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CPA TCP Study Guide

Tax Compliance & Planning — chapter-by-chapter review

2026 CPA Exam Blueprint · tax year 2025 law (incl. One Big Beautiful Bill Act)

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How to Use This Guide and the TCP Exam Format

This guide is a chapter-by-chapter review of the **Tax Compliance and Planning (TCP)** discipline section of the Uniform CPA Examination. It follows the same sixteen chapters as the TCP practice bank on UPractice.org, so you can read a chapter, then immediately drill the matching multiple-choice questions and simulations.

TCP builds on the federal tax material in the REG core section. REG asks whether you can prepare a return correctly; TCP asks you to go further, handle more complex entity and individual situations, and compare alternatives the way a tax adviser would. Expect more computations, more multi-step schedules and more "which choice saves more tax" reasoning than you saw in REG.

The TCP section at a glance

The CPA Exam has three core sections (AUD, FAR, REG) plus one discipline section of your choice (BAR, ISC or TCP). TCP is the tax discipline.

Feature	TCP (2026 Blueprints)
Testing time	4 hours
Multiple-choice questions (MCQs)	68, in two testlets of 34
Task-based simulations (TBSs)	7, in three testlets (2, 3 and 2)
Total testlets	5
Score weighting	MCQs 50%, TBSs 50%
Score scale / passing score	0–99 / 75
Skill levels	Remembering and understanding 5–15%; Application 55–65%; Analysis 25–35%

The skill mix tells you something important: almost all of TCP is **application and analysis**. Very few points come from simply recalling a rule. You must be able to use the rule on numbers, often across several steps.

Content areas and weights

Blueprint area	Weight	Chapters in this guide
I. Tax compliance and planning for individuals and personal financial planning	30–40%	1–6
II. Entity tax compliance (C corporations, S corporations, partnerships, trusts and estates, tax-exempt organizations)	30–40%	7–13
III. Entity tax planning (choice of entity, formation, liquidation and reorganization)	10–20%	14–15
IV. Property transactions (disposition of assets)	10–20%	16

> **Exam tip:** Areas I and II together are 60–80% of the exam. If your study time is short, make sure individual taxation and the pass-through entities (S corporations and partnerships) are rock solid before polishing reorganizations.

Which tax law this guide uses

The AICPA's policy is that changes to the Internal Revenue Code and federal tax regulations become eligible for testing in the calendar quarter that begins **six months after the later of the enactment date or the effective date**. For the One Big Beautiful Bill Act (OBBBA, P.L. 119-21, enacted July 4, 2025), the Board of Examiners adopted a phased plan: provisions with 2024 and 2025 effective dates became testable on REG and TCP on **July 1, 2026**, and old rules that were scheduled to expire after 2025 remained testable through June 30, 2026.

This guide, like the practice bank, therefore uses **one tax year: 2025**, including the OBBBA changes that apply to 2025. Where OBBBA changes a figure starting in 2026 (for example the $15 million estate exclusion), the guide points that out so you do not mix years.

2025 OBBBA changes used in this guide	2026-only changes NOT used in computations
Standard deduction $15,750 / $31,500 / $23,625	Basic exclusion amount $15,000,000
Child tax credit $2,200 per child	0.5% individual / 1% corporate charitable floors
SALT cap $40,000 with phase-down	Larger dependent care credit and $7,500 exclusion
Senior, tips, overtime and car-loan-interest deductions	2026 QBI phase-in ranges
§179 $2,500,000 limit / $4,000,000 threshold	2026 AMT exemption phase-out changes
100% bonus depreciation (property acquired after January 19, 2025)	
§163(j) limit based on EBITDA-style ATI	

Watch out: The AICPA does not require you to memorize inflation-indexed amounts, and exam items usually give you the figure you need. Still, knowing the common 2025 numbers saves time and helps you spot a wrong answer built on an outdated amount.

How each chapter is organized

Every chapter follows the same pattern so you always know where to look:

1. **Plain-language explanation** of each rule that the bank tests.
2. **Key-number tables** with the 2025 amounts and thresholds.
3. **Worked examples** with every step shown. Each figure was computed and re-checked before it was printed here.
4. **Exam tips, traps and memory tricks** in colored boxes.
5. **Key takeaways** — a short summary to reread the night before the exam.

Callout boxes use four colors: green for exam tips, blue for worked examples, red for common traps and purple for memory tricks.

A study plan that works

1. **Refresh REG basics first.** TCP assumes you already know filing status, gross income, basic deductions, basis and the corporate tax rate.
2. **Work the chapters in order.** Individuals (1–6) build the vocabulary for entities (7–13); entity chapters build the background for planning (14–15) and property transactions (16).

3. **Read, then drill immediately.** After each chapter, do a timed set of 20–30 MCQs from the matching bank chapter, then its simulations.
4. **Rebuild the schedules on paper.** For basis roll-forwards, E&P, DNI and the AMT, write the schedule from memory until it is routine.
5. **Keep a one-page number sheet** of 2025 amounts and OBBBA changes. Note which changes start only in 2026.
6. **Take full mock exams** under 4-hour timing in the last two weeks and review every miss by chapter.

Test-day strategy

- **Budget your time.** About 1.5 minutes per MCQ (roughly 100 minutes for 68 questions) leaves well over two hours for seven simulations, plus the optional break.
- **Read the simulation requirement first**, then the exhibits. You will know which numbers matter and skip distractor data.
- **Draw timelines** for equity compensation, holding periods, distributions and redemption dates.
- **Write basis roll-forwards** in the fixed order (increases, distributions, nondeductible items, losses) for S corporations and partnerships.
- **Answer every cell.** Simulations give partial credit; a blank earns nothing.
- **Use whole dollars** and follow the rounding instruction in each item.

> **Memory trick:** "Read the ask, then the facts." In simulations, the question tells you which exhibit matters; the exhibits are full of data you will never use.

Key takeaways

- TCP: 4 hours, 68 MCQs and 7 TBSs in 5 testlets, 50/50 weighting, passing score 75.
- Areas: Individuals 30–40%, Entity compliance 30–40%, Entity planning 10–20%, Property 10–20%.
- This guide uses 2025 law including the OBBBA changes effective for 2025; 2026-only changes are flagged but not used.
- Each chapter: explanation, tables, worked examples, tips and traps, takeaways. Read a chapter, then drill the matching bank chapter right away.

1. Gross Income and Equity Compensation

Gross income is the starting point of every individual return. The Code takes a sweeping approach: **gross income includes all income from whatever source derived** unless a specific provision excludes it. On TCP the tested material falls into three groups: (1) exclusions and their limits, (2) taxable fringe benefits and special inclusions such as Social Security benefits, and (3) the timing and character of equity compensation — stock options, restricted stock and restricted stock units.

The all-inclusive concept

Income is taxable when the taxpayer has an accession to wealth, clearly realized, over which the taxpayer has complete control. Income can be received in cash, property or services; property and services are measured at fair market value (FMV). A cash-method taxpayer includes income when it is actually or **constructively received** — when it is credited to the taxpayer's account or otherwise made available without substantial restriction.

> **Watch out:** A year-end bonus check that the employee could have picked up on December 31 but chose to collect on January 2 is constructively received in December.

Common exclusions

Each exclusion has its own Code section and often a limit. The exam usually tests whether an item is excluded in full, in part, or not at all.

Item	Treatment	Key limit or condition
Gifts and inheritances	Excluded (§102)	Income later earned on the property is taxable
Life insurance death proceeds	Excluded (§101)	Interest on installment payouts is taxable; transfer-for-value rule can tax proceeds
Damages for physical injury or sickness	Excluded (§104)	Punitive damages and interest are taxable; emotional distress excluded only if from physical injury (or to extent of medical costs)
Qualified scholarships	Excluded (§117) for degree candidates	Only tuition, fees, books, supplies and required equipment; room and board are taxable
Municipal bond interest	Excluded (§103)	Private activity bond interest may be an AMT preference

Employee fringe benefits and other exclusions:

Item	Treatment	Key limit or condition
Employer-provided health coverage	Excluded (§106)	—
Dependent care assistance	Excluded (§129)	$5,000 per year for 2025 ($2,500 married filing separately)
Educational assistance	Excluded (§127)	$5,250 per year; may include student loan repayments
Qualified transportation fringe	Excluded (§132(f))	$325 per month parking; $325 per month transit/vanpool (2025)
Group-term life insurance	Excluded (§79)	Cost of the first $50,000 of coverage
No-additional-cost services, employee discounts, working-condition and de minimis fringes	Excluded (§132)	Discounts limited to gross profit percentage (goods) or 20% (services)
Foreign earned income	Elective exclusion (§911)	$130,000 for 2025, plus a housing exclusion
Health FSA salary reductions	Excluded	$3,300 for 2025

Group-term life insurance

The cost of coverage above $50,000 is taxable wages, measured using the IRS **Uniform Premium Table (Table I)** rather than the employer's actual premium. The taxable amount is reduced by any amount the employee paid with after-tax dollars. The table rate depends on the employee's age at year-end and is stated per $1,000 of excess coverage per month.

Age at year-end	Monthly cost per $1,000
Under 25	$0.05
25–29	$0.06
30–34	$0.08
35–39	$0.09
40–44	$0.10
45–49	$0.15
50–54	$0.23
55–59	$0.43
60–64	$0.66
65–69	$1.27
70 and older	$2.06

Example: Lena, age 47, has $250,000 of employer group-term life coverage all year and pays $100 toward it with after-tax dollars.

1. Excess coverage = $250,000 − $50,000 = $200,000, or 200 units of $1,000.
2. Table cost = 200 × $0.15 × 12 months = **$360**.
3. Less employee payments of $100 → taxable wages = **$260**.

Scholarships, damages and insurance — fast rules

- A scholarship that pays for **room and board** is taxable even for a degree candidate. Payments that require the student to teach or do research are taxable compensation.
- In a lawsuit, sort each component: compensatory damages for a physical injury are excluded; **punitive damages are always taxable**; lost wages from a non-physical claim (such as discrimination) are taxable.
- Life insurance received because of the insured's death is excluded, but **cash surrender** of a policy is taxable to the extent the cash exceeds premiums paid.

Other inclusions you must know

Social Security benefits

Up to **85%** of Social Security benefits can be taxable. The test uses **provisional income**:

Provisional income = modified AGI (AGI before counting benefits) + tax-exempt interest + 50% of benefits.

Filing status	Base amount (50% tier)	Adjusted base (85% tier)
Single, HOH	$25,000	$34,000
Married filing jointly	$32,000	$44,000
Married filing separately and living together	$0	$0

These base amounts are statutory and are **not** indexed for inflation.

- Provisional income at or below the base amount: no benefits are taxable.
- Between the two amounts: taxable = lesser of 50% of benefits or 50% of the excess over the base amount.
- Above the adjusted base: taxable = lesser of (a) 85% of benefits, or (b) 85% of the excess over the adjusted base **plus** the lesser of 50% of benefits or 50% of the difference between the two base amounts ($4,500 single; $6,000 joint).

Example: Omar is single. His AGI without benefits is $30,000, he has $2,000 of municipal bond interest and he received $16,000 of Social Security.

1. Provisional income = $30,000 + $2,000 + 50% × $16,000 = **$40,000**, which exceeds $34,000.
2. Limit (a): 85% × $16,000 = $13,600.
3. Limit (b): 85% × ($40,000 − $34,000) = $5,100, plus the lesser of $8,000 (50% of benefits) or $4,500 → $5,100 + $4,500 = $9,600.
4. Taxable benefits = lesser of $13,600 or $9,600 = **$9,600**.

Watch out: Tax-exempt interest is not taxed itself, but it **is** added in provisional income. Forgetting it is the classic error.

Other items that are taxable

- Unemployment compensation, alimony received under pre-2019 divorce instruments (not post-2018 instruments), gambling winnings, prizes and awards (unless transferred to charity under §74(b)), discharge of indebtedness (unless an exclusion such as insolvency or qualified principal residence debt applies), and the value of most employer-provided fringe benefits that are not specifically excluded.
- **Below-market loans:** interest forgone on gift or compensation loans may be imputed as income to the lender and as a gift or compensation to the borrower, subject to $10,000 and $100,000 safe harbors for gift loans.

Equity compensation

Equity compensation questions are about **timing** (when is income recognized?), **character** (ordinary or capital?) and **basis** (what is the stock's basis for computing later gain?). Always draw a timeline with three dates: grant, exercise or vesting, and sale.

Nonqualified stock options (NQSOs)

Most options traded only inside the company have no readily ascertainable value at grant, so nothing is taxed at grant.

- **At exercise:** ordinary compensation income = FMV of the shares − exercise price (the "spread"). The employer deducts the same amount and withholds as wages.
- **Basis** of the shares = exercise price paid + income recognized = **FMV at exercise**.
- **Holding period** starts the day after exercise.
- **At sale:** capital gain or loss = sale price − FMV at exercise; long-term if held more than one year after exercise.

> **Example:** Priya receives 1,000 NQSOs with an exercise price of $20. She exercises when the stock is worth $35 and sells 18 months later at $50.
>
> 1. At grant: no income.
> 2. At exercise: ordinary income = 1,000 × ($35 − $20) = **$15,000** (W-2 wages).
> 3. Basis = 1,000 × $35 = **$35,000**.
> 4. At sale: 1,000 × $50 − $35,000 = **$15,000 long-term capital gain**.
> 5. Check: $15,000 ordinary + $15,000 capital = $30,000 total economic gain (1,000 × ($50 − $20)).

Incentive stock options (ISOs)

ISOs are statutory options with favorable regular-tax treatment.

- **Grant and exercise:** no regular taxable income. However, the spread at exercise is an **AMT adjustment** (see Chapter 3).
- **Qualifying disposition:** the shares are sold **more than 2 years after grant AND more than 1 year after exercise**. All gain (sale price − exercise price) is long-term capital gain. The employer gets **no deduction**.
- **Disqualifying disposition:** either holding period is failed. The employee has ordinary income equal to the **lesser of** (a) the spread at exercise or (b) the actual gain on sale. Any remaining gain is capital (short- or long-term depending on how long the shares were held after exercise). The employer deducts the ordinary income amount in that year.
- ISOs must be exercised while employed or within 3 months after leaving (12 months for disability), and only $100,000 of ISOs (by grant-date value) may first become

exercisable per year; any excess is treated as NQSOs.

Example: Marco exercises ISOs on 500 shares at $10 when the FMV is $30.

- **Qualifying sale at $45:** LTCG = 500 × ($45 − $10) = **$17,500**; no ordinary income. In the exercise year he had an AMT adjustment of 500 × ($30 − $10) = **$10,000**.
- **Disqualifying sale at $45 (within a year of exercise):** ordinary income = lesser of the $10,000 spread or the $17,500 actual gain = **$10,000**; remaining 500 × ($45 − $30) = **$7,500** is short-term capital gain.
- **Disqualifying sale at $25:** ordinary income = lesser of $10,000 spread or actual gain 500 × ($25 − $10) = $7,500 → **$7,500** ordinary, **$0** capital gain.

Memory trick: ISO "2-and-1": more than **2** years from grant and more than **1** year from exercise. NQSO: "exercise = wages." ISO: "sale = tax."

Restricted stock and the §83(b) election

Restricted stock is stock transferred to an employee subject to a substantial risk of forfeiture (for example, it is forfeited if the employee leaves within three years).

- **Default rule (§83(a)):** ordinary income at **vesting** = FMV at vesting − amount paid. Basis = FMV at vesting; holding period starts at vesting.
- **§83(b) election:** filed with the IRS **within 30 days of the transfer**. The employee recognizes ordinary income at **grant** = FMV at grant − amount paid. Nothing is taxed at vesting; all later appreciation is capital gain, and the holding period starts at grant.
- If stock is forfeited after an §83(b) election, the employee gets **no deduction** for the income previously recognized (only a capital loss for any amount actually paid).

Example: Hana receives 2,000 restricted shares worth $5 each, vesting in 3 years. At vesting the stock is worth $25; she sells at $40 more than a year after vesting.

	With §83(b) election	Without election
Ordinary income at grant	2,000 × $5 = $10,000	$0
Ordinary income at vesting	$0	2,000 × $25 = $50,000
Basis	$10,000	$50,000
Capital gain at sale	$80,000 − $10,000 = $70,000 LTCG	$80,000 − $50,000 = $30,000 LTCG

The election converted $40,000 of ordinary income into long-term capital gain, at the cost of paying tax earlier and risking forfeiture.

Restricted stock units (RSUs) and other plans

- **RSUs** are a promise to deliver shares (or cash) later. Nothing is transferred at grant, so an §83(b) election is **not available**. Ordinary income arises when shares are delivered (usually at vesting) equal to their FMV.
- **Employee stock purchase plans (§423)** allow a discount of up to 15%. A qualifying disposition (2 years from grant, 1 year from purchase) produces ordinary income equal to the lesser of the actual gain or the discount measured at grant; the rest is capital.
- **Nonqualified deferred compensation (§409A)** is taxed when paid if plan rules are met; violations accelerate income and add a 20% tax.

Exam tip: In any equity compensation question, check that **ordinary income + capital gain = total economic gain** (sale price minus amount paid). If your numbers do not add up, you used the wrong basis.

Common traps

- Using the **exercise price** instead of FMV at exercise as the basis of NQSO shares (that double-taxes the spread).
- Treating an ISO sale within one year of exercise as qualifying because more than two years passed since grant.
- Forgetting that the ISO spread is an AMT adjustment in the year of exercise.
- Thinking an §83(b) election can be made after 30 days or for RSUs.
- Excluding room and board from a scholarship.
- Omitting tax-exempt interest from provisional income for Social Security.

Key takeaways

- Everything is income unless a specific section excludes it; know the 2025 limits: dependent care $5,000, transit and parking $325 per month, educational assistance $5,250, FEIE $130,000, group-term life first $50,000.
- Social Security: provisional income = MAGI + tax-exempt interest + 50% of benefits; at most 85% taxable; base amounts $25,000/$34,000 single and $32,000/$44,000 joint.
- NQSO: ordinary income at exercise; basis = FMV at exercise.
- ISO: no regular income at exercise (AMT adjustment); qualifying sale gives all LTCG; disqualifying sale gives ordinary income = lesser of spread or actual gain.
- Restricted stock: taxed at vesting unless an §83(b) election within 30 days moves income to grant.

2. Passive Activity and At-Risk Rules

Congress built several walls between business losses and a taxpayer's other income. On TCP you must apply them **in order**, carry forward whatever each wall blocks, and know what releases the suspended amounts. The order is:

1. **Basis** — you cannot deduct more than your investment (for partners and S corporation shareholders, outside or stock/debt basis).
2. **At-risk (§465)** — you cannot deduct more than the amount you could actually lose.
3. **Passive activity (§469)** — passive losses offset only passive income.
4. **Excess business loss (§461(l))** — total net business losses above a threshold become a net operating loss carryforward.

> **Memory trick:** "**BAPE**" — **B**asis, **A**t-risk, **P**assive, **E**xcess business loss. A loss must clear each wall before it reaches the next one.

The at-risk rules (§465)

The at-risk rules apply to individuals and closely held C corporations engaged in almost any trade, business or income-producing activity. A taxpayer's amount at risk in an activity starts with:

Increases amount at risk	Not at risk
Cash contributed	Nonrecourse debt (other than qualified nonrecourse real estate financing)
Adjusted basis of property contributed	Debt protected by guarantees, stop-loss agreements or similar arrangements
Recourse debt for which the taxpayer is personally liable	Amounts borrowed from a person with an interest in the activity (other than as a creditor), in most cases
Qualified nonrecourse financing secured by real property used in the activity and borrowed from a commercial lender or government	
Share of income from the activity	

The amount at risk is **reduced** by losses allowed and by distributions (withdrawals). A loss disallowed by the at-risk rules is carried forward indefinitely and treated as a deduction from the same activity in the next year, allowed when the amount at risk increases. If the

amount at risk falls below zero (for example because a distribution exceeds it), previously allowed losses are **recaptured** into income.

