871 of the Social Security Act).<sup>100</sup>

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

## Q. Other

### 1. Tax benefits effective for individuals

- a. The deductible limit for health insurance premiums for self-employed taxpayers in 2025 is the lesser of 100 percent of the premium or the earned income derived by the taxpayer from the trade or business with respect to which the plan providing the medical-care coverage is established.
- b. The exclusion for foreign-earned income is \$130,000 in 2025.
- (i) Under the new law, the base housing amount used in calculating the foreign housing cost exclusion in a taxable year is 16 percent of the amount (computed on a daily basis) of the foreign-earned-income exclusion limitation (instead of the present-law 16 percent of the grade GS-14, step 1 amount), multiplied by the number of days of foreign residence or presence (as previously described) in that year.
- (ii) Reasonable foreign-housing expenses in excess of the base housing amount remain excluded from gross income (or, if paid by the taxpayer, are deductible), **but** the amount of the exclusion is limited to 30 percent of the maximum amount of a taxpayer's foreign-earned-income exclusion. Under the 30-percent rule, the maximum amount of the foreign-housing-cost exclusion in 2025 is (assuming foreign residence or presence on all days in the year) \$18,200 (( $\$130,000 \times 30$  percent) – ( $\$130,000 \times 16$  percent)).

#### **Caution:**

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

<sup>95</sup> I.R.C. §223(c)(1)(A).  
<sup>96</sup> I.R.C. §223(c)(2)(A).  
<sup>97</sup> Rev. Proc. 2024-25.  
<sup>98</sup> Rev. Proc. 2024-25.  
<sup>99</sup> I.R.C. §223(c)(2)(B).  
<sup>100</sup> I.R.C. §223(c)(2)(C).

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

The Service has issued a notice that uses a higher daily rate for certain higher-priced foreign localities that is taken into account in determining the 30-percent multiplier.<sup>101</sup>

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

- c. In order for taxpayers in 2025 having adjusted gross income in excess of \$150,000 in 2024 to avoid estimated tax penalties, estimated tax payments must be at least 110 percent of the 2023 tax liability.
- d. The Disaster Act, passed on December 20, 2019 as part of the 2020 year-end spending package, amends IRC §213(f) and provides for a reduction in the medical expense deduction floor from 10% to 7.5%. Individuals were eligible to claim an itemized deduction for unreimbursed medical expenses to the extent that the expenses exceeded 7.5% of AGI for tax years beginning after December 31, 2018 and before January 1, 2021. The Consolidated Appropriations Act of 2021 makes the 7.5-percent-of-AGI threshold for the medical expense deduction floor permanent for itemizers claiming unreimbursed medical expenses. This provision is applicable for tax years beginning after December 31, 2020.

## 2. Interest rates for third quarter of 2025

The IRS has announced that the interest rates for the quarter beginning July 1, 2025, are 7 percent for overpayments (6 percent for a corporation), 7 percent for underpayments (noncorporate taxpayers and corporations), 9 percent for large corporate underpayments, and 4.5 percent for the portion of a corporate overpayment exceeding \$10,000.<sup>102</sup>

### **Note:**

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

<sup>101</sup> Notice 2007-77; 2007-40 I.R.B. 1.

<sup>102</sup> I.R.B. 2025-23.

### 3. FUTA surtax reduced

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

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

The gross receipts limitation of §448(c)(1) increases to \$31,000,000 in 2025. Section 448(c)'s primary purpose has been to limit the ability of C corporations to use the cash method of accounting.

C corporations may use the cash method of accounting if their average gross receipts for the prior three years do not exceed the §448(c)(1) amount. However, the TCJA and OBBBA references the §448(c) limit for other purposes. Some impacted code sections include:

- a. **Section 163(j) business interest limitation:** Businesses are not subject to the business interest limitation if they meet the gross receipts test of §448(c).<sup>103</sup>
- b. **Section 263A capitalization rules:** A business is exempt from the §263A Unicap rules if it meets the gross receipts test of §448(c).<sup>104</sup>
- c. **Section 460 accounting for long-term contracts:** A contractor that meets the gross receipts test of §448(c) may use the completed contract method to account for contracts if the taxpayer and contracts qualify under the provisions of §460.<sup>105</sup>
- d. **Section 471 inventory requirement:** A business is not required to follow the inventory rules of §471 if they meet the gross receipts test of §448(c). They may instead treat inventories in a manner consistent with applicable financial statements or as non-essential materials and supplies. This means that businesses who were required to use the accrual method of accounting in the past because they had inventories and their gross receipts exceeded \$1,000,000 may now use the cash method of accounting and change their inventory method.<sup>106</sup>