> **Watch out: Qualified nonrecourse financing** for real estate counts toward the amount at risk; other nonrecourse debt does not. For a partnership, a partner's share of qualified nonrecourse real estate debt is at risk even though it is nonrecourse.

The passive activity rules (§469)

What is passive

A **passive activity** is (1) any trade or business in which the taxpayer does not **materially participate**, and (2) any **rental activity**, regardless of participation (with exceptions for real estate professionals and certain short-term rentals).

Income falls into three baskets:

Basket	Examples	Passive losses can offset it?
Active (nonpassive)	Wages, self-employment income, guaranteed payments, material-participation business income	No
Portfolio	Interest, dividends, annuities, royalties not from an ordinary trade or business, gains on investment property	No
Passive	Rentals; businesses without material participation	Yes

Passive losses (and passive credits) can offset only **passive income**. The excess is **suspended** and carried forward indefinitely for that activity.

Material participation

Material participation means regular, continuous and substantial involvement. A taxpayer materially participates if **any one** of seven tests is met. The four most tested are:

Test	Condition
500-hour test	More than 500 hours in the activity during the year
Substantially all	The taxpayer's participation is substantially all of the participation of all individuals
100-hour test	More than 100 hours and not less than any other individual
5-of-10 test	Material participation in any 5 of the preceding 10 years

The others are: significant participation activities totaling more than 500 hours; material participation in a personal service activity for any 3 prior years; and a facts-and-

circumstances test (more than 100 hours). A **spouse's participation counts** in determining whether the taxpayer materially participates, even if they file separately. Limited partners generally cannot materially participate except under the 500-hour, 5-of-10 and 3-year personal service tests.

Rental real estate: the $25,000 allowance

An individual who **actively participates** in rental real estate (owns at least 10% and makes management decisions such as approving tenants and setting rents) may deduct up to **$25,000** of rental real estate losses against nonpassive income.

- The allowance is reduced by **50% of modified AGI over $100,000** and is fully eliminated at $150,000.
- MAGI here is computed without passive losses, IRA deductions, taxable Social Security and certain other items.
- Married filing separately and living together: no allowance.
- These dollar amounts are statutory and not indexed.

> **Example:** Dana actively manages a rental house that produced a $30,000 loss in 2025. Her MAGI is $128,000 and she has no passive income.
>
> 1. Excess MAGI = $128,000 − $100,000 = $28,000.
> 2. Reduction = 50% × $28,000 = $14,000.
> 3. Allowance = $25,000 − $14,000 = **$11,000** deductible against her salary.
> 4. Suspended passive loss carried forward = $30,000 − $11,000 = **$19,000**.

Real estate professionals

A taxpayer who spends **more than 750 hours** in real property trades or businesses in which he or she materially participates, **and** more than half of all personal services in all trades or businesses in those real property businesses, is a real estate professional. Rentals of a real estate professional are not automatically passive; if the taxpayer materially participates in the rental, its losses are nonpassive and fully deductible. For joint filers, one spouse alone must meet both tests (spouses' hours are not combined for this purpose), though either spouse's work counts for material participation.

Freeing suspended losses

Event	Effect on suspended losses
Passive income in a later year	Suspended losses offset it
Fully taxable disposition of the **entire** interest to an **unrelated** party	All suspended losses (and current-year loss) of that activity are freed and become nonpassive, applied first against gain on the disposition, then other passive income, then any income
Sale to a related party	Losses stay suspended until the related buyer sells to an unrelated party
Death of the taxpayer	Suspended losses are deductible on the final return only to the extent they exceed the **basis step-up**
Gift of the interest	Suspended losses are **added to the donee's basis**; never deductible by the donor
Installment sale	Losses freed in proportion to gain recognized each year

Example: Kofi sells his entire interest in a passive limited partnership to an unrelated buyer for a $5,000 gain. He has $18,000 of suspended losses from prior years and a $3,000 loss from the current year up to the date of sale.

1. Total losses freed = $18,000 + $3,000 = $21,000.
2. They first offset the $5,000 passive gain.
3. The remaining **$16,000** is deductible against his wages and portfolio income.

Example: At her death, Rosa had $18,000 of suspended passive losses in a rental property whose basis is stepped up by $10,000. Only the excess of the suspended losses over the step-up, $18,000 − $10,000 = **$8,000**, is deductible on her final return. The other $10,000 is lost.

Credits and other passive details

- Passive **credits** can offset only the tax attributable to passive income; rental real estate credits get a deduction-equivalent share of the $25,000 allowance (low-income housing and rehabilitation credits use a higher MAGI phase-out range).
- Closely held C corporations can use passive losses against net active income but not portfolio income; personal service corporations follow the individual rules.
- Rental activities with an average customer stay of 7 days or less are not "rental activities" and are tested under the material participation rules instead.

The excess business loss limitation (§461(l))

After the passive rules, a noncorporate taxpayer's **aggregate net business loss** is limited. For 2025, the excess of total business deductions over total business income (plus gains) is allowed only up to **$313,000** (single) or **$626,000** (married filing jointly). The disallowed amount is an **excess business loss** that is carried forward as a **net operating loss** to the next year. Wages are not treated as business income for this computation.

Example: Victor, single, has a $500,000 loss from his Schedule C manufacturing business in 2025 (after clearing basis, at-risk and passive rules) and $150,000 of wages.

1. Net business loss = $500,000.
2. Allowed in 2025 = $313,000 (the single threshold), offsetting his wages and other nonbusiness income.
3. Excess business loss = $500,000 − $313,000 = **$187,000**, carried to 2026 as an NOL.

Putting it together: a four-wall example

Example: Lin invests $20,000 cash in an equipment-leasing limited partnership and is allocated a $30,000 share of nonrecourse (non-real-estate) partnership debt. Her share of the 2025 loss is $45,000. She does not materially participate and has no passive income.

1. **Basis:** $20,000 + $30,000 debt share = $50,000. The $45,000 loss clears basis.
2. **At-risk:** only the $20,000 cash is at risk (nonrecourse equipment debt is not). Allowed so far: $20,000; **$25,000** is suspended under §465.
3. **Passive:** the $20,000 that cleared at-risk is passive and she has no passive income, so the **$20,000** is suspended under §469.
4. **Deductible in 2025: $0.** Of the $45,000 loss, $25,000 is carried forward under the at-risk rules and $20,000 under the passive rules. The $20,000 that cleared the at-risk wall reduces her amount at risk to $0, even though the passive rules then suspend it.

Exam tip: Simulations often give a table of losses and ask which Code section suspends each portion. Fill it in order: basis first, then at-risk, then passive, then excess business loss. A loss suspended at an earlier wall never reaches the later ones in that year.

Common traps

- Counting ordinary nonrecourse debt as at risk (only qualified nonrecourse **real estate** financing counts).
- Letting passive losses offset wages, interest or dividends.
- Reducing the $25,000 allowance dollar-for-dollar instead of by 50% of excess MAGI.
- Freeing suspended losses on a sale to a related party.
- Deducting all suspended losses at death without subtracting the basis step-up.
- Forgetting that a net loss above $313,000/$626,000 becomes an NOL rather than disappearing.

Key takeaways

- Order of limits: basis → at-risk → passive → excess business loss.
- At-risk = cash + adjusted basis of property + recourse debt + qualified nonrecourse real estate financing.
- Passive = business without material participation, plus most rentals. Passive losses offset only passive income.
- Material participation: more than 500 hours, or one of the other six tests; spouse's hours count.
- Active participation in rental real estate: up to $25,000, phased out at 50% of MAGI from $100,000 to $150,000.
- A fully taxable sale of the whole interest to an unrelated party frees all suspended losses.
- 2025 excess business loss thresholds: $313,000 single, $626,000 joint; excess becomes an NOL.

3. Individual Tax, Credits and AMT

This chapter assembles the individual return: from AGI to taxable income, through the regular tax computation with preferential capital gain rates, to credits, the alternative minimum tax (AMT) and the two 3.8%/0.9% surtaxes. For 2025, OBBBA changed several of the most-tested figures, so the numbers in this chapter are worth learning carefully.

The individual tax formula

Step	Notes
Gross income	Chapter 1
− Deductions for AGI	Half of SE tax, SE health insurance, HSA, deductible IRA, student loan interest, educator expenses, alimony paid (pre-2019 instruments), Schedule C/E losses
= Adjusted gross income (AGI)	
− Greater of standard deduction or itemized deductions	
− New 2025–2028 deductions (Schedule 1-A): senior, qualified tips, qualified overtime, car loan interest	Available whether or not the taxpayer itemizes
− Qualified business income deduction	Chapter 4
= Taxable income	
× Tax rates (ordinary brackets plus 0/15/20% on qualified dividends and net capital gain)	
− Credits; + AMT, NIIT, Additional Medicare Tax, SE tax	

2025 key amounts

Item	Single	Married filing jointly	Head of household
Standard deduction (OBBBA)	$15,750	$31,500	$23,625
Additional standard deduction, 65+ or blind (each)	$2,000	$1,600	$2,000
Senior deduction (age 65+, per person)	$6,000	$6,000 each	$6,000
Senior deduction phase-out begins (6% of MAGI excess)	$75,000	$150,000	$75,000
0% capital gain rate up to taxable income of	$48,350	$96,700	$64,750
15% capital gain rate up to	$533,400	$600,050	$566,700

2025 ordinary brackets

Rate	Single — taxable income over	MFJ — taxable income over
10%	$0	$0
12%	$11,925	$23,850
22%	$48,475	$96,950
24%	$103,350	$206,700
32%	$197,300	$394,600
35%	$250,525	$501,050
37%	$626,350	$751,600

Watch out: OBBBA raised the 2025 standard deduction above the amount originally announced in late 2024 ($15,000 / $30,000 / $22,500). TCP uses the OBBBA amounts.

Dependents and the kiddie tax

- A dependent's standard deduction is the greater of **$1,350** or earned income + **$450**, capped at the regular standard deduction.
- **Kiddie tax:** a child's **net unearned income** above **$2,700** (2025) is taxed at the parent's marginal rate. The first $1,350 is sheltered by the standard deduction and the next $1,350 is taxed at the child's rate. It applies to children under 19, or full-time students under 24, whose earned income does not exceed half their support.

Example: A 12-year-old has $6,000 of interest and dividends and no earned income. Net unearned income taxed at the parent's rate = $6,000 − $2,700 = **$3,300**.

Itemized deductions

Deduction	2025 rule
Medical and dental	Amount over 7.5% of AGI
State and local taxes (SALT)	Cap $40,000 ($20,000 MFS), reduced by 30% of MAGI over $500,000 ($250,000 MFS), but not below $10,000 ($5,000 MFS)
Home mortgage interest	Acquisition debt up to $750,000 (post-Dec. 15, 2017 loans; $1,000,000 for older debt); home equity interest only if proceeds improve the home
Investment interest	Limited to net investment income; excess carried forward
Charitable contributions	Cash to public charities 60% of AGI; capital gain property to public charities 30% (at FMV); private nonoperating foundations 30% cash / 20% capital gain property; 5-year carryforward
Casualty and theft losses	Only from federally declared disasters: $100 floor per event, then 10% of AGI
Gambling losses	Up to gambling winnings
Miscellaneous 2%-floor items (unreimbursed employee expenses, tax prep)	Not deductible

Example (SALT phase-down): A married couple pays $45,000 of state income and property taxes.

- MAGI $560,000: cap = $40,000 − 30% × ($560,000 − $500,000) = $40,000 − $18,000 = **$22,000** deductible.
- MAGI $620,000: $40,000 − 30% × $120,000 = $4,000, but the floor applies → **$10,000** deductible.

Computing the tax with capital gains

Net capital gain (net LTCG over net STCL) and qualified dividends are "stacked" on top of ordinary income and taxed at 0%, 15% or 20% depending on where they fall in taxable income. Unrecaptured §1250 gain is taxed at a maximum of 25% and collectibles gain at a maximum of 28%.

Example (full computation): Jordan and Casey file jointly in 2025. Wages $180,000; qualified dividends $6,000; long-term capital gain $14,000. Itemized deductions: SALT $18,000, mortgage interest $12,000, charitable cash $5,000. Two qualifying children under 17. MAGI is below $400,000.

1. AGI = $180,000 + $6,000 + $14,000 = **$200,000**.
2. Itemized $35,000 exceeds the $31,500 standard deduction → deduct $35,000.
3. Taxable income = $200,000 − $35,000 = **$165,000**, of which $20,000 is preferential income and $145,000 is ordinary.
4. Tax on $145,000 of ordinary income: 10% × $23,850 = $2,385; 12% × ($96,950 − $23,850) = $8,772; 22% × ($145,000 − $96,950) = $10,571 → **$21,728**.
5. The $20,000 of preferential income sits between $145,000 and $165,000 — above the $96,700 0% breakpoint and below $600,050 — so it is taxed at 15% = **$3,000**.
6. Regular tax = $21,728 + $3,000 = **$24,728**.
7. Child tax credit = 2 × $2,200 = $4,400 → tax after credits **$20,328**.

Credits

Nonrefundable credits reduce tax to zero; refundable credits can create a refund.

Credit	2025 key rules
Child tax credit (CTC)	$2,200 per qualifying child under 17; up to $1,700 per child refundable (15% of earned income over $2,500); reduced $50 for each $1,000 **or fraction** of MAGI over $200,000 ($400,000 MFJ); SSN required
Credit for other dependents	$500 per other dependent; same phase-out
Child and dependent care credit	20%–35% of up to $3,000 (one) / $6,000 (two or more) of expenses; 35% rate falls to 20% as AGI rises from $15,000 to $43,000
American opportunity / lifetime learning	Chapter 5
Earned income credit	Refundable; maximum $649 / $4,328 / $7,152 / $8,046 for 0 / 1 / 2 / 3+ children
Adoption credit	Up to $17,280 per child; phase-out begins at MAGI of $259,190
Saver's credit, residential clean energy, foreign tax credit, premium tax credit	Know they exist and whether refundable (premium tax credit is refundable)

Example (CTC phase-out): A married couple with two children has MAGI of $423,500.

1. Excess MAGI = $423,500 − $400,000 = $23,500 → **24** steps of $1,000 (a partial thousand counts as a full step).
2. Reduction = 24 × $50 = $1,200.
3. Credit = $4,400 − $1,200 = **$3,200**.

The new 2025 deductions

These deductions apply for 2025 through 2028 and are taken in computing taxable income whether the taxpayer itemizes or not.

Deduction	Maximum	Phase-out
Senior deduction	$6,000 per individual 65 or older ($12,000 if both spouses qualify)	Reduced by 6% of MAGI over $75,000 ($150,000 MFJ)
Qualified tips	$25,000 per return	MAGI over $150,000 ($300,000 MFJ)
Qualified overtime (premium portion only)	$12,500 ($25,000 MFJ)	MAGI over $150,000 ($300,000 MFJ)
Car loan interest (new U.S.-assembled personal vehicle, loan after 2024)	$10,000	MAGI over $100,000 ($200,000 MFJ)

Example: Ruth, single and age 68, has MAGI of $95,000. Her senior deduction = $6,000 − 6% × ($95,000 − $75,000) = $6,000 − $1,200 = **$4,800**. She also keeps her regular $2,000 additional standard deduction for age.

The alternative minimum tax (AMT)

The AMT is a parallel tax system with a broader base and flatter rates. A taxpayer pays the AMT only to the extent the **tentative minimum tax (TMT)** exceeds the regular tax.

AMT formula

Step	Notes
Regular taxable income	
+ Standard deduction (if claimed)	Not allowed for AMT
+ State and local taxes deducted	Not allowed for AMT
± Adjustments	ISO spread at exercise; depreciation differences; installment sales of inventory; percentage-of-completion; mortgage interest not used to buy/build/improve
+ Preferences	Private activity bond interest; excess percentage depletion; 50% of excluded §1202 gain (7% for older stock)
= AMTI	
− Exemption (phased out at 25% of AMTI over threshold)	
= AMT base × 26% / 28%	Capital gains keep their preferential rates
= Tentative minimum tax − regular tax = AMT	

2025 AMT amounts	Single / HOH	MFJ	MFS
Exemption	$88,100	$137,000	$68,500
Phase-out begins (25% of excess)	$626,350	$1,252,700	$626,350
28% rate applies above AMT base of	$239,100	$239,100	$119,550

For 2025 the TMT can be computed as 26% × base when the base is $239,100 or less, and as 28% × base − $4,782 above it.

Example: Elena is single. Her 2025 regular taxable income is $300,000 after itemized deductions that include $10,000 of state income tax. She exercised ISOs with a $150,000 spread.

1. AMTI = $300,000 + $10,000 (SALT) + $150,000 (ISO spread) = **$460,000**.
2. AMTI is below $626,350, so the full **$88,100** exemption applies.
3. AMT base = $460,000 − $88,100 = **$371,900**.
4. TMT = 26% × $239,100 + 28% × ($371,900 − $239,100) = $62,166 + $37,184 = **$99,350**.
5. Regular tax on $300,000 (single) = **$74,547.25**.
6. AMT = $99,350 − $74,547.25 = **$24,802.75**.

Minimum tax credit

AMT caused by **deferral** items (ISO spread, depreciation) generates a **minimum tax credit** that can reduce regular tax in later years when regular tax exceeds TMT. AMT caused by **exclusion** items (SALT, standard deduction, tax-exempt private activity bond interest) does not create a credit. When ISO shares are sold, the AMT basis is higher than the regular basis (it includes the spread), so the AMT gain is smaller — the adjustment reverses.

Exam tip: "Is this a credit item?" Ask whether the difference will reverse later. ISO and depreciation: yes. SALT and the standard deduction: never.

Surtaxes: NIIT and Additional Medicare Tax

Tax	Rate	Base	Thresholds (not indexed)
Net investment income tax (NIIT)	3.8%	Lesser of net investment income or MAGI over the threshold	$200,000 single/HOH; $250,000 MFJ; $125,000 MFS
Additional Medicare Tax	0.9%	Wages and SE income over the threshold	Same thresholds

Net investment income includes interest, dividends, annuities, rents and royalties (not from a nonpassive business), passive business income and gains on investment property. It excludes wages, SE income, tax-exempt interest, distributions from qualified retirement plans and IRAs, and gain on a home excluded by §121.

Example: Sam, single, has MAGI of $260,000 including $40,000 of net investment income, and $230,000 of wages.

- NIIT = 3.8% × lesser of $40,000 or ($260,000 − $200,000 = $60,000) = 3.8% × $40,000 = **$1,520**.
- Additional Medicare Tax = 0.9% × ($230,000 − $200,000) = **$270**. (The employer withholds only on wages over $200,000 regardless of filing status.)

Common traps

- Multiplying all income by the marginal rate instead of using the brackets.
- Using 2026 amounts (for example, the AMT phase-out at 50% or lower thresholds, or the $15 million exclusion) for 2025.
- Forgetting that a fraction of $1,000 of excess MAGI counts as a full step for the CTC.
- Treating the SALT or standard deduction add-back as generating a minimum tax credit.
- Taxing qualified dividends at ordinary rates or forgetting to stack them on top of ordinary income.
- Including tax-exempt interest in net investment income.

Key takeaways

- 2025 standard deduction: $15,750 / $31,500 / $23,625. SALT cap $40,000, phased down by 30% of MAGI over $500,000 to a $10,000 floor.
- CTC $2,200 per child (up to $1,700 refundable); $50 reduction per $1,000 or fraction over $200,000/$400,000.
- New deductions: senior $6,000, tips $25,000, overtime $12,500/$25,000, car loan interest $10,000 — each with its own phase-out.
- AMT 2025: exemption $88,100 / $137,000, phased out 25% above $626,350 / $1,252,700; 26% to $239,100, then 28%. Only deferral items create a minimum tax credit.
- NIIT 3.8% and Additional Medicare 0.9% use thresholds of $200,000 single and $250,000 joint.