### 5. Educator expense deduction

The Educator Expense deduction was originally enacted in 2002, allowing teachers and other eligible educators to deduct up to \$250 of out-of-pocket classroom expenses (\$500 if married filing jointly and both spouses are eligible educators, but not more than \$250 each). An individual is considered an eligible educator if, for the tax year, he or she is a kindergarten through grade 12 teacher, instructor, counselor, principal, or aide for at least 900 hours a school year in a school that provides elementary or secondary education as determined under state law. Qualified expenses for purposes of the Educator Expense deduction include amounts paid or incurred for participation in professional development courses, books, supplies, computer equipment, and supplementary materials used in the classroom. Additionally, qualified expenses include amounts spent on PPE, disinfectant, or supplies used to prevent the spread of the COVID-19 virus. In order to be eligible for the Educator Expense deduction, the expenses must be paid or incurred during the tax year.

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<sup>103</sup> I.R.C. §163(j)(3).

<sup>104</sup> I.R.C. §263A(i).

<sup>105</sup> I.R.C. §460(e)(1)(B)(ii).

<sup>106</sup> I.R.C. §471(c)(1).

For the first time since 2002, the IRS increased the maximum Educator Expense deduction from \$250 to \$300 in 2022, remaining at this level through 2025. As a result, in 2025, an eligible educator can deduct up to \$300 of qualifying expenses (\$600 if married filing jointly and both spouses are eligible educators, but not more than \$300 each). The limit will rise in \$50 increments in future years based on inflation adjustments.

### 6. Excess Business Loss Threshold

For taxable years beginning in 2025, the excess business loss thresholds are as follows:

Filing Status	2025 Threshold Amount
Joint filers	\$626,000
Other returns	\$313,000

As discussed, the OBBBA makes the excess business loss limitation permanent.

## R. Retirement plan 2025 numbers<sup>107</sup>

### 1. Maximum annual benefit

The maximum single-life annuity for a defined-benefit plan in 2025 is \$280,000, increased from \$275,000 in 2024.

### 2. Maximum annual addition

The maximum annual addition to a defined-contribution plan in 2025 is \$70,000, increased from \$69,000 in 2024.

### 3. Maximum compensation considered

The maximum amount of compensation that can be taken into account under any qualified plan allocation or benefit formula in 2025 is \$350,000, increased from \$345,000 in 2024.

**Note:**

Generalizations with respect to a defined-benefit plan are more difficult, as the contributions not only depend on compensation level but also the age of the participant and the number of years before the normal retirement age under the plan when the benefits must be fully funded. If the benefit formula is a fixed amount (\$3,000 per month), the change in the limit has no effect. If the formula is a unit benefit type, where the benefit that is earned each year is based solely on the compensation for that year, the change in the maximum will require marginally more funding in all succeeding years for the highly compensated employee. The most interesting and potentially most expensive case is where the benefit formula is based on some percentage of a career-high average. As the higher compensation is taken into account, it not only increases the funding requirement for the current year, but generates in effect liabilities in respect of past years. Quantifying the effect for budgeting purposes requires the services of an actuary. Again, while the effect may be to require a higher funding level for the highly compensated to the extent there is an increased benefit, now is the time to have the additional costs determined so as to choose whether to continue the plan as is, or reduce, in respect of future years, the benefit formula.

<sup>107</sup> Retirement plan numbers updated by IRS Notice 2024-80.

**Note:**

Qualified retirement-planning services provided to an employee and his or her spouse by an employer maintaining a qualified plan after December 31, 2001 are excludable from income and wages without regard to the requirements of an education-assistance program or fringe benefit. "Qualified retirement-planning services" are retirement-planning advice and information. The exclusion is not limited to information regarding the qualified plan, and thus, for example, applies to advice and information regarding retirement-income planning for an individual and his or her spouse and how the employer's plan fits into the individual's overall retirement-income plan.

**Caution:**

On the other hand, the exclusion does not apply to services that may be related to retirement planning, such as tax-preparation, accounting, legal, or brokerage services.