4. Self-Employment and Business Income

A sole proprietor reports business income and expenses on **Schedule C**. TCP tests how to measure that income (what is deductible, and when), how capital costs are recovered, how self-employment tax is computed, and how the **qualified business income (QBI) deduction** works below, inside and above its income thresholds.

Deductible business expenses

A business expense is deductible under §162 if it is **ordinary** (common in the industry), **necessary** (helpful and appropriate) and paid or incurred in carrying on a trade or business. Capital expenditures must be capitalized and recovered over time.

Item	2025 treatment
Business meals	50% deductible (business associate present, not lavish)
Entertainment	Not deductible
Business gifts	$25 per recipient per year
Travel away from home	Transportation and lodging 100%; meals 50%
Fines and penalties paid to a government	Not deductible (restitution amounts identified as such may be)
Lobbying and political contributions	Not deductible
Federal income tax	Not deductible; state income tax on business income is a personal itemized deduction, not Schedule C
Health insurance for self-employed owner	Deduction **for** AGI (not on Schedule C), limited to net SE earnings
Home office	Regular and exclusive use; simplified method $5 per sq. ft. up to 300 sq. ft.; limited to income from the business
Bad debts	Business bad debts deductible when worthless (ordinary); cash-method taxpayers have no basis in unpaid receivables
Research and experimental costs	Domestic costs deductible currently for tax years beginning after 2024 (OBBBA §174A); foreign research amortized over 15 years

Start-up and organizational costs

Start-up costs (§195) and organizational costs (§248 for corporations, §709 for partnerships) are handled the same way:

- Deduct up to **$5,000** in the year business begins, reduced dollar-for-dollar when total costs exceed **$50,000** (no immediate deduction at $55,000 or more).
- Amortize the remainder over **180 months**, starting with the **month business begins**.

Example: Mia incurs $53,000 of start-up costs and opens her shop on July 1, 2025.

1. Immediate deduction = $5,000 − ($53,000 − $50,000) = **$2,000**.
2. Remaining $51,000 ÷ 180 × 6 months (July–December) = **$1,700**.
3. Total 2025 deduction = $2,000 + $1,700 = **$3,700**.

Accounting methods

- **Cash method** is available to sole proprietors and to C corporations and partnerships with a C-corporation partner whose average annual gross receipts for the prior 3 years do not exceed **$31,000,000** (2025 §448(c) test). Small businesses under the same test may also skip inventory capitalization (§471(c)), uniform capitalization (§263A) and the §163(j) interest limit.
- Prepaid expenses: the **12-month rule** allows deducting a prepayment whose benefit does not extend beyond the earlier of 12 months after the benefit begins or the end of the following tax year.

Cost recovery

§179 expensing (2025)

Item	Amount
Maximum §179 deduction (tax years beginning in 2025, OBBBA)	$2,500,000
Reduced dollar-for-dollar when §179 property placed in service exceeds	$4,000,000
SUV limit	$31,300
Business income limitation	Deduction cannot exceed taxable income from active trades or businesses; excess carried forward

Example: A company places $4,300,000 of qualifying equipment in service in 2025. The §179 limit is $2,500,000 − ($4,300,000 − $4,000,000) = **$2,200,000**, subject to the business income limit.

Bonus depreciation

- **100%** bonus depreciation for qualified property **acquired after January 19, 2025** (OBBBA, permanent). The taxpayer may elect out by class or elect 40% for the first tax year ending after January 19, 2025.
- Property acquired under a binding contract before January 20, 2025 and placed in service in 2025: **40%**.
- Bonus has **no** income limit and can create a loss; §179 cannot.
- Order: §179 first, then bonus, then regular MACRS on the remaining basis.

MACRS basics

Property	Recovery period / method	Convention
Computers, autos, light trucks	5-year, 200% DB	Half-year (mid-quarter if more than 40% of the year's personal property is placed in service in Q4)
Office furniture, most machinery	7-year, 200% DB	Same
Residential rental real property	27.5 years, straight-line	Mid-month
Nonresidential real property	39 years, straight-line	Mid-month
Land	Not depreciable	—

> **Watch out:** In the year of disposal, half-year property gets a half year of depreciation; mid-month real property gets depreciation through the middle of the month of sale.

Self-employment tax

Self-employment (SE) tax funds Social Security and Medicare for the self-employed:

1. Net earnings from self-employment = **92.35%** × net SE profit (the 7.65% reduction mimics the employer's deduction).
2. No SE tax if net earnings are less than **$400**.
3. Social Security portion: **12.4%** × net earnings, up to the 2025 wage base of **$176,100**, reduced by any W-2 wages subject to Social Security tax.
4. Medicare portion: **2.9%** × all net earnings (no cap).
5. **Half of SE tax** is a deduction for AGI.
6. Additional Medicare Tax of 0.9% applies to combined wages and SE earnings over $200,000/$250,000 (it is not part of SE tax and is not half-deductible).

Example: Theo's Schedule C net profit is $120,000 and he has no wages.

1. Net earnings = $120,000 × 92.35% = **$110,820**.
2. Social Security = 12.4% × $110,820 = $13,741.68.
3. Medicare = 2.9% × $110,820 = $3,213.78.
4. SE tax = **$16,955.46**; deduction for AGI = half = **$8,477.73**.

Example: Ava has $100,000 of W-2 wages and a $220,000 Schedule C profit.

1. Net earnings = $220,000 × 92.35% = $203,170.
2. Remaining Social Security base = $176,100 − $100,000 = $76,100 → 12.4% × $76,100 = $9,436.40.
3. Medicare = 2.9% × $203,170 = $5,891.93.
4. SE tax = **$15,328.33**.

Who owes SE tax

Income	SE income?
Schedule C profit	Yes
General partner's distributive share of trade or business income	Yes
Guaranteed payments for services (any partner)	Yes
Limited partner's distributive share	No
S corporation pass-through income	No (wages paid to the owner bear FICA instead)
Rental income (non-dealer), interest, dividends, capital gains	No

Qualified business income (QBI) deduction — §199A

Owners of sole proprietorships, partnerships and S corporations (and certain trusts and estates) may deduct up to **20% of qualified business income**. OBBBA made the deduction permanent.

What is QBI

QBI is the net amount of ordinary income, gain, deduction and loss from a qualified U.S. trade or business. It **excludes** capital gains and losses, dividends, interest not allocable to the business, **reasonable compensation** paid by an S corporation to the owner, and **guaranteed payments** to partners. Wages earned as an employee are never QBI.

The overall limit

The deduction cannot exceed **20% × (taxable income before the QBI deduction − net capital gain**, including qualified dividends).

Thresholds for 2025

Filing status	Threshold	Top of phase-in range
Married filing jointly	$394,600	$494,600 ($100,000 range)
All others	$197,300	$247,300 ($50,000 range)

- **Below the threshold:** deduction = 20% × QBI (subject to the overall limit). SSTB status and wages do not matter.
- **Above the top of the range:** the deduction for each business is limited to the greater of (a) **50% of W-2 wages** or (b) **25% of W-2 wages + 2.5% of the unadjusted basis immediately after acquisition (UBIA)** of qualified property. A **specified service trade or business (SSTB)** — health, law, accounting, actuarial science, performing arts, consulting, athletics, financial and brokerage services, or any business whose principal asset is the skill or reputation of its owners — gets **no** deduction.
- **Inside the range:** the wage/UBIA limit phases in, and an SSTB's QBI, wages and UBIA are reduced to the "applicable percentage."

Example (below threshold): Kim, single, has QBI of $90,000 and taxable income before the QBI deduction of $120,000 with no capital gains. Deduction = lesser of 20% × $90,000 = $18,000 or 20% × $120,000 = $24,000 → **$18,000**.

Example (above the range): A married couple's taxable income is $600,000. Their non-SSTB partnership allocates QBI of $400,000, W-2 wages of $120,000 and UBIA of $800,000.

1. 20% × QBI = $80,000.
2. 50% × W-2 wages = $60,000.
3. 25% × $120,000 + 2.5% × $800,000 = $30,000 + $20,000 = $50,000.
4. Wage/UBIA limit = greater of $60,000 or $50,000 = $60,000.
5. Deduction = lesser of $80,000 or $60,000 = **$60,000** (also below 20% × $600,000).

Example (inside the range): Same business, but taxable income is $444,600 — halfway through the $100,000 range.

1. Excess of 20% QBI over the wage limit = $80,000 − $60,000 = $20,000.
2. Phase-in percentage = ($444,600 − $394,600) ÷ $100,000 = 50%.
3. Reduction = 50% × $20,000 = $10,000.
4. Deduction = $80,000 − $10,000 = **$70,000**.

Exam tip: Decide the zone first: below, inside or above the range. Then ask whether the business is an SSTB. Only then pull in wages and UBIA.

Estimated taxes and other compliance

- Individuals avoid the underpayment penalty by paying the lesser of **90% of current-year tax** or **100% of prior-year tax** (**110%** if prior-year AGI exceeded $150,000), in four installments due April 15, June 15, September 15 and January 15.
- No penalty if the tax due after withholding is less than $1,000.
- Hobby income is fully taxable, but hobby expenses are not deductible (the §67 miscellaneous itemized deduction is suspended). A profit in 3 of 5 consecutive years creates a presumption of a profit motive (2 of 7 for horses).
- Form 1099-NEC is required for $600 or more of nonemployee compensation for payments in 2025 (OBBBA raises the threshold starting with 2026 payments).

Common traps

- Applying 15.3% to net profit without first multiplying by 92.35%.
- Ignoring W-2 wages that already used part of the Social Security wage base.
- Using pre-OBBBA §179 figures ($1,250,000 / $3,130,000) for 2025.
- Treating guaranteed payments or S corporation reasonable compensation as QBI.
- Starting §195 amortization in January instead of in the month the business begins.
- Deducting entertainment or 100% of meals.

Key takeaways

- Expenses must be ordinary and necessary; meals 50%, entertainment 0%, gifts $25.
- Start-up and organizational costs: $5,000 each, reduced over $50,000; remainder over 180 months from the month business begins.
- 2025 §179 $2,500,000 limit with a $4,000,000 phase-out threshold; 100% bonus for property acquired after January 19, 2025.

- SE tax = 92.35% × net profit × (12.4% to the $176,100 base, reduced by wages, + 2.9% uncapped); half deductible for AGI.
- QBI: 20% of QBI, capped at 20% of taxable income less net capital gain; thresholds $197,300 / $394,600 with $50,000 / $100,000 phase-in ranges; above the range, wage/UBIA limit applies and SSTBs get nothing.

5. Retirement and Education Planning

Personal financial planning is part of Blueprint Area I. TCP expects you to choose the right savings vehicle, compute contribution and deduction limits, decide how distributions are taxed and penalized, and coordinate education tax benefits without claiming the same expense twice.

Retirement savings vehicles

Vehicle	Contribution	Growth	Distribution
Traditional IRA	Deductible (if eligible) or nondeductible	Tax-deferred	Taxable except recovery of nondeductible basis
Roth IRA	Never deductible	Tax-free	Qualified distributions tax-free
401(k) / 403(b) / governmental 457(b)	Pre-tax elective deferrals (or Roth deferrals)	Tax-deferred	Taxable (Roth: tax-free if qualified)
SEP IRA	Employer contribution, up to 25% of compensation	Tax-deferred	Taxable
SIMPLE IRA / SIMPLE 401(k)	Employee deferrals + employer match (or 2% nonelective)	Tax-deferred	Taxable; 25% additional tax on early withdrawals in first 2 years of participation

2025 limits

Limit	2025 amount
IRA contribution (traditional + Roth combined)	$7,000; plus $1,000 catch-up at age 50+
401(k), 403(b), 457(b) elective deferral	$23,500
Catch-up, age 50+ (401(k) etc.)	$7,500
Higher catch-up, ages 60–63	$11,250
SIMPLE deferral	$16,500 (catch-up $3,500; ages 60–63 $5,250)
§415(c) annual additions (defined contribution, SEP)	Lesser of $70,000 or 100% of compensation
Compensation limit §401(a)(17)	$350,000

An IRA contribution requires earned income (compensation) at least equal to the contribution; a spousal IRA can be funded from the working spouse's compensation on a joint return. Contributions for 2025 may be made until April 15, 2026.

Traditional IRA deduction phase-outs (2025)

If neither spouse is an active participant in an employer plan, the IRA contribution is fully deductible at any income. Otherwise:

Situation	MAGI phase-out range
Single / HOH, active participant	$79,000 – $89,000
MFJ, contributing spouse is an active participant	$126,000 – $146,000
MFJ, contributing spouse not covered but other spouse is	$236,000 – $246,000
MFS, active participant	$0 – $10,000

Roth IRA contribution phase-outs (2025)

Filing status	MAGI phase-out range
Single / HOH	$150,000 – $165,000
Married filing jointly	$236,000 – $246,000
MFS (lived with spouse)	$0 – $10,000

Within a range, the limit is reduced proportionally; the result is rounded **up** to the next $10, and a minimum of $200 applies if any amount remains.

> **Example:** Noah, age 40 and single, participates in his employer's 401(k) and has MAGI of $83,000. Deductible IRA = $7,000 × ($89,000 − $83,000) ÷ $10,000 = **$4,200**. He can contribute the other $2,800 as a nondeductible contribution (creating basis) or to a Roth IRA, since his MAGI is far below the Roth range.

> **Example:** A married couple filing jointly has MAGI of $240,000. Each spouse's Roth contribution limit = $7,000 × ($246,000 − $240,000) ÷ $10,000 = **$4,200**.

SEP contributions for the self-employed

For an employee, a SEP contribution is up to 25% of W-2 compensation. For a self-employed owner, compensation is net SE earnings reduced by half of SE tax **and** by the contribution itself, so the effective rate is 20% (25% ÷ 1.25) of net SE earnings after the half-SE-tax deduction, capped at $70,000.

Distributions

Early distributions — the 10% additional tax

Distributions before age **59½** are taxable (to the extent not basis) and generally subject to an additional **10%** tax. Exceptions apply to the amount that qualifies:

Exception	IRAs	Qualified plans (401(k))
Death or total and permanent disability	Yes	Yes
Substantially equal periodic payments	Yes	Yes (after separation)
Separation from service in or after the year the employee turns 55	No	Yes
Unreimbursed medical expenses over 7.5% of AGI	Yes	Yes
Health insurance premiums while unemployed	Yes	No
Qualified higher education expenses	Yes	No
First-time home purchase (up to $10,000 lifetime)	Yes	No
Birth or adoption (up to $5,000)	Yes	Yes
Emergency personal expense (one per year, up to $1,000)	Yes	Yes
Qualified domestic relations order (QDRO)	No	Yes

Example: Grace, age 45, withdraws $20,000 from her traditional IRA (all deductible contributions) and uses $8,000 for her son's college tuition.

1. Taxable distribution = **$20,000** (the exception removes the penalty, not the income tax).
2. 10% additional tax applies to $20,000 − $8,000 = $12,000 → **$1,200**.

Watch out: A 401(k) **hardship** withdrawal is allowed by the plan, but it is **not** an exception to the 10% tax.

Roth IRA ordering rules

A **qualified** Roth distribution is entirely tax-free. It must be made after a 5-tax-year period beginning with the first Roth contribution **and** on account of age 59½, death, disability or a first-time home purchase.

Nonqualified distributions come out in this order:

1. **Regular contributions** — always tax- and penalty-free.
2. **Conversions** (first in, first out; taxable portion first) — not taxable again, but subject to the 10% tax if withdrawn within 5 years of that conversion and before 59½.
3. **Earnings** — taxable and subject to the 10% tax unless an exception applies.

Example: Leo, age 50, has a Roth IRA with $30,000 of regular contributions, a $20,000 conversion made two years ago (fully taxed at conversion) and $15,000 of earnings. He withdraws $45,000.

1. First $30,000 = contributions → tax-free, no penalty.
2. Next $15,000 = conversion → not taxable, but within 5 years → 10% × $15,000 = **$1,500** additional tax.
3. No earnings were withdrawn, so taxable income = **$0**.

Required minimum distributions (RMDs)

- RMDs begin for the year the owner reaches **age 73** (75 for those born in 1960 or later). The first RMD may be delayed to April 1 of the following year.
- Each RMD = prior December 31 balance ÷ life expectancy factor from the IRS Uniform Lifetime Table.
- Roth IRAs (and, since 2024, Roth accounts in employer plans) have **no lifetime RMDs**.
- Penalty for a missed RMD: **25%** excise tax, reduced to **10%** if corrected timely.
- Most non-spouse beneficiaries must empty an inherited account within **10 years**.
- **Qualified charitable distributions** from IRAs (age 70½+) count toward the RMD and are excluded from income, up to $108,000 for 2025.

Rollovers and conversions

- **60-day rollover:** one IRA-to-IRA indirect rollover per 12 months; plan distributions paid to the participant have **20% withholding**, which must be made up from other funds to roll over the full amount.
- **Direct trustee-to-trustee transfers** have no limit and no withholding.
- **Roth conversion:** the pre-tax amount converted is taxable in the year of conversion, with no 10% tax. Nondeductible basis is recovered pro rata across **all** traditional IRAs (the "pro-rata rule").

Education planning

Credits (2025)

Feature	American opportunity tax credit (AOTC)	Lifetime learning credit (LLC)
Maximum	$2,500 per eligible student (100% of first $2,000 + 25% of next $2,000)	$2,000 per **return** (20% of up to $10,000)
Years available	First 4 years of postsecondary education; 4 tax years per student	Unlimited years, including graduate school and courses to improve job skills
Enrollment	At least half-time in a degree program	One course is enough
Refundable	40% (up to $1,000)	No
Qualified expenses	Tuition, fees, course materials (books even if not bought from the school)	Tuition and fees required to be paid to the school
MAGI phase-out	$80,000–$90,000 single; $160,000–$180,000 MFJ	Same
MFS	Not allowed	Not allowed

Example: Zoe, single with MAGI of $84,000, pays $3,500 of qualified tuition for her first year of college.

1. Tentative AOTC = $2,000 + 25% × $1,500 = **$2,375**.
2. Phase-out fraction = ($90,000 − $84,000) ÷ $10,000 = 60% → credit = **$1,425**.
3. Refundable portion = 40% × $1,425 = **$570**.

Savings vehicles

Vehicle	Key rules
§529 qualified tuition program	No federal deduction for contributions (gifts eligible for the annual exclusion, with a 5-year election); tax-free earnings when used for qualified higher education expenses, including room and board for at least half-time students; up to $10,000 per year for K-12 tuition in 2025 (OBBBA expands K-12 expenses and raises the limit to $20,000 from 2026); up to $10,000 lifetime for student loans; rollover to the beneficiary's Roth IRA up to $35,000 lifetime if the account is at least 15 years old
Coverdell ESA	$2,000 per beneficiary per year; contributor income limits; can pay K-12 expenses
Series EE/I savings bonds	Interest excludable when used for higher education tuition, subject to income phase-out
Student loan interest	Up to $2,500 deduction for AGI, phased out by MAGI

Coordination — no double benefit

The same dollars of expense cannot be used for a credit **and** a tax-free 529/Coverdell distribution **and** a scholarship exclusion. If a 529 distribution exceeds the adjusted qualified expenses (expenses minus tax-free scholarships minus expenses used for the AOTC/LLC), the **earnings portion** of the excess is taxable and generally subject to the 10% additional tax. The penalty is waived to the extent the excess is due to a tax-free scholarship.

Example: A $12,000 distribution comes from a 529 account worth $40,000, of which $30,000 is contributions (basis). Adjusted qualified expenses are $9,000.

1. Earnings ratio = ($40,000 − $30,000) ÷ $40,000 = 25% → earnings in the distribution = **$3,000**.
2. Taxable earnings = $3,000 × ($12,000 − $9,000) ÷ $12,000 = **$750**.
3. 10% additional tax = **$75**.