The exclusion does not apply with respect to highly compensated employees unless the services are available on substantially the same terms to each member of the group of employees that is normally provided education and information regarding the employer's qualified plan. It is intended that the treatment of retirement advice will be provided in a nondiscriminatory manner. It is intended that, in determining the application of the exclusion to highly compensated employees, the Service may permit employers to take into consideration employee circumstances other than compensation and position in providing advice to classifications of employees. Thus, for example, the Secretary may permit employers to limit certain advice to individuals nearing retirement age under the plan.

**4. SIMPLE deferral maximum**

The maximum amount of deferral in a SIMPLE plan in 2025 is \$16,500, increased from \$16,000 in 2024.

**Table 1 -- SIMPLE Deferral Limits**

<b>For year beginning in calendar year:</b>	<b>The applicable dollar amount:</b>
2025	\$16,500

**Table 2 -- Catch-Up Elective Deferrals for SIMPLE and SIMPLE-§401(k) Plans**

<b>For taxable years beginning in:</b>	<b>The applicable dollar amount is:</b>
2025	\$3,500

Under a SIMPLE plan, an employer is generally required to make a contribution on behalf of each eligible employee in an amount equal to the employee's salary-reduction contributions, up to a limit of three percent of the employee's compensation for the entire calendar year.<sup>108</sup>

**Note:**

For the business owner concerned about the maximum tax-shelter potential of the SIMPLE, note that the maximum matching contribution for an individual with \$550,000 of compensation or more is \$16,500. A \$16,500 salary deferral, plus the \$16,500 match, results in a maximum contribution of \$33,000. Above \$550,000 in compensation, the match cannot exceed \$16,500. If the participant earns less than \$550,000, the maximum contribution is less. For example, a person with compensation of \$150,000 is eligible for the matching contribution of \$4,500 (three percent of \$150,000). The table below identifies the maximum contribution for individuals at various salary levels.

<sup>108</sup> I.R.C. §§408(p)(2)(A)(iii) and (C)(ii)(I). See Notice 98-4, 1998-2 I.R.B. 25, Q&A, D-4.

In 2025:

Maximum SIMPLE IRA Contribution			
Salary	Maximum salary deferral	Matching contribution	Total contribution
\$50,000	\$16,500	\$1,500	\$18,000
\$75,000	\$16,500	\$2,250	\$18,750
\$100,000	\$16,500	\$3,000	\$19,500
\$125,000	\$16,500	\$3,750	\$20,250
\$150,000	\$16,500	\$4,500	\$21,000
\$160,000	\$16,500	\$4,800	\$21,300
\$175,000	\$16,500	\$5,250	\$21,750
\$550,000 or more	\$16,500	\$16,500	\$33,000

### 5. SEP minimum compensation

The threshold level of compensation at which an employer must cover an employee in a SEP in 2025 remains \$750.

- a. If an employer establishes and maintains an individual retirement account or annuity that qualifies as a SEP, the maximum amount that the employer may contribute is the lesser of \$70,000 in 2025 or 25 percent of the employee's compensation.<sup>109</sup> An employee for whom an employer contributes under a SEP is allowed a deduction for the employee's contributions to an IRA subject to the phaseout rule for active participants.
- b. Generally, any employee is protected from current tax only if the employer's contribution does not exceed the lesser of 25 percent of the employee's compensation from that employer or \$70,000 in 2025.

**Example:** Corporation Q has established a SEP arrangement for the benefit of its eligible employees. Employee A earns \$100,000 in compensation from Q in 2025. For 2025, the most Q can contribute to the SEP of A (without causing tax to A) is \$25,000 (25 percent of \$100,000). Twenty-five percent of A's compensation is less than \$70,000, so this is the applicable prong of the two-part limitation. Note that for purposes of calculating 25 percent of the employee's compensation, the employer's contribution to the employee's SEP is ignored. Thus, the limitation for Q is 25 percent of \$100,000, not 25 percent of \$125,000.

- c. If an employer contributes more than the lesser of 25 percent of compensation or \$70,000 in 2025 to the SEP of an employee, the amount in excess of that limitation is treated as an excess contribution by the employee to an IRA. On or before the due date for filing the employee's tax return (including extensions), the employee should withdraw the amount of the excess and any income on that amount. The employee thus would avoid a six-percent excise tax on the excess contribution, but must pay tax on the amount of the contribution that exceeds the limitation.

<sup>109</sup> For the self-employed person, compensation means earned income as reduced for other contributions. I.R.C. §408(k)(7)(B). This is further reduced by the deduction for self-employment taxes.