Exam tip: In education planning questions, first assign expenses to the AOTC (the first $4,000 gives the largest benefit), then let the 529 cover the rest.

Common traps

- Using the active-participant phase-out for a taxpayer whose spouse, not the taxpayer, is covered (use $236,000–$246,000).
- Treating a 401(k) hardship withdrawal as penalty-free.
- Applying the age-55 separation exception to an IRA.
- Claiming the AOTC for graduate school or more than four years.
- Taxing the whole excess 529 distribution instead of only its earnings portion.
- Forgetting that the LLC limit is per return, while the AOTC is per student.

Key takeaways

- 2025: IRA $7,000 (+$1,000), 401(k) $23,500 (+$7,500; $11,250 at 60–63), SIMPLE $16,500, §415(c) $70,000.
- Traditional IRA deduction phase-outs: $79,000–$89,000 single, $126,000–$146,000 MFJ, $236,000–$246,000 for a non-covered spouse. Roth: $150,000–$165,000 / $236,000–$246,000.
- Early distributions: taxable plus 10% unless an exception applies; know which exceptions are IRA-only and which are plan-only.
- Roth ordering: contributions, conversions, earnings.
- RMDs from 73; Roth IRAs exempt; missed RMD penalty 25% (10% if corrected).

- AOTC $2,500 per student, 40% refundable; LLC $2,000 per return; both phase out at $80,000–$90,000 / $160,000–$180,000.

6. Gift and Estate Tax

The federal gift tax and estate tax form one **unified transfer tax system**. Lifetime taxable gifts and transfers at death are taxed on the same rate schedule (top rate 40%) and share a single lifetime exclusion. TCP tests both compliance (which transfers are taxable, what goes in the gross estate) and planning (annual exclusion gifts, gift splitting, marital and charitable deductions, and basis consequences).

Key 2025 amounts

Item	2025
Annual gift tax exclusion per donee	$19,000
Annual exclusion for gifts to a non-citizen spouse	$190,000
Basic exclusion amount (estate and lifetime gifts)	$13,990,000
Top transfer tax rate	40% (on amounts over $1,000,000)
Tentative tax on the first $1,000,000	$345,800
Generation-skipping transfer (GST) exemption	$13,990,000

Watch out: OBBBA raises the basic exclusion to **$15,000,000** for decedents dying and gifts made **after 2025**. For a 2025 death or gift, use $13,990,000.

The gift tax

What is a gift

A gift is a transfer for less than full and adequate consideration. It is complete when the donor gives up dominion and control. Not gifts: transfers in the ordinary course of business, payments of legal support obligations, and transfers to political organizations.

Exclusions and deductions

Rule	Treatment
Annual exclusion	$19,000 per donee per year — **present interests only** (the donee can use the property now)
Future interests (remainders, most trust gifts)	No annual exclusion, unless a **Crummey** withdrawal power turns the gift into a present interest
Tuition paid **directly** to an educational institution	Unlimited exclusion (tuition only, not books or room and board)
Medical expenses paid **directly** to the provider	Unlimited exclusion
Gifts to a U.S.-citizen spouse	Unlimited marital deduction
Gifts to charity	Unlimited charitable deduction
§529 contributions	May elect to spread up to 5 × $19,000 = $95,000 over five years

Gift splitting

A married couple may elect to treat every gift made by either spouse to a third party during the year as made one-half by each. Both spouses must consent (on Form 709). Splitting effectively doubles the annual exclusion to $38,000 per donee.

> **Example:** In 2025 Arjun gives $100,000 cash to his daughter and $40,000 to his grandson, pays $30,000 of the grandson's tuition directly to the university, gives $500,000 to his wife (a U.S. citizen) and $50,000 to a public charity. Arjun and his wife elect gift splitting.
>
> 1. Tuition paid directly: excluded entirely.
> 2. Gift to wife: marital deduction (not split; splitting applies only to gifts to third parties).
> 3. Gift to charity: charitable deduction.
> 4. Split gifts: each spouse is treated as giving $50,000 to the daughter and $20,000 to the grandson.
> 5. Taxable gifts per spouse = ($50,000 − $19,000) + ($20,000 − $19,000) = **$32,000**.
> 6. Without splitting, Arjun's taxable gifts would be ($100,000 − $19,000) + ($40,000 − $19,000) = **$102,000**.
>
> No gift tax is payable in either case; the taxable gifts simply use part of each spouse's $13,990,000 exclusion. (The grandson gift is also a direct skip for GST purposes, covered by the GST annual exclusion and exemption.)

Filing

Form 709 is due **April 15** of the year after the gift (extended automatically when the donor extends Form 1040). It is required for any gift above the annual exclusion, any gift of a future interest, and whenever spouses elect gift splitting. Gifts to a spouse covered by the marital deduction and qualifying tuition/medical payments do not trigger filing by themselves.

Basis of gifted property

Situation	Donee's basis
FMV at gift ≥ donor's basis	Donor's basis (carryover), increased by the portion of gift tax paid attributable to the appreciation
FMV at gift < donor's basis — sale at a gain	Donor's basis
FMV at gift < donor's basis — sale at a loss	FMV at date of gift
FMV at gift < donor's basis — sale between the two	No gain or loss

Holding period tacks on (includes the donor's) when the donor's basis is used.

Example: Mom's basis in stock is $50,000; FMV is $30,000 when she gives it to Ben.

- Ben sells for $55,000 → gain basis $50,000 → **$5,000 gain**.
- Ben sells for $25,000 → loss basis $30,000 → **$5,000 loss**.
- Ben sells for $40,000 → between the two → **no gain or loss**.

Exam tip: For planning, give **appreciated** assets to low-bracket donees or charity, hold appreciated assets until death to get a step-up, and sell loss assets yourself to use the loss.

The estate tax

Computation

Step	
Gross estate (FMV at date of death or alternate valuation date)	
− Funeral expenses, administration expenses, debts, mortgages, casualty losses	
− Marital deduction (unlimited, to a U.S.-citizen spouse)	
− Charitable deduction (unlimited)	
− State death taxes	
= Taxable estate	
+ Adjusted taxable gifts (post-1976 taxable gifts not included in the gross estate)	
= Tax base × unified rate schedule = tentative tax	
− Gift taxes payable on post-1976 gifts	
− Unified credit (tax on the $13,990,000 basic exclusion = $5,541,800)	
= Estate tax	

What is in the gross estate

Included	Notes
Property owned outright at death	Cash, securities, real estate, business interests, receivables
Life insurance on the decedent's life	If payable to the estate, or the decedent held **incidents of ownership**, or the policy was transferred within **3 years** of death
Revocable trusts	Fully included
Transfers with a retained life estate or retained control	Included (§2036)
Joint tenancy with spouse	**50%** included, regardless of who paid
Joint tenancy with a non-spouse	Included in proportion to the decedent's contribution
Retirement accounts and annuities with survivor benefits	Value of the survivor's interest
General powers of appointment	Included
Gift tax paid on gifts within 3 years of death	Included ("gross-up")

Valuation

- Generally FMV on the date of death.

- **Alternate valuation date:** 6 months after death (or the date of earlier sale or distribution). It may be elected only if it **reduces both** the gross estate and the estate tax (after credits). Assets that change merely because time passes (such as annuities) are valued at death.
- Special use valuation (§2032A) for qualifying farm and business real property, subject to an indexed cap.

Example: Helen dies in 2025 with a gross estate of $18,000,000. Debts are $300,000, funeral expenses $20,000 and administration expenses $80,000. She leaves $2,000,000 to her husband and $500,000 to a charity. She made $1,000,000 of post-1976 taxable gifts on which no gift tax was paid.

1. Taxable estate = $18,000,000 − $300,000 − $20,000 − $80,000 − $2,000,000 − $500,000 = **$15,100,000**.
2. Tax base = $15,100,000 + $1,000,000 adjusted taxable gifts = **$16,100,000**.
3. Tentative tax = $345,800 + 40% × ($16,100,000 − $1,000,000) = **$6,385,800**.
4. Unified credit = $345,800 + 40% × ($13,990,000 − $1,000,000) = **$5,541,800**.
5. Estate tax = $6,385,800 − $5,541,800 = **$844,000**. (Shortcut: 40% × ($16,100,000 − $13,990,000) = $844,000.)

Portability and the marital deduction

- A surviving spouse can use the deceased spouse's **unused exclusion amount (DSUE)** if the executor elects portability on a timely filed Form 706 — even when no tax is owed.
- Property passing to a spouse in a **QTIP** trust (income to the spouse for life, paid at least annually) qualifies for the marital deduction if elected; it is then included in the surviving spouse's estate.
- Bequests to a non-citizen spouse qualify only through a qualified domestic trust (QDOT).

Filing and payment

- **Form 706** is due **9 months** after death; a **6-month** extension of time to file is available. Filing is required when the gross estate plus adjusted taxable gifts exceeds the basic exclusion amount (or to elect portability).
- Estate tax attributable to a closely held business that is more than 35% of the adjusted gross estate may be deferred and paid in installments (§6166).

Basis of inherited property

Property acquired from a decedent takes a basis equal to **FMV at date of death** (or the alternate valuation date if elected) — the "step-up" (or step-down). The holding period is automatically **long-term**. Income in respect of a decedent (IRD), such as unpaid salary or

traditional IRA balances, gets **no** step-up; the recipient is taxed when it is received but may deduct the estate tax attributable to it.

> **Memory trick:** "Gifts **carry**, deaths **step**." Gifted property carries over the donor's basis; inherited property steps to FMV.

Generation-skipping transfer tax

A separate flat **40%** tax applies to transfers to **skip persons** (two or more generations below the transferor, such as grandchildren) above the GST exemption ($13,990,000 for 2025). If the skip person's parent is deceased at the time of the transfer, the grandchild moves up a generation (predeceased parent exception). The annual exclusion and the tuition/medical exclusions also apply.

Common traps

- Using the $15 million 2026 exclusion for a 2025 death.
- Allowing the annual exclusion for a future interest (a remainder or a trust without Crummey powers).
- Including 100% of property held in joint tenancy with a spouse.
- Forgetting adjusted taxable gifts in the estate tax base.
- Treating payments of tuition made to the student (not the school) as excluded.
- Electing alternate valuation when it raises the gross estate.

Key takeaways

- 2025: annual exclusion $19,000 (present interests only); basic exclusion $13,990,000; top rate 40%.
- Unlimited exclusions for direct tuition and medical payments; unlimited marital (citizen spouse) and charitable deductions.
- Gift splitting doubles the annual exclusion; both spouses must consent and file.
- Gross estate includes owned property, life insurance with incidents of ownership or transferred within 3 years, revocable trusts, retained life estates and 50% of spousal joint tenancy.
- Estate tax = tentative tax on (taxable estate + adjusted taxable gifts) − gift taxes payable − unified credit ($5,541,800 for 2025).
- Form 706 due 9 months after death (6-month extension); Form 709 due April 15.
- Gifts carry over basis (with the dual-basis loss rule); inherited property steps up to FMV.

7. C Corporation Taxable Income and Schedules M-1/M-3

A C corporation is a separate taxpayer. It computes taxable income on **Form 1120** and pays a flat **21%** federal income tax. TCP focuses on the differences between corporate and individual rules, on the special corporate deductions (dividends received deduction, charitable contributions, NOLs, capital losses) and on reconciling book income to taxable income on Schedule M-1 or M-3.

Corporate taxable income formula

Step	
Gross income (sales − cost of goods sold, dividends, interest, rents, royalties, net capital gain, §1231 gains, other)	
− Ordinary and necessary business deductions	
= Taxable income before special deductions	
− Charitable contributions (10% limit)	Computed before DRD and NOL
− Dividends received deduction (DRD)	
− NOL deduction (80% limit for post-2017 NOLs)	
= Taxable income × 21%	

Key differences from individuals

Item	C corporation rule
Tax rate	Flat 21%; no preferential capital gain rate
Capital losses	Deductible **only against capital gains**; net capital loss carried **back 3 years and forward 5**, always as short-term

Deductions and loss rules:

Item	C corporation rule
Charitable contributions	Limited to **10%** of taxable income computed before the charitable deduction, DRD, NOL carryback and capital loss carryback; excess carried forward 5 years. (For 2025 there is no floor; a 1% floor begins in 2026.)
Accrual-basis charitable pledges	Deductible in the year accrued if the board authorizes and payment is made within 3½ months after year-end (for calendar years, by April 15)
Inventory contributions	Enhanced deduction for certain inventory (basis + half the appreciation, up to twice basis)

Other differences:

Item	C corporation rule
Organizational costs	$5,000 immediate (reduced over $50,000), rest over 180 months
Dividends received	DRD of 50%, 65% or 100%
AMT	Repealed for most corporations; a 15% corporate AMT applies only to corporations with average adjusted financial statement income over $1 billion
Excess business loss and passive rules	Not for widely held C corporations (personal service corporations and closely held corporations have special passive rules)

Dividends received deduction (DRD)

A corporation that receives a dividend from a taxable domestic corporation deducts a percentage of it, based on its ownership of the payer:

Ownership of the distributing corporation	DRD
Less than 20%	50%
20% to less than 80%	65%
80% or more (affiliated group)	100%

Taxable income limit: the 50% and 65% DRDs are limited to that percentage of taxable income computed **without** the DRD, NOL deduction and capital loss carryback — **unless** taking the full DRD creates or increases an NOL, in which case the full DRD is allowed. The stock must be held more than 45 days around the ex-dividend date, and debt-financed portfolio stock reduces the DRD.

Example: Kestrel Corp. owns 25% of Finch Corp. and receives a $100,000 dividend from Finch. Kestrel's other revenue is $400,000. The tentative DRD is 65% × $100,000 = $65,000.

Operating expenses	TI before DRD	65% of TI	DRD allowed	Taxable income
$340,000	$160,000	$104,000	$65,000 (full)	$95,000
$420,000	$80,000	$52,000	$52,000 (limited)	$28,000
$440,000	$60,000	$39,000	$65,000 (full — creates a $5,000 NOL)	($5,000)

In the middle case, the full $65,000 DRD would leave $15,000 of positive income, so no NOL is created and the 65%-of-TI limit applies.

Memory trick: "Limit unless loss." The DRD is limited to the percentage of taxable income **unless** the full DRD produces a **loss**.

Charitable contribution limit

Example: Taxable income before the charitable deduction, DRD, NOL and capital loss carryback is $300,000. The corporation contributes $40,000 cash to public charities.

1. Limit = 10% × $300,000 = **$30,000** deducted in 2025.
2. Excess **$10,000** carries forward 5 years (used after current-year gifts).

Net operating losses

NOL arising in	Carryback	Carryforward	Limit
Tax years beginning before 2018	2 years	20 years	100% of taxable income
2018, 2019, 2020 (CARES Act)	5 years	Indefinite	No 80% limit through 2020
2021 and later	None (farming losses 2 years)	Indefinite	**80%** of taxable income (computed without the NOL deduction)

Example: In 2025 a corporation has taxable income before the NOL deduction of $200,000 and a $250,000 NOL carryforward from 2022.

1. NOL deduction limited to 80% × $200,000 = **$160,000**.
2. Taxable income = $40,000; tax = 21% × $40,000 = $8,400.
3. NOL carryforward to 2026 = $250,000 − $160,000 = **$90,000**.

Business interest limit — §163(j)

Business interest expense is deductible up to business interest income + **30% of adjusted taxable income (ATI)** + floor plan financing interest. For tax years beginning after 2024, OBBBA restores an **EBITDA-style** ATI: depreciation, amortization and depletion are added back again. Disallowed interest carries forward indefinitely. Taxpayers meeting the **$31,000,000** gross receipts test (2025) are exempt, as are certain real property and farming businesses that elect out.

Book-tax differences

Book income (GAAP) and taxable income differ for two kinds of reasons:

Permanent differences (never reverse)	Temporary differences (reverse over time)
Tax-exempt municipal interest (book income, never taxable)	Depreciation (tax MACRS/bonus vs. book straight-line)
Federal income tax expense (book expense, never deductible)	Bad debts (book allowance vs. tax direct write-off)
Fines and penalties (never deductible)	Warranty and other reserves (deductible for tax when paid)
50% of business meals; entertainment	Prepaid income (taxed when received, subject to deferral rules)
Life insurance premiums when the corporation is the beneficiary; death proceeds received	Capital losses in excess of capital gains (carried over)
Political contributions and lobbying	Charitable contributions over 10% (carried over)
DRD (a tax-only deduction)	Accrued compensation unpaid 2½ months after year-end; related-party accruals
Excess compensation over $1 million (public companies)	Start-up and organizational cost amortization

Schedule M-1

Schedule M-1 starts with **net income per books** and reconciles to **taxable income before the NOL deduction and special deductions** (line 28 of Form 1120).

Add	Subtract
Federal income tax per books	Tax-exempt interest and other book income not taxed
Excess of capital losses over capital gains	Tax deductions not charged against book income (e.g., excess tax depreciation)
Income taxable but not recorded on books (e.g., prepaid rent received)	
Book expenses not deductible (fines, 50% of meals, life insurance premiums, excess charitable contributions, book depreciation in excess of tax)	

Schedule M-2 analyzes unappropriated retained earnings (beginning balance + net income − dividends ± other changes). **Schedule M-3** replaces M-1 for corporations with total assets of **$10 million or more**; it separates temporary and permanent differences and starts from financial statement income.

Example: Harbor Corp.'s 2025 book net income is $500,000. The books include: federal income tax expense $120,000; municipal bond interest $10,000; premiums on key-person life insurance (Harbor is beneficiary) $6,000; a government fine $4,000; business meals $20,000; book depreciation $70,000 versus tax depreciation $100,000; an increase in the bad-debt allowance of $8,000 while actual write-offs were $5,000; and a $7,000 net capital loss.

Item	Adjustment
Book net income	$500,000
+ Federal income tax expense	+120,000
− Tax-exempt interest	−10,000
+ Life insurance premiums	+6,000
+ Fine	+4,000
+ Nondeductible 50% of meals	+10,000
− Excess tax depreciation ($100,000 − $70,000)	−30,000
+ Bad debt: book expense $8,000 − tax write-offs $5,000	+3,000
+ Net capital loss (not deductible)	+7,000
= Taxable income	$610,000

Federal income tax = 21% × $610,000 = **$128,100**.

Compliance

Item	Rule
Form 1120 due date	15th day of the 4th month after year-end (April 15 for calendar years); June 30 fiscal-year corporations: 15th day of the 3rd month (September 15) until 2026
Extension	Automatic 6 months (Form 7004)
Estimated tax	Installments due the 15th day of the 4th, 6th, 9th and 12th months (April, June, September, December for calendar years)
Safe harbor	100% of current-year tax, or 100% of prior-year tax (prior year must be a full 12 months with positive tax; **large corporations** with $1 million or more of taxable income in any of the prior three years can use prior-year tax only for the first installment)
Estimated tax required	When expected tax is $500 or more

Other corporate penalty taxes

- **Accumulated earnings tax:** 20% on accumulated taxable income beyond reasonable business needs (minimum accumulated earnings credit $250,000; $150,000 for personal service corporations).
- **Personal holding company tax:** 20% on undistributed PHC income when 5 or fewer individuals own more than 50% of stock and 60% or more of adjusted ordinary gross income is passive.

Common traps

- Forgetting to add back federal income tax expense on Schedule M-1.
- Deducting a corporate net capital loss up to $3,000 (that is an individual rule).
- Computing the charitable limit **after** the DRD instead of before.
- Applying the 80% NOL limit to pre-2018 NOLs, or forgetting it for post-2020 NOLs.
- Giving the full 65% DRD without checking the taxable income limit.
- Using the 2026 1% charitable floor for 2025.