## 6. Maximum elective deferral

The maximum amount of deferral in a §401(k) plan or §403(b) plan in 2025 is \$23,500, increased from \$23,000 in 2024.

Elective deferrals increase to the applicable amount in accordance with the following schedule.

**Table 3 -- Elective-Deferral Limits**

For taxable years beginning in calendar year:	The applicable dollar amount is:
2025	\$23,500

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

**Table 4 -- Catch-Up Elective Deferrals for §401(k) and Other Qualified Plans**

For taxable years beginning in:	The applicable dollar amount is:
2025	\$7,500

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

**Note:**

Since elective deferrals generally represent amounts the employer would have deducted under §162 for reasonable compensation but for the preemptive effect of §404 with respect to amounts contributed to a qualified plan, the elective-deferral component of the contribution is deducted as compensation rather than as a contribution.

**Planning point:**

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

**Planning point:**

One of the major motivations for the use of a money-purchase pension plan rather than a profit-sharing plan lay in the enhanced deductibility of contributions up to 25 percent of total compensation to “fully fund” the annual additions. The disadvantage of a money-purchase pension plan is that as a pension plan, the formula for contributions is fixed and creates an annual liability much as a defined-benefit plan does. The change in the deductibility of contributions to a profit-sharing plan puts the future of the money-purchase plan in some doubt, as the enhanced deductibility and the annual-additions limitation can now be met by a profit-sharing plan that does not commit the employer to any specific level of contributions annually.

**7. Highly compensated employee**

The minimum compensation of an employee owning less than five percent of the stock of the employer to be treated as a highly compensated employee is \$160,000 in 2025, increased from \$155,000 in 2024.

**8. Self-employed persons**

- a. The §401(k) plan is essentially a profit-sharing plan with elective deferrals. The following worksheet assumes that the employer’s contributions are allocated to each participant’s account in accordance with compensation, i.e., the plan is not age-weighted or otherwise cross-tested.
- b. Since the base of contributions to a SEP is earned income, the following worksheet is necessary to determine the contribution to a SEP on behalf of that self-employed person.

**In 2025:**

1. Nominal plan stated rate	
2. Add “1” to Step (1)	
3. Self-employed rate Step 1/Step 2	
4. Net earnings (Line 31, Sch. C; Line 34, Sch. F; Box 14, code A, Schedule K-1)	
5. Self-employment income Step (4) x 0.9235	
6. Taxable wage base	
7. Lesser of Step (5) or Step (6)	
8. Step (7) x 0.124	
9. Step (5) x 0.029	
10. Total self-employment tax Step (8) plus Step (9)	
11. Self-employment tax deduction Step (8) x 0.5 + .5 x Step (9)	
12. Earned income Step (4) – Step (11)	
13. Nominal contribution Step (12) x Step (3)	
14. \$350,000 x Step (3)	
15. Maximum dollar annual addition	
16. Lesser of Step (14) and Step (15)	
17. Maximum deductible contribution lesser of Step (13) and Step (16)	
18. Elective deferral	
19. Catch-up contribution†	
20. Total maximum contribution (Step (17) + Step (18) + Step (19))	

† Only available to SARSEPS in place as of December 31, 1996. All other SEPS stop at line 17.

- c. The contribution level for self-employed persons in a SIMPLE plan depends on the net earnings from self-employment. Remember, neither the §415 nor the compensation limitations generally apply.

1. Net earnings (Line 31, Schedule C; Line 34, Sch. F; Box 14, code A, Schedule K-1)	
2. Self-employment income Step (1) x 0.9235)	
3. Contribution rate	
4. Contribution Step (2) x Step (3)	
5. Elective deferral	
6. Total contribution sum of Step (4) and Step (5)	
7. Catch-up contribution	
8. Total contributions Step (6) and Step (7)	

To obtain the maximum contribution to a SIMPLE, the self-employed person must have bottom-line Schedule C income of at least \$577,513.