Key takeaways

- Flat 21% rate. Capital losses only offset capital gains (3 back, 5 forward as short-term).
- DRD 50% / 65% / 100%; the 50%/65% DRD is limited to that percentage of taxable income unless the full DRD creates an NOL.
- Charitable limit: 10% of taxable income before charitable deduction, DRD, NOL and capital loss carryback; 5-year carryforward.
- Post-2020 NOLs: no carryback, indefinite carryforward, 80% limit.
- M-1 reconciles book income to taxable income; M-3 required at $10 million of total assets.
- Form 1120 due April 15 (calendar year) with a 6-month extension; estimates due April, June, September and December 15.

8. E&P, Distributions and Consolidated Returns

When a C corporation distributes cash or property to shareholders, the tax result depends on its **earnings and profits (E&P)** — a tax concept that measures the corporation's economic ability to pay dividends. This chapter covers computing E&P, sourcing distributions, property distributions, stock redemptions and the consolidated return rules for affiliated groups.

Computing earnings and profits

E&P starts with taxable income and adjusts it toward economic income. There is no Code formula; the adjustments come from §312, regulations and case law.

Adjustment to taxable income	Direction	Examples
Income excluded from taxable income	Add	Tax-exempt interest, life insurance proceeds
Deductions allowed for tax but not real economic outflows	Add back	DRD, NOL carryovers from other years, capital loss carryovers, excess charitable carryovers used
Accelerated tax deductions	Add back the excess	MACRS/bonus/§179 in excess of E&P depreciation (alternative depreciation system, straight-line); §179 is deducted ratably over 5 years for E&P
Deferred income	Add	Installment sale gain (E&P uses full gain in year of sale); percentage-of-completion
Expenses not deductible for tax	Subtract	Federal income tax, fines and penalties, nondeductible 50% of meals, life insurance premiums, excess charitable contributions, political contributions
Losses disallowed for tax	Subtract	Related-party losses (§267), net capital loss in excess of capital gains

Example: Cedar Corp.'s 2025 taxable income is $300,000. It also had $10,000 of tax-exempt interest, a $13,000 DRD, tax depreciation $20,000 more than E&P depreciation, federal income tax of $63,000, a nondeductible fine of $2,000 and $3,000 of nondeductible meals.

Current E&P = $300,000 + $10,000 + $13,000 + $20,000 − $63,000 − $2,000 − $3,000 = **$275,000**.

Sourcing distributions

A distribution of cash or property with respect to stock is treated in this order (§301 and §316):

1. **Dividend** to the extent of **current E&P** (computed at year-end, with no reduction for distributions during the year).
2. **Dividend** to the extent of **accumulated E&P** (E&P from prior years, as of the date of the distribution).
3. **Return of capital** — tax-free, reducing the shareholder's stock basis to zero.
4. **Capital gain** — any excess over basis.

Allocation rules

Situation	Rule
Current E&P with several distributions	Allocated **pro rata** to every distribution (by amount)
Accumulated E&P with several distributions	Applied **chronologically** — the earliest distribution uses it first
Positive current E&P, accumulated **deficit**	Distributions are dividends to the extent of current E&P; **do not net** the accumulated deficit
Current **deficit**, positive accumulated E&P	Prorate the current deficit to the distribution date (by days) and net it against accumulated E&P at that date
Both negative	No dividend; return of capital, then gain

Example: Birch Corp., owned entirely by Sofia (stock basis $25,000), has current E&P of $40,000 and accumulated E&P of $30,000 at January 1. It distributes $50,000 on March 1 and $50,000 on September 1.

1. Current E&P pro rata: $40,000 × 50% = $20,000 to each distribution.
2. Accumulated E&P chronologically: the March distribution uses all $30,000.
3. March 1: dividend = $20,000 + $30,000 = **$50,000**.
4. September 1: dividend = **$20,000**; remaining $30,000 is return of capital → reduces basis $25,000 to zero, and **$5,000** is capital gain.

Example: Elm Corp. has accumulated E&P of $60,000 at January 1 and a current-year deficit of $36,000 that accrues evenly. It distributes $50,000 on June 30 (treat the deficit as half accrued).

1. Deficit through June 30 = $36,000 × 6/12 = $18,000.
2. Accumulated E&P at distribution = $60,000 − $18,000 = $42,000.
3. Dividend = **$42,000**; return of capital = **$8,000**.

(Exam items normally prorate by days; months are used here to keep the arithmetic visible.)

Watch out: Positive current E&P **always** supports a dividend, even if accumulated E&P is a large deficit. This is the "nimble dividend" rule.

Property distributions

Party	Rule
Distributing corporation	Recognizes **gain** as if it sold appreciated property at FMV (§311(b)); recognizes **no loss** on depreciated property. If the property is subject to a liability greater than FMV, FMV is treated as no less than the liability
Shareholder — amount distributed	FMV of property − liabilities assumed or taken subject to
Shareholder — basis in property	**FMV** (not reduced by liabilities)
Shareholder — holding period	Begins on the distribution date
E&P	Increased by the recognized gain (net of tax); decreased by the greater of FMV or adjusted basis of the property, net of liabilities

Example: Oak Corp. (ample E&P) distributes land with FMV $100,000, adjusted basis $40,000, subject to a $30,000 mortgage that the shareholder assumes.

1. Oak's recognized gain = $100,000 − $40,000 = **$60,000** (taxed at 21%).
2. Shareholder's dividend = $100,000 − $30,000 = **$70,000**.
3. Shareholder's basis in land = **$100,000**.

Constructive dividends and stock dividends

- Payments that benefit shareholders without a formal declaration — excessive salaries to shareholder-employees, below-market loans, personal use of corporate property, bargain sales — can be **constructive dividends**.
- Pro rata **stock dividends** on common stock are generally **nontaxable** (§305(a)); basis is spread over old and new shares and the holding period tacks. Stock dividends are taxable if any shareholder can elect cash, if they are disproportionate, or if preferred stock is distributed to common shareholders in certain cases.

Stock redemptions

A redemption is a corporation's purchase of its own stock. It is treated as a **sale or exchange** (capital gain or loss against basis) if it meets one of the §302(b) tests; otherwise it is a §301 **distribution** (dividend to the extent of E&P).

§302(b) test	Requirement
Not essentially equivalent to a dividend	A meaningful reduction in the shareholder's interest (facts and circumstances)
Substantially disproportionate	After the redemption the shareholder owns **less than 50%** of voting power **and** less than **80% of the percentage owned before** (both voting and common stock)
Complete termination	All of the shareholder's stock is redeemed; family attribution can be waived if the shareholder keeps no interest (other than as a creditor) for 10 years and files an agreement
Partial liquidation	Distribution to a noncorporate shareholder from a genuine contraction of the business
Redemption to pay death taxes (§303)	Up to death taxes and funeral/administration expenses, when the stock exceeds 35% of the adjusted gross estate

Constructive ownership (§318)

Source	Treated as owning
Family	Spouse, children, grandchildren and parents — **not** siblings or grandparents
Partnerships and estates	Partners/beneficiaries own their proportionate share of entity-owned stock, and the entity owns all stock its partners/beneficiaries own
Corporations	A 50%-or-more shareholder owns a proportionate share of the corporation's stock
Options	Option holders own the optioned stock

Example: Corvid Corp. has 100 shares outstanding. Ann owns 60; unrelated parties own the rest. Corvid redeems 30 of Ann's shares.

1. Before: 60%. After: 30 ÷ 70 = **42.86%**.
2. Test 1: 42.86% < 50% ✔. Test 2: 80% × 60% = 48%; 42.86% < 48% ✔.
3. The redemption is **substantially disproportionate** → exchange treatment.

Now suppose Ann's **son** owns 20 of the other 40 shares. With attribution, Ann owns 80% before (60 + 20) and 50 ÷ 70 = **71.4%** after → fails the 50% test → dividend treatment (to the extent of E&P).

Exam tip: In a redemption question, always apply §318 attribution **before** testing — and remember siblings are not attributed.

The corporation's E&P is reduced in an exchange-treated redemption by the ratable share of E&P attributable to the redeemed stock (not more than the amount paid).

Consolidated returns

An **affiliated group** may file one consolidated Form 1120. The group consists of a common parent and includable corporations connected through stock ownership of at least **80% of total voting power and 80% of total value**. Excluded: S corporations, foreign corporations, most insurance companies, REITs and RICs.

Consolidated return feature	Effect
Combining income	Losses of one member offset income of another
Intercompany dividends	Eliminated (excluded from consolidated taxable income)
Intercompany sales	Gain or loss **deferred** until the property leaves the group or the buyer recovers it (e.g., by depreciation)
Capital gains and losses, charitable contributions, §1231	Computed on a consolidated basis
Election	All members consent; once made, the group must continue filing consolidated unless the IRS grants permission to stop
Tax year	Members adopt the parent's tax year
Stock basis	Parent adjusts its basis in subsidiary stock for the subsidiary's income, losses and distributions (investment adjustments; negative basis is an excess loss account)

Example: Parent sells land with a basis of $50,000 to its 100% subsidiary for $80,000 in 2025. In 2027, the subsidiary sells the land to an outsider for $95,000. On the consolidated return, the $30,000 intercompany gain is deferred in 2025. In 2027 the group reports the parent's $30,000 deferred gain plus the subsidiary's $15,000 gain — a total of $45,000, the same as if the parent had sold directly to the outsider.

Common traps

- Netting positive current E&P against an accumulated deficit.
- Allocating current E&P chronologically (it is pro rata) or accumulated E&P pro rata (it is chronological).
- Reducing the shareholder's basis in distributed property by the liability (basis is full FMV).
- Recognizing a loss on a nonliquidating distribution of depreciated property.
- Attributing stock between siblings under §318.
- Using a 50% test for a consolidated group (it is 80% vote and value).

Key takeaways

- E&P = taxable income adjusted toward economic income: add tax-exempt income, DRD and excess tax depreciation; subtract federal tax and nondeductible expenses.

- Distribution order: current E&P (pro rata) → accumulated E&P (chronological) → basis → capital gain.
- Property distributions: corporation recognizes gain, not loss; shareholder's dividend = FMV − liabilities, basis = FMV.
- Substantially disproportionate redemption: after < 50% and after < 80% of before, with §318 attribution.
- Consolidated returns: 80% vote and value; intercompany dividends eliminated, intercompany gains deferred.

9. S Corporations

An S corporation is a corporation under state law that elects to be taxed under Subchapter S. It generally pays no entity-level income tax; instead, its income, deductions, losses and credits pass through to shareholders on Schedule K-1. TCP tests eligibility, elections and terminations, pro rata allocations, shareholder basis, distributions (especially for former C corporations), and the entity-level taxes that can still apply.

Eligibility

To elect and keep S status, a corporation must be a **domestic** corporation that is not an ineligible corporation (such as most banks using the reserve method and insurance companies) and must have:

Requirement	Details
No more than **100 shareholders**	All members of a family (common ancestor plus up to six generations, and spouses) may elect to count as one shareholder; a married couple counts as one
Only eligible shareholders	U.S. citizens and resident aliens, estates, certain trusts (grantor trusts, qualified subchapter S trusts (QSSTs), electing small business trusts (ESBTs), testamentary trusts for 2 years), and §501(c)(3) organizations and qualified retirement plan trusts
Ineligible shareholders	**Nonresident aliens, partnerships, corporations** (except an S corporation owning 100% of a qualified subchapter S subsidiary) and most LLCs taxed as partnerships
One class of stock	All shares have identical rights to distributions and liquidation proceeds; **differences in voting rights are allowed**

Electing S status

- File **Form 2553** with the consent of **all** shareholders (as of the election date, plus any who held stock earlier in the year if the election is to be effective for the current year).
- For the election to apply to the current year, file by the **15th day of the 3rd month** of the tax year (March 15 for a calendar year). A later election takes effect the next year, unless relief for late election is granted.
- An S corporation must generally use a **calendar year** unless it establishes a business purpose or makes a §444 election.

Termination

Cause	Effective date
Voluntary revocation by holders of **more than 50%** of shares (voting and nonvoting)	Beginning of the year if made by the 15th day of the 3rd month; otherwise the next year, or a specified later date
Ceasing to qualify (e.g., 101st shareholder, partnership shareholder, second class of stock)	The date the disqualifying event occurs
Excess passive investment income: accumulated C corporation E&P at year-end **and** passive investment income above **25%** of gross receipts for **3 consecutive years**	Beginning of the 4th year

After termination, the corporation generally must wait **5 years** before re-electing S status, unless the IRS consents. In a termination year, the year is split into an S short year and a C short year (pro rata or, by election, closing of the books).

Pass-through of income and loss

The S corporation computes **ordinary business income** (Schedule K line 1) and **separately stated items** that could affect each shareholder's tax differently: capital gains and losses, §1231 gains and losses, interest, dividends, royalties, rental income, charitable contributions, §179 deductions, tax-exempt income, foreign taxes, investment interest, and credits.

Items are allocated **pro rata per share per day**. When stock changes hands during the year, each shareholder takes a daily share; if a shareholder's entire interest terminates, all affected shareholders may consent to a **closing of the books** instead.

> **Example:** Lark Inc. has $730,000 of ordinary income for 2025 (a 365-day year). Ada owns 60% all year. Ben owns 40% for the first 90 days and then sells his shares to Cara, who holds them for the remaining 275 days.
>
> - Ada: 60% × $730,000 = $438,000.
> - Ben: $730,000 × 40% × 90/365 = **$72,000**.
> - Cara: $730,000 × 40% × 275/365 = **$220,000**.

Built-in characteristics of S pass-through

- **No self-employment tax** on pass-through income. Shareholder-employees must receive **reasonable compensation** as W-2 wages subject to FICA.
- Shareholders owning **more than 2%** are treated like partners for fringe benefits: health insurance paid for them is W-2 wages and they deduct it as self-employed health insurance.

- The pass-through income can qualify for the QBI deduction; W-2 wages paid to owners do not.

Shareholder basis

Stock basis adjustments — the required order

Order	Adjustment
1	**Increase** for income items (including tax-exempt income) and excess depletion
2	**Decrease** for **distributions** (not below zero)
3	Decrease for **nondeductible, noncapital expenses** (fines, 50% of meals, life insurance premiums)
4	Decrease for **losses and deductions** (not below zero)

Because distributions come before losses, a distribution in a loss year is more likely to be tax-free, and losses are more likely to be suspended.

Debt basis

- A shareholder gets **debt basis** only for loans the shareholder **personally makes** to the S corporation (a bona fide debt the corporation owes directly to the shareholder).
- **Guaranteeing** a bank loan to the corporation does **not** create debt basis (unlike a partnership liability).
- Losses in excess of stock basis reduce debt basis. Distributions never reduce debt basis.
- Later net income **restores debt basis first** (up to its original amount) before increasing stock basis.
- Repayment of a loan when debt basis has been reduced produces gain (capital if a note; ordinary if an open account).

Losses that exceed stock plus debt basis are **suspended** and carried forward indefinitely, usable only by that shareholder when basis is restored. They are lost if the stock is sold. A post-termination transition period (generally one year) allows suspended losses to be deducted if stock basis is created.

Example: Dev's stock basis is $30,000 on January 1, 2025, and he has lent the corporation $15,000. His 2025 K-1 shows: tax-exempt interest $2,000; long-term capital gain $4,000; ordinary loss $40,000; nondeductible expenses $3,000; distributions $8,000.

1. Increases: $30,000 + $2,000 + $4,000 = $36,000.
2. Distributions: $36,000 − $8,000 = $28,000 (tax-free, since basis covers them).
3. Nondeductible expenses: $28,000 − $3,000 = $25,000.
4. Loss: $25,000 from stock basis (stock basis → $0), remaining **$15,000** from debt basis (debt basis → $0).
5. The full $40,000 loss clears the basis limit (at-risk and passive rules then apply). Had the loss been $45,000, **$5,000** would be suspended.

In 2026, $12,000 of net income first restores debt basis to $12,000; stock basis stays at $0.

Distributions

S corporation with no accumulated E&P

Distributions are tax-free to the extent of stock basis; any excess is capital gain.

S corporation with accumulated E&P (a former C corporation)

The corporation tracks an **accumulated adjustments account (AAA)** — the cumulative undistributed income taxed to shareholders during S years, computed like basis but **without tax-exempt income** (which goes into a separate other adjustments account, OAA) and without a floor at zero for losses.

Distributions come out in this order:

1. **AAA** — tax-free, reduces basis.
2. **Accumulated E&P** (from C years) — **dividend**.
3. **OAA / remaining stock basis** — tax-free return of capital.
4. Excess — **capital gain**.

The corporation may elect, with consent of all affected shareholders, to distribute E&P first (useful to purge E&P and avoid the passive income tax).

Example: Wren Corp., a former C corporation, has AAA of $20,000 and accumulated E&P of $15,000. Its sole shareholder's stock basis is $50,000 (after the year's income). Wren distributes $45,000.

1. First $20,000 from AAA → tax-free; basis to $30,000.
2. Next $15,000 from accumulated E&P → **dividend** (no basis reduction).
3. Last $10,000 → return of basis; basis to **$20,000**.

Memory trick: "**A**-**E**-**B**-**G**": **A**AA, **E**&P, **B**asis, **G**ain.

Property distributions

An S corporation recognizes gain on distributing appreciated property (as if sold at FMV), and the gain passes through to all shareholders. Losses on distributing depreciated property are not recognized. Shareholders take FMV basis.

Entity-level taxes

Built-in gains tax (§1374)

A C corporation that converts to S status pays a corporate-level tax on **net recognized built-in gain** during the **5-year recognition period** after conversion.

- Tax = **21%** × the **least** of: (a) net recognized built-in gain for the year, (b) remaining net unrealized built-in gain (NUBIG) at conversion not yet recognized, or (c) taxable income computed as if a C corporation.
- Built-in gain recognized but untaxed because of the taxable income limit carries forward within the recognition period.
- The tax paid reduces the gain passed through to shareholders (allocated to the character of the gain).

Example: Robin Inc. converted to S status in 2023 with NUBIG of $200,000. In 2025 it sells an asset with a $80,000 built-in gain; its taxable income computed as a C corporation is $60,000.

1. Least of $80,000, $200,000 and $60,000 = $60,000.
2. Built-in gains tax = 21% × $60,000 = **$12,600**.
3. The untaxed $20,000 of recognized built-in gain carries forward to the next year in the recognition period.

Excess net passive income tax (§1375)

An S corporation with accumulated C corporation E&P and passive investment income above 25% of gross receipts pays tax at 21% on excess net passive income. (Three consecutive years of this situation also terminates the election.)

LIFO recapture

A C corporation using LIFO that elects S status includes the LIFO reserve in its final C year income; the tax is paid in four annual installments.

Compliance

- **Form 1120-S** is due the **15th day of the 3rd month** (March 15 for calendar years); automatic 6-month extension.
- Late-filing penalty is assessed per shareholder per month.
- Shareholders report items on their individual returns for the year in which the S corporation's year ends.

Common traps

- Letting a loan **guarantee** create debt basis.
- Applying losses before distributions in the basis order.
- Including tax-exempt income in AAA.
- Assuming the built-in gains recognition period is 10 years (it is 5).
- Allowing a partnership or nonresident alien as a shareholder.
- Treating different voting rights as a second class of stock.
- Treating S corporation pass-through income as SE income.

Key takeaways

- Eligibility: domestic corporation, at most 100 eligible shareholders (no NRAs, partnerships or corporations), one class of stock.
- Form 2553 by the 15th day of the 3rd month for current-year effect; revocation needs more than 50% of shares; 5-year wait to re-elect.
- Items are allocated per share per day.
- Basis order: income up, distributions down, nondeductible expenses down, losses down. Debt basis only from direct shareholder loans; restored first.
- With E&P: distributions come from AAA, then E&P (dividend), then basis, then gain.
- Built-in gains tax: 21% × least of recognized built-in gain, remaining NUBIG or taxable income; 5-year period.
- Form 1120-S due March 15 (calendar year).

10. Partnership Income, Allocations and Basis

A partnership (including an LLC with two or more members that has not elected corporate treatment) files **Form 1065** but pays no income tax. Its income and deductions flow to the partners, who are taxed whether or not cash is distributed. TCP tests formation, the computation of ordinary business income and separately stated items, special allocations, built-in gain on contributed property, outside basis and its liability component, guaranteed payments and self-employment tax.

Formation — §721

No gain or loss is recognized when a partner contributes **property** in exchange for a partnership interest (§721). Unlike §351, there is **no control requirement**.

Item	Rule
Partner's initial outside basis (§722)	Cash + adjusted basis of property contributed
Partnership's inside basis in property (§723)	Carryover from the partner
Holding period	Tacks for capital and §1231 assets; starts fresh for cash and ordinary property
Liabilities	Partner's basis is reduced by liabilities the partnership assumes and increased by the partner's share of all partnership liabilities
Liability relief exceeding basis	Net decrease in liabilities is a **deemed cash distribution**; gain if it exceeds basis (§731)
Services for a capital interest	Ordinary income equal to the FMV of the interest received
Services for a profits interest	No income on receipt under the IRS safe harbor (if not disposed of within 2 years and not tied to a predictable income stream)
Investment partnership exception	Gain recognized if contributions diversify the contributor's portfolio into a partnership that would be an investment company

Example: Amir contributes $50,000 cash and Bea contributes land (FMV $80,000, basis $30,000) subject to a $30,000 recourse mortgage the partnership assumes. They share liabilities equally.

- **Bea:** $30,000 basis − $30,000 liability relieved + $15,000 share of the partnership's liability = **$15,000**.
- **Amir:** $50,000 + $15,000 share of liability = **$65,000**.
- Neither recognizes gain; Bea's net liability relief ($15,000) does not exceed her basis.

If instead Bea's land had a basis of $20,000 and a $50,000 mortgage: $20,000 − $50,000 + $25,000 = −$5,000 → Bea recognizes **$5,000** of gain and her basis is **$0**.

Watch out: §357(c) (liabilities in excess of basis) is a **corporate** rule. In a partnership, the gain arises only under §752/§731 — and only for the **net** liability relief after adding back the partner's own share.

Partnership income

Ordinary business income vs. separately stated items

The partnership computes **ordinary business income** (Form 1065 page 1) and reports on Schedule K the items that must be separately stated because they can affect partners' taxes differently:

Separately stated	Included in ordinary business income
Short- and long-term capital gains and losses	Sales less cost of goods sold
§1231 gains and losses	Salaries and wages to employees
Interest, dividends, royalties (portfolio income)	**Guaranteed payments** (deductible)
Net rental real estate and other rental income	Depreciation (MACRS, bonus)
Charitable contributions	Rent, utilities, repairs, taxes
§179 deduction	Ordinary gain from §1245 recapture (Form 4797 Part II)
Tax-exempt income and nondeductible expenses	Business bad debts
Investment interest expense	
Foreign taxes, credits, AMT items	
Guaranteed payments (also reported to the recipient partner)	

Example: Pine Partners has: sales $500,000; cost of goods sold $200,000; employee salaries $100,000; a guaranteed payment to partner A of $60,000; MACRS depreciation $30,000; charitable contributions $5,000; interest income $4,000; LTCG $10,000; §179 deduction $20,000; tax-exempt interest $2,000.

Ordinary business income = $500,000 − $200,000 − $100,000 − $60,000 − $30,000 = **$110,000**.

Separately stated: charitable $5,000, interest $4,000, LTCG $10,000, §179 $20,000, tax-exempt interest $2,000.

Allocations

- Items are allocated according to the **partnership agreement** if the allocations have **substantial economic effect** (capital accounts are maintained properly, liquidating distributions follow capital accounts, and partners with deficit capital accounts must restore them or a qualified income offset applies). Otherwise items follow the partners' interests in the partnership.
- When interests change during the year, items are allocated using the interim closing of the books or proration methods (the **varying interest** rule).

Built-in gain or loss — §704(c)

When property with a difference between FMV and basis is contributed, the **pre-contribution gain or loss** must be allocated to the **contributing partner** when the partnership sells the property (and through depreciation). Post-contribution gain or loss is shared under the general profit ratios. The **traditional method** is subject to the **ceiling rule** (tax allocations cannot exceed the partnership's total tax gain or loss); the remedial and curative methods fix ceiling-rule distortions.

Example: Continuing the formation example, the partnership later sells Bea's land (contributed at FMV $80,000, basis $30,000) for $90,000.

1. Total tax gain = $90,000 − $30,000 = $60,000.
2. Built-in gain of $80,000 − $30,000 = $50,000 → all to Bea.
3. Post-contribution gain of $10,000 → split 50/50: $5,000 each.
4. Bea: **$55,000**; Amir: **$5,000**.

Guaranteed payments

Guaranteed payments are payments to a partner for services or the use of capital that are determined without regard to partnership income. They are:

- **Deductible** by the partnership in computing ordinary business income (unless capitalized).

- **Ordinary income** to the partner in the partnership tax year in which the partnership deducts them, regardless of when paid.
- **Self-employment income** for services (both general and limited partners).
- **Not QBI**, and not wages (no withholding; partners are not employees).
- They do not change the partner's outside basis directly.

Self-employment tax for partners

Partner	SE income
General partner	Distributive share of ordinary business income + guaranteed payments
Limited partner	Guaranteed payments for services only
LLC member	Depends on functional role; members with management authority or substantial hours are generally treated like general partners

Outside basis

Annual adjustments (§705)

A partner's outside basis is adjusted each year in this order:

1. **Increase** for contributions, the distributive share of income and gains (including tax-exempt income), and **increases in the partner's share of liabilities**.
2. **Decrease** for **distributions** (including decreases in the share of liabilities, which are deemed cash distributions).
3. Decrease for nondeductible, noncapital expenses.
4. Decrease for the distributive share of losses and deductions (including §179 and charitable contributions), but not below zero. Excess losses are suspended until basis is restored.

Sharing liabilities (§752)

Liability type	Shared by
Recourse	Partners who bear the economic risk of loss (generally by loss ratio, considering guarantees and deficit restoration obligations)
Nonrecourse	Generally by **profit** ratios (after minimum gain and §704(c) layers)
Qualified nonrecourse real estate financing	Shared as nonrecourse; counts as at-risk

Example: Partner A of Pine Partners (from the previous example) is allocated 40% of every item. Her outside basis at January 1 is $40,000. During the year her share of partnership liabilities rises by $6,000 and she receives $25,000 of cash distributions. Her $60,000 guaranteed payment is taxed to her as ordinary SE income but does not change her outside basis.

Item	Amount
Beginning basis	$40,000
+ Increase in share of liabilities	+6,000
+ Ordinary business income (40% × $110,000)	+44,000
+ Interest income (40% × $4,000)	+1,600
+ LTCG (40% × $10,000)	+4,000
+ Tax-exempt interest (40% × $2,000)	+800
− Cash distributions	−25,000
− §179 deduction (40% × $20,000)	−8,000
− Charitable contributions (40% × $5,000)	−2,000
Ending outside basis	**$61,400**

Exam tip: Draw the basis schedule in the fixed order: **increases, distributions, nondeductibles, losses**. If a loss would push basis below zero, the excess loss is suspended — distributions are never suspended.

Capital accounts vs. basis

A partner's **capital account** (tax basis capital, reported on the K-1) excludes liabilities, while **outside basis** includes the partner's share of liabilities. Outside basis = tax capital account + share of liabilities (in the usual case). A loss can make a capital account negative, but never outside basis.

Loss limits for partners

Partnership losses pass the same walls as in Chapter 2: outside **basis** (§704(d)), **at-risk** (§465), **passive** (§469) and **excess business loss** (§461(l)).

Compliance

Item	Rule
Form 1065 due	15th day of the 3rd month after year-end (March 15 for calendar years); 6-month extension
Tax year	Majority interest taxable year → principal partners' year → least aggregate deferral; §444 election possible
Late-filing penalty	Per partner per month
Audit regime	**BBA centralized partnership audit**: adjustments assessed at the partnership level (imputed underpayment) unless the partnership pushes out to partners; a **partnership representative** must be designated; partnerships with **100 or fewer** eligible partners (individuals, C and S corporations, estates) may elect out annually
Schedules K-2/K-3	International tax information

Common traps

- Leaving guaranteed payments out of the deduction in computing ordinary business income.
- Ignoring the partner's share of liabilities in outside basis.
- Splitting built-in gain on contributed property by profit ratios instead of allocating it to the contributor.
- Treating a limited partner's distributive share as SE income.
- Applying §357(c) instead of the §752 net liability rule.
- Reducing outside basis below zero for losses.

Key takeaways

- §721: no gain or loss on contributing property; no control test. Basis = cash + adjusted basis of property ± liabilities.
- A net decrease in a partner's share of liabilities is a deemed cash distribution; gain only if it exceeds basis.
- Ordinary business income excludes separately stated items; guaranteed payments are deducted in computing it.
- §704(c): pre-contribution gain or loss belongs to the contributing partner.
- Basis order: increases, distributions, nondeductibles, losses; never below zero.
- Guaranteed payments are ordinary SE income to the partner; limited partners have SE income only from guaranteed payments for services.
- Form 1065 due March 15; BBA audit regime with election out for 100 or fewer eligible partners.

11. Partnership Distributions and Sales

Partnership distributions are designed to be tax-neutral: in most cases the partner simply shifts basis from the partnership interest to the property received. Gain or loss arises only in narrow situations. On a sale of a partnership interest, by contrast, the selling partner recognizes gain or loss — partly ordinary under the "hot asset" rules. This chapter covers current and liquidating distributions, basis allocation under §732, sales and exchanges of interests, §751, and the §754 election.

Current (nonliquidating) distributions

A current distribution reduces the partner's interest without ending it.

Rule	Current distribution
Gain to partner	Only if **money** distributed exceeds outside basis (§731(a)). Money includes **marketable securities** (generally at FMV) and **decreases in the partner's share of liabilities**
Loss to partner	**Never**
Gain or loss to partnership	None (§731(b))
Basis of property received	Partnership's inside basis, but **limited to** the partner's outside basis remaining after money (§732(a))
Order	Money first, then hot assets (unrealized receivables and inventory), then other property
Partner's outside basis after	Reduced by money and by the basis assigned to property (not below zero)
Holding period	Tacks on the partnership's holding period

Example: Gabe's outside basis is $30,000. In a current distribution he receives $10,000 cash and land with an inside basis of $25,000 (FMV $40,000).

1. Cash reduces basis: $30,000 − $10,000 = $20,000. No gain (cash does not exceed basis).
2. Land basis = lesser of $25,000 inside basis or $20,000 remaining outside basis = **$20,000**.
3. Gabe's outside basis after = **$0**. No gain is recognized even though the land is worth $40,000.

If Gabe had instead received $35,000 of cash, he would recognize **$5,000** of capital gain and his basis would be zero.

Liquidating distributions

A liquidating distribution ends the partner's entire interest. The partner's outside basis must be fully used up (or a loss recognized).

Step	Liquidating distribution rule
1	Reduce outside basis by **money** (including liability relief). Excess money → **gain**
2	Assign basis to **unrealized receivables and inventory** equal to the partnership's inside basis (never more). If the remaining outside basis is less than their inside basis, reduce them (§732(c))
3	Assign the **remaining** outside basis to other property — this can be more or less than its inside basis
Loss	Recognized **only** if the partner receives **solely** money, unrealized receivables and inventory, and their basis is less than outside basis (capital loss)

Allocating a basis increase or decrease among other property (§732(c))

- **Increase** (remaining basis > total inside basis of other property): first give each property an increase up to its **unrealized appreciation**, in proportion to that appreciation; then allocate any remaining increase in proportion to **FMV**.
- **Decrease** (remaining basis < total inside basis): first reduce properties with **unrealized depreciation**, in proportion to that depreciation, up to the depreciation; then allocate any remaining decrease in proportion to the properties' **adjusted bases** (as already reduced).

Example (increase): Hal's outside basis is $50,000. In complete liquidation he receives $10,000 cash, inventory (inside basis $8,000), Land A (inside basis $12,000, FMV $30,000) and Land B (inside basis $18,000, FMV $15,000).

1. After cash: $50,000 − $10,000 = $40,000.
2. Inventory takes its inside basis: $8,000 → $32,000 left for the land.
3. Inside basis of land = $12,000 + $18,000 = $30,000 → increase of $2,000 needed.
4. Only Land A has unrealized appreciation ($18,000), so it receives the full $2,000.
5. Bases: Inventory **$8,000**, Land A **$14,000**, Land B **$18,000**. Total $40,000 ✔. No gain or loss.

Example (decrease): Same assets, but Hal's outside basis is $30,000.

1. After cash and inventory: $30,000 − $10,000 − $8,000 = $12,000 for the land, versus inside basis of $30,000 → decrease of $18,000.
2. First, Land B's unrealized depreciation ($18,000 − $15,000 = $3,000) → Land B reduced to $15,000. Remaining decrease = $15,000.
3. Allocate $15,000 by adjusted bases ($12,000 and $15,000; total $27,000): - Land A: $12,000 − $15,000 × 12/27 = **$5,333**. - Land B: $15,000 − $15,000 × 15/27 = **$6,667**.
4. Total $12,000 ✔.

Example (loss): If Hal (basis $30,000) received **only** $10,000 cash and the $8,000-basis inventory, he would recognize a **$12,000 capital loss**. Had he also received any land, no loss would be allowed — the land would absorb the remaining basis.

Anti-abuse rules connected to distributions

Rule	Effect
Mixing bowl — §704(c)(1)(B)	If contributed built-in gain property is distributed to **another** partner within **7 years**, the contributor recognizes the remaining built-in gain
§737	A partner who contributed built-in gain property and receives **other** property within 7 years recognizes gain (lesser of remaining built-in gain or excess of FMV of property received over outside basis)
Disguised sale — §707(a)(2)(B)	A contribution followed by a distribution to the contributor within **2 years** is presumed to be a sale
§735	Distributed inventory keeps its ordinary character if sold within **5 years**; unrealized receivables remain ordinary forever
§751(b)	Disproportionate distributions of hot assets can create ordinary income

Sale of a partnership interest

Amount realized and gain

- **Amount realized** = cash + FMV of property received + the selling partner's **share of partnership liabilities** relieved.
- **Gain or loss** = amount realized − outside basis (with the partnership's income through the sale date already added to basis).
- Generally **capital** (§741), with a **long-term** holding period if the interest was held more than 1 year (split holding periods can arise).

Hot assets — §751(a)

The portion of the amount realized attributable to **unrealized receivables** and **inventory items** produces **ordinary** income or loss.

- **Unrealized receivables** include cash-method accounts receivable, and potential **depreciation recapture** (§1245, §1250, §291) — the recapture that would arise if the partnership sold its property.
- **Inventory items** include inventory and any other property that would not be a capital or §1231 asset (for a sale of an interest, all inventory counts; no "substantially appreciated" test).

Ordinary income = the selling partner's share of (FMV − inside basis) of hot assets. Capital gain = total gain − ordinary portion (this can produce an ordinary gain and a capital loss at the same time).

Example: Cora sells her one-third interest to Dan for $100,000 cash. Her share of partnership liabilities is $20,000, and her outside basis is $70,000. Her share of the partnership's inventory has FMV $30,000 and inside basis $18,000; her share of cash-basis receivables has FMV $15,000 and basis $0.

1. Amount realized = $100,000 + $20,000 = **$120,000**.
2. Total gain = $120,000 − $70,000 = **$50,000**.
3. §751 ordinary income = ($30,000 − $18,000) + ($15,000 − $0) = **$27,000**.
4. Capital gain = $50,000 − $27,000 = **$23,000**.

Other sale consequences

- The partnership's tax year **closes** for the selling partner (on the date of sale) when the partner's entire interest is sold.
- The buyer's outside basis = price paid + share of partnership liabilities assumed.
- Installment reporting is not available for the §751 ordinary portion.

The §754 election and §743(b) adjustment

When a partnership interest is purchased (or inherited), the buyer's outside basis often differs from the buyer's share of the partnership's inside basis. Without an adjustment, the buyer could be taxed again on gain the seller already paid tax on.

- A **§754 election** (made by the partnership, binding for all future years) causes a **§743(b) basis adjustment** for the transferee partner only: adjustment = buyer's outside basis − buyer's share of inside basis.
- The adjustment is allocated among partnership assets under §755 and benefits only the buyer (it does **not** change the seller's gain).
- A §743(b) adjustment is **mandatory**, even without an election, when the partnership has a **substantial built-in loss** (inside basis exceeds FMV by more than **$250,000**, or the transferee would be allocated a loss of more than $250,000 on a hypothetical sale).
- A §754 election also triggers **§734(b)** adjustments to the partnership's remaining assets when a distribution causes the partner to recognize gain or loss or to take a basis different from inside basis. A §734(b) adjustment is mandatory for a **substantial basis reduction** over $250,000.

Example: Dan buys Cora's interest for $100,000 cash and assumes her $20,000 share of liabilities, so his outside basis is $120,000. His share of the partnership's inside basis is $70,000. With a §754 election, Dan gets a §743(b) step-up of $120,000 − $70,000 = **$50,000**, allocated to the inventory, receivables and other assets. Without it, Dan would recognize the inventory's $12,000 appreciation again when the partnership sells it.

Death or retirement of a partner

- Payments to a retiring or deceased partner's successor are split under **§736**: payments for the partner's interest in partnership property are §736(b) distributions; other payments (for unrealized receivables and goodwill of a service partnership where capital is not a material income-producing factor and the partner was a general partner, and any premium) are §736(a) guaranteed payments or distributive shares — ordinary to the recipient and deductible or excluded for the remaining partners.
- On death, the heir's outside basis is FMV at death (plus the share of liabilities), but income in respect of a decedent (such as cash-basis receivables) gets no step-up.

Common traps

- Recognizing gain because distributed property's FMV exceeds the partner's basis (only money triggers gain).
- Giving hot assets more basis than the partnership's inside basis in a liquidation.
- Recognizing a loss in a liquidation that included capital or §1231 property.
- Forgetting the selling partner's share of liabilities in the amount realized.
- Thinking a §754 election changes the seller's gain or helps other partners.
- Allocating a §732(c) decrease by FMV instead of first to depreciated property and then by basis.

Key takeaways

- Current distribution: gain only if money exceeds basis; no loss; property takes inside basis limited to remaining outside basis.
- Liquidating distribution: money first, hot assets at inside basis, other property absorbs the rest; loss only if solely money, receivables and inventory are received.
- §732(c): increases go first to appreciated property, decreases first to depreciated property.
- Sale: amount realized includes relieved liabilities; §751(a) makes the hot-asset portion ordinary; the rest is capital (§741).

- §754/§743(b): buyer's adjustment = outside basis − share of inside basis; mandatory for a substantial built-in loss over $250,000.
- Anti-abuse: 7-year mixing bowl and §737, 2-year disguised sale presumption, 5-year inventory taint.

12. Trusts and Estates (Fiduciary Income)

Trusts and decedents' estates are separate taxpayers that file **Form 1041**. They work as **partial conduits**: income the fiduciary keeps is taxed to the entity, while income distributed (or required to be distributed) is taxed to the beneficiaries. The key device that divides the income between them is **distributable net income (DNI)**. TCP tests DNI, the distribution deduction, the beneficiary's inclusion and character, the entity's taxable income and tax, and the different rules for simple trusts, complex trusts, estates and grantor trusts.

Types of fiduciary entities

Entity	Defining features	Exemption
Simple trust	Must distribute **all** fiduciary accounting income currently; makes **no** charitable contributions; makes **no** corpus distributions in the year	$300
Complex trust	Any trust that is not simple in a given year (may accumulate income, distribute corpus or give to charity)	$100
Decedent's estate	Exists from death until administration ends	$600
Grantor trust	The grantor keeps certain powers or interests (e.g., power to revoke) — income taxed to the grantor, not the trust	n/a
Qualified disability trust	Special higher exemption	Indexed

A trust can be simple one year and complex the next (for example, in the year it distributes corpus). In the year of termination, every trust is complex.