1. Net earnings (Line 31, Schedule C; Line 34, Sch. F; Box 14, code A, Schedule K-1)	\$595,560
2. Self-employment income Step (1) x 0.9235)	\$550,000
3. Contribution rate	0.03
4. Contribution Step (2) x Step (3)	\$16,500
5. Elective deferral	\$16,500
6. Total contribution Sum of Step (4) and Step (5)	\$33,000
7. Catch-up contribution	\$3,500
8. Total contributions Step (6) and Step (7)	\$36,500

**Representative Table of Maximum SIMPLE contributions**

Schedule C	Employer contribution	Elective deferral	Under-50 Maximum	Catch-up	Over-50 Maximum
\$50,000	\$1,500	\$16,500	\$18,000	\$3,500	\$21,500
\$100,000	\$3,000	\$16,500	\$19,500	\$3,500	\$23,000
\$150,000	\$4,500	\$16,500	\$21,000	\$3,500	\$24,500
\$200,000	\$6,000	\$16,500	\$22,500	\$3,500	\$26,000
\$250,000	\$7,500	\$16,500	\$24,000	\$3,500	\$27,500

## 9. IRAs

An IRA (other than SEP or SIMPLE) cannot accept more than \$7,000 (\$8,000 if age 50 or older) in contributions for any taxable year (not including rollover amounts) in 2025 (remaining the same as \$7,000, or \$8,000 if age 50 or older in 2024).<sup>110</sup> This limit applies to both regular and Roth IRAs, but the annual contribution limit may be divided between such IRAs as the owner may determine. In certain circumstances, a married individual may make IRA contributions of more than \$7,000 (\$8,000 if age 50 or older) per taxable year. The contributions must be made to a combination of the married individual's own IRA and the nonworking spouse's IRA, because neither IRA is permitted to receive more than \$7,000 (\$8,000 if age 50 or older) in contributions per taxable year (excluding rollover contributions).

- a. An IRA owner may never deduct more than the lesser of \$7,000 (\$8,000 if age 50 or older) or taxable compensation.<sup>111</sup> This amount may be further limited if the IRA owner or the owner's spouse is an "active participant" in an employer-sponsored retirement plan.
- b. In 2025, the deductibility of contributions to regular IRAs for active participants is phased out in a pro rata fashion over the applicable phaseout range of AGI. For example, if the applicable phaseout range of AGI is \$79,000 to \$89,000, a taxpayer with AGI of \$83,000 who actively participates in a qualified plan would be permitted to contribute \$7,000 to an IRA, but would only be permitted to deduct \$4,900 of that 7,000 contribution. The remaining \$2,100 (0.3 of \$7,000) would be a nondeductible contribution.

<sup>110</sup> I.R.C. §408(o)(2); Notice 2024-80.

<sup>111</sup> I.R.C. §219(b)(1).

- c. **AGI phaseout ranges** -- The phaseout range depends upon filing status and the year in which the contribution is made.

<b>Taxable years beginning in:</b>	<b>Joint returns phaseout range</b>	<b>Single taxpayers phaseout range</b>
2025	\$126,000 - \$146,000	\$79,000 - \$89,000

- d. The maximum deductible IRA contribution for an individual who is not an active participant, but whose spouse is, is phased out for taxpayers with AGI between \$236,000 and \$246,000 in 2025.
- e. For 2025, the dollar amount an individual who is not married may contribute to a Roth IRA is phased out ratably between modified AGI of \$150,000 and \$165,000; for a married individual filing a joint return, between modified AGI of \$236,000 and \$246,000 and for a married individual filing separately, between modified AGI of \$0 and \$10,000.



# Sale of Passthrough Entity Interest and Net Investment Income Tax

<b>Learning objective</b>	<b>1</b>
<b>I. Background</b>	<b>1</b>
<b>II. NIIT Excepted dispositions under §1411(c)(4)</b>	<b>4</b>
<b>A. Special rules</b>	<b>4</b>
<b>B. Section 469 passive activities</b>	<b>5</b>
1. <i>Activities and groups of activities</i>	6
2. <i>Material participation for business activities</i>	7
3. <i>Real estate professional</i>	8
<b>III. Calculation of gain (loss) attributable to passthrough entity interest dispositions – Primary Method</b>	<b>9</b>
<b>A. Optional simplified reporting method</b>	<b>11</b>
1. <i>Qualifications and exceptions</i>	11
2. <i>Calculation details</i>	12
3. <i>Deferred recognition transactions</i>	14
4. <i>Information reporting and other considerations</i>	14



# Sale of Passthrough Entity Interest and Net Investment Income Tax

## *Learning objective*

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

### ***I. Background***

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

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

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

- (i) Gross income of interest, dividends, annuities, royalties, and rent not derived from the ordinary course of business;
- (ii) Gross income derived from a trade or business that is either: (1) a passive activity within the meaning of §469 or (2) a financial instruments/commodities trading business under §475(e)(2); AND
- (iii) The net gain (to the extent accounted for in computing taxable income) attributable to the disposition of property described in (ii).