Fiduciary accounting income vs. taxable income

Fiduciary accounting income (FAI) is determined by the trust instrument and state law (the Uniform Principal and Income Act). Generally:

Usually income (FAI)	Usually principal (corpus)
Interest, dividends, rents	Capital gains (unless the instrument allocates them to income)
Business net income	Stock dividends, proceeds from sale of assets
	Trustee fees are often split between income and principal by the instrument

FAI determines how much a simple trust must distribute. **Taxable income** follows tax rules. **DNI** bridges the two and limits the distribution deduction.

Distributable net income (DNI)

DNI is the entity's taxable income with these modifications:

Start	Taxable income of the entity before the distribution deduction
+	Personal exemption
+	Net **tax-exempt interest** (tax-exempt income less expenses allocable to it)
−	**Capital gains allocated to corpus** (and not distributed or set aside for charity)
+	Capital losses (they stay with the entity, except in the final year)

A shortcut that usually gives the same answer: DNI = all income items except corpus capital gains (including net tax-exempt interest) − deductible expenses.

Expenses allocable to tax-exempt income

Expenses that are not directly related to a class of income (such as trustee fees) are allocated in part to tax-exempt income, in proportion to tax-exempt income to total accounting income. That portion is **not deductible**, and it reduces the tax-exempt income included in DNI.

The distribution deduction and beneficiary inclusion

Item	Simple trust	Complex trust / estate
Distribution deduction	Lesser of FAI required to be distributed or DNI, **minus the tax-exempt portion**	Lesser of (required + other amounts distributed) or DNI, **minus the tax-exempt portion**
Beneficiary inclusion	Amount required to be distributed, up to DNI	**Tier 1** (required distributions) absorbs DNI first; **Tier 2** (discretionary distributions) gets what remains
Character	Each item retains its character in proportion to DNI (tax-exempt interest stays tax-exempt; qualified dividends stay qualified)	Same

Worked example — complex trust

Example: The Maple Trust (a complex trust) has the following 2025 items:

Item	Amount
Dividends (assume nonqualified)	$20,000
Taxable interest	$10,000
Tax-exempt municipal interest	$10,000
Long-term capital gain, allocated to corpus	$15,000
Trustee fee, charged to corpus	$4,000
Discretionary distribution to beneficiary Nina	$25,000

Step 1 — Allocate the fee. Accounting income = $20,000 + $10,000 + $10,000 = $40,000 (the fee is charged to corpus). Portion allocable to tax-exempt interest = $4,000 × $10,000/$40,000 = **$1,000** (nondeductible). Deductible fee = **$3,000**.

Step 2 — DNI. $20,000 + $10,000 + ($10,000 − $1,000) − $3,000 = **$36,000**. The $15,000 corpus gain is excluded.

Step 3 — Distribution deduction. Lesser of $25,000 distributed or $36,000 DNI = $25,000. Tax-exempt portion = $25,000 × $9,000/$36,000 = $6,250. Deduction = $25,000 − $6,250 = **$18,750**.

Step 4 — Nina's inclusion. $25,000, of which **$6,250** is tax-exempt interest and **$18,750** is taxable (dividends and interest in proportion).

Step 5 — Trust taxable income. $20,000 + $10,000 + $15,000 − $3,000 fee − $18,750 − $100 exemption = **$23,150**, consisting of $15,000 LTCG and $8,150 of ordinary income.

Step 6 — Trust tax (2025 rates). Ordinary $8,150: 10% × $3,150 + 24% × $5,000 = $315 + $1,200 = **$1,515**. Capital gain: the ordinary income already fills the 0% band (to $3,250); 15% applies from $8,150 to $15,900 = $7,750 × 15% = $1,162.50; the remaining $7,250 is taxed at 20% = $1,450. Capital gain tax = **$2,612.50**. Total regular tax = **$4,127.50**.

Step 7 — NIIT. A trust pays 3.8% on the lesser of undistributed net investment income or AGI over $15,650. Here AGI ($23,250, before the exemption) − $15,650 = $7,600, which is less than undistributed NII, so NIIT = 3.8% × $7,600 = **$288.80**.

> **Exam tip:** DNI is the ceiling on both sides: the trust cannot deduct more than DNI, and beneficiaries are not taxed on more than DNI. Whatever is distributed above DNI is a tax-free distribution of corpus.

Simple trust example

> **Example:** The Ash Trust must distribute all income to Omar. Its income is $24,000 of taxable interest and $6,000 of tax-exempt interest; a $2,000 trustee fee is charged to income; a $8,000 capital gain is allocated to corpus.
>
> 1. FAI = $24,000 + $6,000 − $2,000 = $28,000, all required to be distributed.
> 2. Fee allocable to tax-exempt income = $2,000 × $6,000/$30,000 = $400; deductible fee = $1,600.
> 3. DNI = $24,000 + ($6,000 − $400) − $1,600 = $28,000.
> 4. Distribution deduction = $28,000 − tax-exempt portion $5,600 = **$22,400**; Omar includes $22,400 of taxable interest and $5,600 of tax-exempt interest.
> 5. Trust taxable income = $24,000 + $8,000 − $1,600 − $22,400 − $300 = **$7,700** (the corpus capital gain, less the exemption).

2025 fiduciary rates and other amounts

Taxable income over	Rate
$0	10%
$3,150	24%
$11,450	35%
$15,650	37%

Item	2025
0% capital gain rate up to	$3,250
15% capital gain rate up to	$15,900
NIIT threshold	$15,650 (start of the top bracket)
AMT exemption (estates and trusts)	$30,700, phased out from $102,500

Watch out: The brackets are extremely compressed — 37% applies above only $15,650. Distributing income to beneficiaries in lower brackets is a common planning answer.

Special rules and elections

Rule	Effect
65-day election	A complex trust or estate may treat distributions made within 65 days after year-end as made in the prior year
§645 election	A qualified revocable trust may elect to be treated as part of the decedent's estate (fiscal year, $600 exemption, other estate benefits)
Tax year	Trusts must use a **calendar** year; estates may choose a **fiscal** year
Estimated taxes	Trusts must pay; estates are exempt for their first 2 years
Charitable deduction	Complex trusts and estates may deduct amounts paid (or for estates, set aside) for charity from gross income under the governing instrument — not limited by AGI percentages
Losses	Net operating losses and capital losses do not pass through except in the termination year, when excess deductions and carryovers pass to beneficiaries
Depreciation	Allocated between fiduciary and beneficiaries based on the instrument or income allocation
§663(a) specific gifts	A specific bequest of property or sum of money paid in no more than 3 installments is not a distribution that carries out DNI
Kiddie-like trust rules	Grantor trust rules (§§671–679) tax the grantor on income from revocable trusts, trusts where the grantor keeps a reversion over 5%, administrative powers, or income usable for the grantor or spouse

Income in respect of a decedent (IRD)

IRD is income earned by the decedent but not received before death (final paychecks, IRA balances, installment note collections, accrued interest). It is taxed to the recipient (estate

or beneficiary) when received, gets **no basis step-up**, keeps its character, and the recipient may deduct the federal estate tax attributable to it (§691(c)). Deductions in respect of a decedent (unpaid business expenses, state taxes) are deductible when paid.

Compliance

Item	Rule
Form 1041 filing requirement	Estate: gross income of $600 or more; trust: any taxable income or gross income of $600 or more; any nonresident alien beneficiary
Due date	15th day of the 4th month after year-end (April 15 for calendar-year trusts)
Extension	Automatic **5½ months** (Form 7004), to September 30 for calendar-year filers
Beneficiary reporting	Schedule K-1 (Form 1041)

Common traps

- Including capital gains allocated to corpus in DNI.
- Deducting the tax-exempt portion of distributions.
- Using the wrong exemption ($600 estate, $300 simple trust, $100 complex trust).
- Using individual brackets for a trust.
- Forgetting to allocate part of indirect expenses to tax-exempt income.
- Taxing a beneficiary on distributions in excess of DNI.

Key takeaways

- DNI = taxable income before distribution deduction + exemption + net tax-exempt interest − capital gains allocated to corpus.
- Distribution deduction = lesser of distributions or DNI, minus the tax-exempt portion; beneficiaries include the same amount (up to DNI), keeping its character.
- Exemptions: estate $600, simple trust $300, complex trust $100.
- 2025 trust brackets: 10% to $3,150; 24% to $11,450; 35% to $15,650; 37% above. Capital gain 0% to $3,250, 15% to $15,900.
- 65-day election, §645 election; trusts use calendar years, estates may choose a fiscal year.
- Form 1041 due April 15 (calendar year) with a 5½-month extension; grantor trusts are taxed to the grantor.

13. Tax-Exempt Organizations

Tax-exempt organizations do not pay income tax on income from their exempt activities, but they must earn and keep their exemption, file annual information returns, and pay tax on **unrelated business taxable income (UBTI)**. Private foundations face an extra layer of excise taxes. TCP tests qualification, the public charity/private foundation distinction, the Form 990 family, UBTI and the excise taxes on private foundations and excess benefit transactions.

Types of exempt organizations

Section	Examples	Contributions deductible?
§501(c)(3)	Charitable, religious, educational, scientific, literary, public safety testing, amateur sports, prevention of cruelty to children or animals	Yes
§501(c)(4)	Social welfare organizations, civic leagues	Generally no
§501(c)(5)	Labor, agricultural and horticultural organizations	No (dues may be business expenses)
§501(c)(6)	Business leagues, chambers of commerce, trade associations	No (dues may be business expenses, less lobbying portion)
§501(c)(7)	Social and recreational clubs	No

Requirements for §501(c)(3) status

- **Organizational test:** the governing documents limit the purposes to exempt purposes and dedicate assets to exempt purposes on dissolution.
- **Operational test:** the organization is operated **primarily** for exempt purposes.
- **No private inurement:** net earnings may not benefit insiders.
- **No political campaign activity** for or against any candidate (absolute prohibition).
- **Lobbying:** no substantial part of activities (or, under the §501(h) election, within expenditure limits).

Applying for exemption

Item	Rule
Form 1023	Filed within **27 months** after the end of the month of formation for exemption to be retroactive to formation
Form 1023-EZ	Available if projected annual gross receipts **≤ $50,000** for the next 3 years and total assets **≤ $250,000**
Exceptions from filing	Churches and organizations with gross receipts normally not more than $5,000 are automatically exempt
Other §501(c) organizations	Form 1024 (§501(c)(4) organizations also notify the IRS on Form 8976 within 60 days)

Public charities vs. private foundations

Every §501(c)(3) organization is presumed to be a **private foundation** unless it shows it is a public charity:

- Churches, schools, hospitals and medical research organizations, governmental units.
- **Publicly supported** organizations — generally at least **one-third** of support from the general public and government (or 10% plus facts and circumstances).
- Organizations receiving more than one-third of support from contributions, membership fees and gross receipts from related activities, and not more than one-third from investment income.
- **Supporting organizations** of other public charities.

Private foundations are generally funded by one family or company. They are subject to excise taxes and stricter donor deduction limits (30% cash / 20% capital gain property, and generally only basis for appreciated non-stock property).

Annual information returns

Return	Who files (based on gross receipts and assets)
Form 990-N (e-Postcard)	Gross receipts normally **≤ $50,000**
Form 990-EZ	Gross receipts **< $200,000** and total assets **< $500,000**
Form 990	Gross receipts ≥ $200,000 or total assets ≥ $500,000
Form 990-PF	**Every private foundation**, regardless of size
Form 990-T	Gross income from unrelated businesses of **$1,000 or more**
Exempt from filing	Churches and their integrated auxiliaries; certain governmental units

- Returns are due the **15th day of the 5th month** after year-end (May 15 for calendar years); a 6-month extension is available (Form 8868).

- Failure to file for **3 consecutive years** results in **automatic revocation** of exemption.
- Penalties for late filing apply per day, with higher amounts for organizations over $1 million in gross receipts.
- Forms 990 and 990-T (for (c)(3)s) are publicly available; donor names are generally not disclosed except for private foundations.

Unrelated business income tax (UBIT)

What is unrelated business income

Income is UBTI if it comes from a **trade or business** that is **regularly carried on** and **not substantially related** to the organization's exempt purpose (other than by providing funds).

Exclusions

Excluded from UBTI	Note
Dividends, interest, annuities, royalties	Unless from a controlled subsidiary or debt-financed
Rents from real property	Unless debt-financed, based on net profits, or with substantial services; personal property rent excluded only if incidental (≤ 10%)
Gains on sale of property (other than inventory)	Unless debt-financed
Activities run substantially by **volunteers**	
Activities for the **convenience** of members, students, patients or employees (a §501(c)(3) or governmental college cafeteria)	
Sale of **donated** merchandise (thrift shops)	
Qualified trade shows, conventions, bingo (where legal), public entertainment at fairs	
Low-cost articles distributed incidental to solicitations	
Research income for universities and hospitals	

Debt-financed property

Income from property bought with borrowed money is UBTI in proportion to the debt:

UBTI = (gross income − related deductions) × (average acquisition indebtedness ÷ average adjusted basis).

Example: A charity rents out a building it bought with a loan. Rent is $100,000 and related expenses are $60,000. Average acquisition indebtedness is 40% of average adjusted basis. UBTI = ($100,000 − $60,000) × 40% = **$16,000**.

Computing UBTI and the tax

- **Silo rule (§512(a)(6)):** UBTI is computed **separately for each unrelated trade or business**. A loss from one business **cannot offset** income from another; it carries forward as an NOL for that business only.
- Then subtract the **$1,000 specific deduction**.
- Charitable contributions (up to 10% of UBTI for corporations) are deductible.
- Tax: exempt **corporations** pay **21%**; exempt **trusts** use the trust rate schedule.
- Quarterly estimated tax is required when the expected tax is $500 or more.

Example: An art museum's activities in 2025:

- Gift shop selling reproductions of its collection (related): excluded.
- Café open to the public on separate premises: net income $30,000 (unrelated).
- Advertising in its magazine: net **loss** of $5,000 (unrelated).
- Public parking lot (not real property rent because of services, assume unrelated): net income $12,000.
- Dividends from its endowment: excluded.

1. Positive silos: $30,000 + $12,000 = $42,000. The $5,000 advertising loss is **not** netted; it carries forward within that silo.
2. Less $1,000 specific deduction → UBTI = **$41,000**.
3. UBIT (corporate form) = 21% × $41,000 = **$8,610**, reported on Form 990-T.

Watch out: Volunteers make the difference. If the museum café were staffed substantially by volunteers, all of its income would be excluded.

Private foundation excise taxes

Tax	Rule
Net investment income tax (§4940)	**1.39%** of net investment income (interest, dividends, rents, royalties and capital gains, less expenses)
Self-dealing (§4941)	Nearly all transactions between the foundation and disqualified persons (substantial contributors, managers, family members, 20% owners) are prohibited, even at fair value. Initial tax 10% on the self-dealer, 5% on knowing managers
Minimum distribution (§4942)	Must distribute about **5%** of the average FMV of noncharitable-use assets each year (by the end of the next year); initial tax 30% on undistributed amounts
Excess business holdings (§4943)	Generally 20% limit on combined holdings with disqualified persons in a business
Jeopardizing investments (§4944)	Investments that jeopardize exempt purposes
Taxable expenditures (§4945)	Lobbying, electioneering, improper grants to individuals or non-charities

Example: A private foundation has $10,000,000 of average investment assets and $500,000 of net investment income. Its excise tax is 1.39% × $500,000 = **$6,950**. Its minimum distributable amount is about 5% × $10,000,000 = **$500,000**, reduced by the excise tax.

Excess benefit transactions — intermediate sanctions (§4958)

For public charities and §501(c)(4) and (c)(29) organizations, a transaction that gives a **disqualified person** (an insider with substantial influence) more than fair value creates an excess benefit. The **organization itself is not taxed**; the tax falls on the people involved:

Who	Tax
Disqualified person	**25%** of the excess benefit; **200%** if not corrected within the taxable period
Organization managers who knowingly approved	**10%** of the excess benefit, up to **$20,000** per transaction

Example: A hospital's CEO receives $100,000 above reasonable compensation. The CEO owes 25% × $100,000 = **$25,000**, plus 200% × $100,000 = **$200,000** if the excess is not repaid in time. Board members who knowingly approved owe 10% × $100,000 = $10,000 (within the $20,000 cap).

Other points

- **Excise tax on excess compensation:** 21% on compensation over $1 million paid by applicable tax-exempt organizations to covered employees.
- **Excise tax on net investment income of large private colleges** (endowment tax) — rates change for tax years beginning after 2025 under OBBBA.
- Donor acknowledgment: a written acknowledgment is required for gifts of $250 or more; quid pro quo contributions over $75 require a disclosure statement.

Common traps

- Netting a loss from one unrelated business against income from another.
- Treating all rent as excluded even when the property is debt-financed.
- Letting a private foundation file Form 990-N or 990-EZ (it always files 990-PF).
- Thinking the charity itself pays the §4958 tax.
- Forgetting the $1,000 specific deduction, or applying it to each silo.
- Confusing the 27-month Form 1023 deadline with the 15th-day-of-the-5th-month return due date.

Key takeaways

- §501(c)(3): organizational and operational tests, no private inurement, no political campaigning, limited lobbying.
- Form 1023 within 27 months for retroactive exemption; 1023-EZ if receipts ≤ $50,000 and assets ≤ $250,000.
- 990-N if receipts normally ≤ $50,000; 990-EZ if receipts < $200,000 and assets < $500,000; otherwise 990; private foundations always 990-PF. Due the 15th day of the 5th month; 3 years of non-filing → automatic revocation.
- UBTI: regularly carried on, unrelated trade or business; exclusions for passive income, volunteers, convenience and donated goods; debt-financed income taxable proportionally; silo rule; $1,000 specific deduction; 990-T at $1,000 of gross UBI; corporations pay 21%.
- Private foundations: 1.39% excise tax on net investment income, 5% minimum distribution, self-dealing prohibited.

- Intermediate sanctions: 25% (200% if uncorrected) on the insider; 10% on knowing managers up to $20,000.

14. Entity Choice and Formation (§351 / §721)

Blueprint Area III asks you to think like an adviser: which entity type best fits a business, and how can it be formed (and later restructured) with the least tax? This chapter compares the main entity forms, then works through the nonrecognition rules for forming corporations (§351) and partnerships (§721), including boot, liabilities and basis.

Comparing entity types

Feature	Sole proprietorship / single-member LLC	Partnership / multi-member LLC	S corporation	C corporation
Entity-level income tax	No	No	Generally no (BIG and passive income taxes possible)	Yes, 21%
Tax on distributions	No	Generally no	Generally no (unless E&P from C years)	Qualified dividends 0/15/20% + 3.8% NIIT
Owner limits	One owner	2 or more; any type	≤ 100 eligible shareholders, one class of stock	None
Special allocations	n/a	Yes (substantial economic effect)	No — strictly per share per day	n/a
Entity debt in owner basis	n/a	Yes (§752)	No (only direct shareholder loans)	No

Losses, payroll taxes and other features:

Feature	Sole proprietorship / single-member LLC	Partnership / multi-member LLC	S corporation	C corporation
Losses pass to owners	Yes	Yes	Yes	No (trapped as NOLs)
SE / payroll taxes	SE tax on all net profit	SE tax for general partners and guaranteed payments	FICA only on reasonable compensation	FICA on wages only
QBI deduction	Yes	Yes	Yes	No
Distributing appreciated property	n/a	Generally tax-free	Gain recognized, passes through	Gain taxed at entity level, dividend to shareholder
§1202 QSBS exclusion	No	No	No	Yes
Return	Schedule C	Form 1065	Form 1120-S	Form 1120

The rate comparison

Example: A business earns $100,000 of pre-tax income. Its owner is in the 35% bracket and would receive qualified dividends taxed at 15% (ignore NIIT and state tax).