#### ***Practice note: Common investment expenses deductible in computing NII***

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

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

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

#### ***Note: Line and code references apply to 2024 forms***

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

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

**Practice point: Not Inflation Adjusted**

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

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

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

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

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

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

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

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

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

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

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

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

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

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

**Net Investment Income Tax—  
 Individuals, Estates, and Trusts**

Attach to your tax return.  
 Go to [www.irs.gov/Form8960](http://www.irs.gov/Form8960) for instructions and the latest information.

Name(s) shown on your tax return

Your social security number or EIN

**HOMER AND MARGE**

- Part I Investment Income**  Section 6013(g) election (see instructions)  
 Section 6013(h) election (see instructions)  
 Regulations section 1.1411-10(g) election (see instructions)

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

**Part II Investment Expenses Allocable to Investment Income and Modifications**

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

**Part III Tax Computation**

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

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 59474M

Form **8960**

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

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

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

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

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

### **A. Special rules**

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

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

Further, an S corporation’s allocation of built-in gains (“BIG”) tax under §1374 does not impact the gain determined for NIIT purposes.<sup>5</sup>

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<sup>1</sup> Prop. Reg. §1.1411-7(a)(3)(i).

<sup>2</sup> Prop. Reg. §1.1411-7(a)(3)(ii).

<sup>3</sup> Prop. Reg. §1.1411-7(a)(4)(i).

<sup>4</sup> Prop. Reg. §1.1411-7(a)(4)(iii)(A).

<sup>5</sup> Prop. Reg. §1.1411-7(a)(4)(iii)(C).

## B. Section 469 passive activities

Section 469 restricts certain taxpayers' use of deductions and credits derived from passive activities.

Passive activities exist (§469(c)) in the following scenarios:

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

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

**Though all rentals are categorically passive, an activity is not a "rental activity" for a taxable year if any of the following six conditions exist:**<sup>8</sup>

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

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

<sup>7</sup> I.R.C. §469(c)(2).

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

<sup>9</sup> Temp. Regs. §1.469-1T(e)(3)(ii)(A).

<sup>10</sup> Temp. Regs. §1.469-1T(e)(3)(ii)(B).

<sup>11</sup> Temp. Regs. §1.469-1T(e)(3)(ii)(C).

<sup>12</sup> Temp. Regs. §1.469-1T(e)(3)(ii)(D).

<sup>13</sup> Temp. Regs. §1.469-1T(e)(3)(ii)(E).

<sup>14</sup> Temp. Regs. §1.469-1T(e)(3)(ii)(F).

**Note:**

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

### **1. Activities and groups of activities**

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

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

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

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

<sup>15</sup> *Treas. Regs. §1.469-4(c)(1).*

<sup>16</sup> *Treas. Regs. §1.469-4(c)(2).*

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

<sup>18</sup> *Temp. Regs. §1.469-4T(j)(1).*

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

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

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

## 2. **Material participation for business activities**

Participation is broken down into distinct types:

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

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

1. The individual participates in the activity for **more than 500 hours** during the taxable year;<sup>27</sup>

<sup>19</sup> Temp. Regs. §1.469-4T(j)(2)(i).

<sup>20</sup> Temp. Regs. §1.469-4T(j)(2)(ii).

<sup>21</sup> Temp. Regs. §1.469-4T(j)(3).

<sup>22</sup> Treas. Regs. §1.469-4(d)(1).

<sup>23</sup> Treas. Regs. §1.469-4(e).

<sup>24</sup> Treas. Regs. §1.469-4(d)(5)(i).

<sup>25</sup> I.R.C. §469(h)(1).

<sup>26</sup> Temp. Regs. §1.469-5T(e)(1). Such limited partners may be treated as materially participating only if they meet the 500-hour test, the material-participation-in-five-of-the-preceding-10-taxable-years test, or the material-participation-in-any-three-preceding-taxable-years test. Temp. Regs. §1.469-5T(e)(2).

<sup>27</sup> Temp. Regs. §1.469-5T(a)(1).

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

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

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

### 3. Real estate professional

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

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

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

- a. **More than one-half of the personal services** performed in trades or businesses by the taxpayer during the taxable year **are performed in real property trades or businesses** in which the taxpayer materially participates.<sup>35</sup>
- b. **The services performed by the taxpayer in real property trades or businesses** in which the taxpayer materially participates **exceed 750 hours**.<sup>36</sup>
- c. In the case of a joint return, at least one of the spouses must separately, with respect to all trades or businesses in which the spouse performs services, render a majority of such personal services in real property trades or businesses in which the spouse materially participates, and must perform more than 750 hours of services in real property trades or businesses in which the spouse materially participates.<sup>37</sup> In determining whether a taxpayer materially participates in a real property trade or business, however, the participation of both spouses is taken into account.<sup>38</sup>
- d. The statute makes it clear that the provision for real estate professional status does not affect the determination of whether the taxpayer materially participates with respect to any interest in a limited partnership as a limited partner.<sup>39</sup>
- e. Personal services performed as an employee are not treated as performed in a real property trade or business unless the taxpayer is a five-percent owner of the business.<sup>40</sup>

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

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

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

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

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

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

<sup>35</sup> I.R.C. §469(c)(7)(B)(i).

<sup>36</sup> I.R.C. §469(c)(7)(B)(ii).

<sup>37</sup> I.R.C. §469(c)(7)(B) (flush language).

<sup>38</sup> I.R.C. §469(h)(5).

<sup>39</sup> I.R.C. §469(c)(7)(A) (flush language).

<sup>40</sup> I.R.C. §469(c)(7)(D)(ii).

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

Activity	Classification to A	Adj. Basis	FMV	Total Gain (Loss)	A's Share of Gain (Loss)
X	Passive	136,000	96,000	(40,000)	(20,000)
Y	Passive	60,000	124,000	64,000	32,000
Z	Non-Passive	40,000	160,000	120,000	60,000
<b>Marketable Securities</b>	Portfolio	4,000	20,000	16,000	8,000
<b>Total</b>		240,000	400,000	160,000	80,000
Total Gain					80,000
Portfolio/Passive Gain [(\$20,000) + \$32,000 + \$8,000]					20,000
<b>Gain subject to NIIT *</b>					<b>20,000</b>
<b>* Lesser of Total Gain and Portfolio/Passive Gain but not less than zero</b>					

#### Analysis

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

#### Example 2: Facts (Primary Method)

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

Activity	Classification to A	Adj. Basis	FMV	Total Gain (Loss)	A's Share of Gain (Loss)
X	Passive	136,000	96,000	(40,000)	(20,000)
Y	Non-Passive	60,000	124,000	64,000	32,000
Z	Non-Passive	40,000	160,000	120,000	60,000
<b>Marketable Securities</b>	Portfolio	4,000	20,000	16,000	8,000
<b>Total</b>		240,000	400,000	160,000	80,000
Total Gain					80,000
Portfolio/Passive Gain (Loss) [(\$20,000) + \$8,000]					(12,000)
<b>Gain subject to NIIT *</b>					<b>- *</b>
<b>* Lesser of Total Gain and Portfolio/Passive Gain but not less than zero</b>					

### **Analysis**

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

## **A. Optional simplified reporting method**

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

### **1. Qualifications and exceptions**

The optional simplified reporting method applies to a §1411(c)(4) disposition **if either requirement is met:**<sup>41</sup>

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

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

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

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<sup>41</sup> Prop. Reg. §1.1411-7(c)(2)

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

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

## **2. Calculation details**

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

- (1) Determine the NIIT holding period (i.e., §1411 holding period) and test the optional simplified reporting method requirements are met.
  - **Section 1411 holding period:** generally, the year of disposition and the transferor's two taxable years preceding the disposition or the time period the transferor held the interest, whichever is less.
- (2) Determine the NII disposition fraction:
  - (i) Numerator is the sum of all income, gain, loss, and deduction items (including separately stated items included in NIIT during the NIIT holding period (the aggregate across multiple tax years); if the numerator is a negative amount in connection with a computation of overall gain, then the fraction shall be zero.
  - (ii) Denominator is the sum of all income, gain, loss, and deduction allocated to the taxpayer during the NIIT holding period.
- (3) Multiply the total income tax gain included for income tax purposes by the fraction determined in step 2.

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

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

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

### Analysis

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

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

### Example 2: Facts

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

### **3. Deferred recognition transactions**

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

### **4. Information reporting and other considerations**<sup>42</sup>

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

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

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

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

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<sup>42</sup> Prop. Reg. §1.1411-7(g).

<sup>43</sup> Prop. Reg. §1.1411-7(f).



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