- **C corporation, all earnings distributed:** corporate tax 21% × $100,000 = $21,000; dividend $79,000 × 15% = $11,850; total **$32,850** (32.85%).
- **Pass-through, QBI deduction fully available:** taxable income $100,000 × 80% = $80,000 × 35% = **$28,000** (28%).

The C corporation becomes more attractive when profits are **retained** for growth (only 21% is paid now) or when the stock may qualify for the §1202 exclusion.

Check-the-box classification

Entity	Default classification	Election (Form 8832)
Single-member LLC	Disregarded entity (sole proprietorship or branch)	Corporation (then may file Form 2553 for S status)
Multi-member LLC / partnership	Partnership	Corporation
State-law corporation	Corporation (per se)	Cannot elect partnership status

After an election changes classification, another change generally cannot be made for **60 months**. Converting from a partnership to a corporation is treated as a §351 transfer; converting a corporation to a partnership is a taxable liquidation.

Forming a corporation — §351

No gain or loss is recognized when one or more persons transfer **property** to a corporation solely in exchange for its **stock** if, **immediately after** the exchange, the transferors **control** the corporation.

The control test (§368(c))

The transferors of property, as a group, must own at least **80% of the total combined voting power** and at least **80% of the total shares of each class of nonvoting stock**.

- **Services are not property.** A person who receives stock only for services is not counted as a transferor. That person has **ordinary income** equal to the FMV of the stock.
- If a service provider also transfers property, **all** of that person's stock counts toward control — but the IRS will not rule favorably if the property is worth less than **10%** of the value of stock received for services ("accommodation transfers").
- Existing shareholders who transfer additional property can count, subject to the same accommodation limit.

> **Example:** Ari transfers land for 70 shares of a new corporation; Bo receives 30 shares solely for services. Property transferors own only 70% — **§351 fails**. Ari has a taxable exchange of the land, and Bo has ordinary income equal to the FMV of his 30 shares. If Bo had also contributed property worth at least 10% of the value of his services shares, both would be transferors (100% control).

Boot

If the transferor receives **boot** (cash, other property, or securities/debt of the corporation) in addition to stock:

- **Recognized gain = lesser of realized gain or FMV of boot.**
- **Losses are never recognized.**
- Character depends on the property transferred (capital, §1231, or ordinary — including depreciation recapture).

Basis

Party	Basis rule
Shareholder's stock (§358)	Adjusted basis of property transferred + gain recognized − boot received (FMV) − liabilities assumed by the corporation
Boot property received	FMV
Corporation's basis in property (§362)	Transferor's adjusted basis + gain recognized by the transferor
Built-in loss limit (§362(e)(2))	If total basis of property transferred by a shareholder exceeds its total FMV, the corporation's basis is limited to FMV (or the shareholder may elect to reduce stock basis instead)
Holding period	Tacks for capital and §1231 property; corporation's holding period tacks for all property

Example: Cleo transfers land (basis $60,000, FMV $150,000) to Delta Corp. for stock worth $130,000 and $20,000 cash. She and another property transferor own 100% after the exchange.

1. Realized gain = $150,000 − $60,000 = $90,000.
2. Recognized gain = lesser of $90,000 or $20,000 boot = **$20,000**.
3. Cleo's stock basis = $60,000 + $20,000 − $20,000 = **$60,000** (deferred gain $70,000 = $130,000 FMV − $60,000 basis ✔).
4. Delta's basis in the land = $60,000 + $20,000 = **$80,000**.

Liabilities

- **§357(a):** a corporation's assumption of a liability is generally **not boot**.
- **§357(b):** if the principal purpose of the liability is tax avoidance or there is no bona fide business purpose, **all** liabilities assumed from that transferor are boot.
- **§357(c):** if total liabilities assumed exceed the **total adjusted basis** of property transferred by that transferor, the **excess is gain** (character follows the assets). Liabilities that would give rise to a deduction when paid (such as accounts payable of a cash-method taxpayer) are excluded.

Example: Eli transfers equipment (basis $40,000, FMV $100,000) subject to a $55,000 liability that the corporation assumes, for stock worth $45,000.

1. §357(c) gain = $55,000 − $40,000 = **$15,000** (ordinary to the extent of depreciation recapture).
2. Stock basis = $40,000 + $15,000 − $55,000 = **$0**.
3. Corporation's basis in equipment = $40,000 + $15,000 = $55,000.

Exam tip: In every §351 problem fill in three numbers in order: **realized gain → recognized gain → basis** (shareholder stock, then corporate property). Then check that deferred gain equals stock FMV minus stock basis.

Contributions to capital

A contribution to capital by a shareholder with no stock received is not income to the corporation (§118), and the shareholder adds the property's basis to existing stock basis. Contributions by nonshareholders (such as a city's incentive) are now generally taxable to the corporation.

Forming a partnership — §721 compared

Feature	§351 (corporation)	§721 (partnership)
Control requirement	80% by property transferors	**None**
Boot rule	Gain to extent of boot	Generally no boot concept; a distribution soon after may be a disguised sale
Excess liabilities	§357(c) gain if liabilities > basis	Gain only if **net** liability relief (after the partner's share of partnership debt) exceeds outside basis (§752/§731)
Owner basis includes entity debt	No	Yes
Services	Ordinary income; not counted for control	Capital interest: ordinary income; profits interest: generally no income
Built-in gain	Corporation takes carryover basis; no special allocation	§704(c) allocations to the contributor

Small business stock benefits

§1244 stock — ordinary loss

An individual who is the original holder of stock in a qualifying small business corporation (capital received for stock ≤ $1,000,000) may treat a loss on the stock as **ordinary** up to **$50,000** per year (**$100,000** on a joint return). Any excess is capital loss.

> **Example:** A married couple filing jointly loses $130,000 on qualifying §1244 stock. They deduct **$100,000** as an ordinary loss and **$30,000** as a capital loss (usable against capital gains plus $3,000 per year).

§1202 qualified small business stock (QSBS)

Noncorporate shareholders may exclude gain on the sale of QSBS: original-issue stock of a domestic C corporation engaged in an active qualified business (not most service businesses, finance, farming, hospitality or extraction).

Stock issued	Holding period	Exclusion	Per-issuer cap	Gross assets test
After September 27, 2010 and on or before July 4, 2025	More than 5 years	100%	Greater of $10,000,000 or 10 × basis	$50,000,000
After July 4, 2025 (OBBBA)	3 years / 4 years / 5 years	**50% / 75% / 100%**	Greater of **$15,000,000** (indexed after 2026) or 10 × basis	**$75,000,000**

The non-excluded portion of gain on post-July 4, 2025 stock held 3–4 years is taxed at 28%. Excluded gain on post-2010 stock is not an AMT preference.

Common traps

- Counting service-only shareholders toward the 80% control test.
- Recognizing a loss in a §351 exchange.
- Applying §357(c) in a partnership formation (use the §752 net liability rules).
- Forgetting that the corporation's carryover basis is increased by the shareholder's recognized gain.
- Reducing stock basis by liabilities assumed but forgetting to add the §357(c) gain.
- Using the old $10 million QSBS cap and 5-year rule for stock issued after July 4, 2025.

Key takeaways

- Choice of entity weighs double taxation (21% + dividend tax) against pass-through taxation, owner restrictions, basis from debt, SE tax and QSBS.
- §351: property transferors must have 80% of vote and 80% of each nonvoting class immediately after. Services do not count.

- Recognized gain = lesser of realized gain or boot; losses never recognized.
- Stock basis = property basis + gain − boot − liabilities assumed; corporation's basis = carryover + gain (limited by §362(e)(2)).
- §357(c): liabilities over basis create gain; §357(b) tax-avoidance liabilities are boot.
- §721 has no control test; liability relief beyond basis creates gain through §752/§731.
- §1244 ordinary loss up to $50,000 / $100,000; QSBS issued after July 4, 2025: 50%/75%/100% exclusion at 3/4/5 years, $15 million cap.

15. Liquidations and Reorganizations

At the end of a corporation's life — or when it combines with another company — the tax result depends on whether the transaction is a **taxable liquidation**, a **tax-free subsidiary liquidation** or a **tax-free reorganization**. This chapter covers the corporate and shareholder sides of each, plus the limits on carrying tax attributes into a new owner.

Complete liquidation of a C corporation — double tax

Corporate level (§336)

The liquidating corporation recognizes **gain and loss** as if it sold each distributed asset to the shareholders at **FMV**. If a distributed asset is subject to a liability greater than its FMV, FMV is treated as at least the liability.

Loss limitations (§336(d))

Rule	When it applies	Effect
Related-party rule — §336(d)(1)	Distribution to a **related person** (more than 50% shareholder, with attribution) **and** either the distribution is **non-pro rata** or the property is **disqualified property** (acquired in a §351 transaction or as a contribution to capital within **5 years** before the distribution)	**Entire loss disallowed**
Built-in loss / tax-avoidance rule — §336(d)(2)	Property acquired in a §351 transaction or as a contribution to capital with a principal purpose of recognizing a loss on liquidation (presumed if within **2 years** before adopting the plan)	Loss reduced by the **built-in loss** at contribution (excess of basis over FMV at that time); post-contribution decline remains deductible

Shareholder level (§331)

- The shareholder treats the liquidating distribution as full payment in exchange for the stock.
- **Gain or loss = FMV of money and property received (net of liabilities assumed) − stock basis**, usually capital.
- The shareholder's basis in distributed property = **FMV** at distribution.
- Distributions in a series under a plan: recover basis first, recognize gain as amounts exceed basis, and recognize loss only after the final distribution.

Example: Spruce Corp., owned 100% by Ivy (stock basis $120,000), adopts a plan of complete liquidation and distributes all its assets: cash $150,000; land (FMV $300,000, basis $100,000); equipment (FMV $50,000, basis $80,000). The equipment was not acquired in a §351 transfer.

1. Corporate gain on land = $200,000; loss on equipment = $30,000 (allowed: although Ivy is a related person, the distribution is pro rata and the equipment is not disqualified property). Net gain = **$170,000**.
2. Corporate tax = 21% × $170,000 = **$35,700**, paid from the cash before distribution.
3. Ivy receives $150,000 − $35,700 + $300,000 + $50,000 = **$464,300**.
4. Ivy's capital gain = $464,300 − $120,000 = **$344,300**.
5. Ivy's bases: land **$300,000**; equipment **$50,000**.

Watch out: Liquidating distributions are **not dividends**, even if the corporation has E&P. The shareholder has capital gain or loss.

Filing

- **Form 966** must be filed within **30 days** after the plan of liquidation (or dissolution) is adopted.
- The corporation files a final Form 1120; shareholders receive Form 1099-DIV reporting liquidating distributions.

Liquidation of a subsidiary — §332 and §337

When a parent corporation liquidates a subsidiary, the transaction is **tax-free** to both if the parent owns at least **80% of the voting power and 80% of the value** of the subsidiary's stock from the plan's adoption through the final distribution, and the subsidiary distributes all its property within the year (or within 3 years under a plan).

Party	Result
Parent (§332)	No gain or loss on its subsidiary stock; the stock basis disappears
Subsidiary on distribution to parent (§337)	No gain or loss
Parent's basis in assets received (§334(b))	**Carryover** from the subsidiary (limited to FMV if net built-in loss property is imported from a non-U.S. taxpayer)
Tax attributes (§381)	NOLs, E&P, capital loss carryovers, accounting methods carry over to the parent
Distributions to **minority** shareholders	Subsidiary recognizes **gain** (§336) but **no loss** (§336(d)(3)); minority shareholders have §331 capital gain or loss
Debt owed by the subsidiary to the parent	Satisfying the debt with appreciated property is treated like a §332 distribution (no gain to the subsidiary)

Example: Parent owns 85% of Sub; an individual owns 15%. In liquidation, Sub distributes a building (FMV $100,000, basis $60,000) to the minority shareholder and other assets to Parent. Sub recognizes **$40,000** of gain on the building; had the building's FMV been below basis, the loss would be **disallowed**. Distributions to Parent are tax-free with carryover basis.

Electing to treat a stock purchase as an asset purchase

- **§338(g):** a corporate buyer that acquires 80% or more of a target's stock within 12 months may elect to treat the target as selling its assets at FMV (taxable to target) and buying them back with a stepped-up basis.
- **§338(h)(10)** and **§336(e):** buyer and seller (consolidated group or S corporation shareholders) jointly elect; the target is treated as selling its assets and liquidating, so only one level of tax applies to the seller.

Corporate reorganizations — §368

A **reorganization** lets corporations combine, divide or restructure without immediate tax. Each type has its own requirements, and all require **business purpose**, **continuity of interest (COI)** and **continuity of business enterprise (COBE)**.

Type	Description	Key requirement
A — statutory merger or consolidation	Target merges into acquirer under state law	Flexible consideration; COI satisfied with roughly **40%** stock
B — stock-for-stock	Acquirer exchanges **solely voting stock** for target stock and has **80% control** immediately after	**No boot at all** (cash for fractional shares is tolerated)
C — stock-for-assets	Acquirer exchanges voting stock for **substantially all** of target's assets (generally 90% of net assets and 70% of gross assets); target liquidates	Boot limited: voting stock must be at least 80% of the consideration, counting liabilities assumed as boot only if other boot is present
D — transfer to controlled corporation	Divisive (spin-off, split-off, split-up under §355) or acquisitive	Transferor or shareholders control the transferee
E — recapitalization	Changing the capital structure of one corporation (e.g., bonds for stock)	—
F — mere change in identity, form or place of organization	Reincorporation in another state	One corporation
G — bankruptcy reorganization	Transfer in a Title 11 case	—

Triangular mergers (forward and reverse) use a subsidiary of the acquirer and the parent's stock.

Tax results in a reorganization

Party	Result
Target corporation	No gain or loss on transfer of assets for stock (§361); gain on distributing boot property it keeps (if appreciated)
Acquiring corporation	No gain or loss on issuing stock (§1032); carryover basis in target assets (§362(b))
Target shareholders (§354, §356)	No gain or loss on exchanging stock for stock; **recognized gain = lesser of realized gain or boot**; **no loss** recognized
Character of boot gain	Dividend if the exchange has the effect of a dividend (tested by comparing the shareholder's interest to a hypothetical redemption by the acquirer), otherwise capital gain
New stock basis (§358)	Old stock basis + gain recognized − boot received
Holding period	Tacks
Tax attributes (§381)	Carry over in A, C, D (acquisitive), F and G reorganizations

Example: Maya owns target stock with a basis of $40,000. In a Type A merger she receives acquirer stock worth $90,000 and $15,000 cash.

1. Realized gain = $105,000 − $40,000 = $65,000.
2. Recognized gain = lesser of $65,000 or $15,000 boot = **$15,000** (capital gain unless it has the effect of a dividend).
3. Basis in acquirer stock = $40,000 + $15,000 − $15,000 = **$40,000**.
4. Deferred gain = $90,000 − $40,000 = $50,000 ✔.

Memory trick: "**B** = **B**are voting stock." A Type B reorganization allows no cash or other boot.

Limits on acquired tax attributes

§382 — NOL limitation after an ownership change

When there is an **ownership change** (5% shareholders increase their ownership by more than **50 percentage points** within a 3-year testing period), the loss corporation's pre-change NOLs can offset post-change income only up to an annual **§382 limitation**:

Annual limit = value of the old loss corporation's stock immediately before the change × the long-term tax-exempt rate (published monthly by the IRS).

- Unused limitation carries forward to later years.

- If the loss corporation does not continue its business enterprise for 2 years, the limit is **zero**.
- Recognized built-in gains within 5 years can increase the limit.

> **Example:** Loss Co. is worth $5,000,000 when it undergoes an ownership change. Assume the long-term tax-exempt rate for the month is 3.5%. Annual §382 limitation = $5,000,000 × 3.5% = **$175,000** of pre-change NOLs per year.

Related limits

- **§383:** similar limit on credits and capital loss carryovers.
- **§384:** limits using pre-acquisition losses of one corporation to offset built-in gains of another acquired corporation.
- **§269:** disallows attributes when the principal purpose of an acquisition is tax avoidance.

Common traps

- Treating liquidating distributions as dividends.
- Allowing a loss on property distributed to minority shareholders in a §332 liquidation.
- Forgetting the double tax in a §331/§336 liquidation (corporate gain **and** shareholder gain).
- Allowing cash (other than for fractional shares) in a Type B reorganization.
- Recognizing a loss in a reorganization.
- Using FMV, rather than carryover basis, for the parent's basis in a §332 liquidation.

Key takeaways

- §336: liquidating corporation recognizes gain and loss at FMV, with §336(d) loss limits for related parties (5-year disqualified property) and built-in-loss property (2-year presumption).
- §331: shareholder gain = FMV received − stock basis; basis in property = FMV; Form 966 within 30 days.
- §332/§337: 80% parent — no gain or loss, carryover basis, attributes carry over; gain (not loss) on distributions to minority shareholders.
- Reorganizations: A (merger, ~40% stock), B (solely voting stock for 80% control), C (voting stock for substantially all assets), D, E (recapitalization), F (change in form), G (bankruptcy).
- Shareholder gain = lesser of realized gain or boot; new stock basis = old basis + gain − boot; no losses.
- §382: annual NOL limit = value of old loss corporation × long-term tax-exempt rate.

16. Property Transactions and Recapture

Blueprint Area IV covers the disposition of assets. Every property question follows the same path: compute **realized gain or loss**, decide how much is **recognized** (nonrecognition rules may defer it), determine its **character** (ordinary, capital or §1231, after **depreciation recapture**), and decide the **timing** (for example, under the installment method).

Realized gain or loss

Term	Definition
Amount realized	Cash + FMV of property received + liabilities of the seller assumed by the buyer − selling expenses
Adjusted basis	Cost (or other basis) + capital improvements − depreciation, amortization, casualty losses and other recoveries
Realized gain or loss	Amount realized − adjusted basis

Basis rules by acquisition method: purchase = cost; gift = carryover (with the dual-basis loss rule); inheritance = FMV at death; §351/§721/§1031 = substituted basis (Chapters 6, 14).

Character of gain or loss

Asset category	Examples	Character
Capital assets	Investments, personal-use property (losses not deductible), collectibles	Capital: short-term if held 1 year or less, long-term if more
§1231 property	Depreciable property and land used in a trade or business held **more than 1 year**	Net gain → long-term capital gain (after recapture and lookback); net loss → ordinary
Ordinary assets	Inventory, accounts and notes receivable from sales, depreciable property held 1 year or less, self-created copyrights and art in the creator's hands	Ordinary

Individual capital gain and loss netting

1. Net short-term gains and losses; net long-term gains and losses (within the long-term group, 28% collectibles and 25% unrecaptured §1250 gain are taxed at their own maximum rates).
2. Net the two results against each other.
3. A **net capital loss** is deductible up to **$3,000** per year ($1,500 MFS) against ordinary income; the rest carries forward indefinitely, keeping its short- or long-term character.

Corporations (Chapter 7) cannot deduct net capital losses and carry them back 3 / forward 5.

Loss disallowance rules

Rule	Effect
Related-party sales (§267)	Loss on a sale to a related party (family members — spouse, siblings, ancestors, lineal descendants; corporations more than 50% owned) is disallowed. The buyer may use the disallowed loss to **reduce later gain** on resale, but never to create or increase a loss
Wash sales (§1091)	Loss on stock or securities is disallowed if substantially identical securities are bought within **30 days before or after** the sale. The disallowed loss is **added to the basis** of the replacement shares, and the holding period tacks
Personal-use property	Losses not deductible (except casualty losses in federally declared disasters)

Example: Lucas sells stock (basis $10,000) to his brother Max for $6,000. Lucas's $4,000 loss is disallowed.

- If Max later sells for $9,000: his $3,000 gain is reduced by the disallowed loss → **$0** recognized (the excess $1,000 of disallowed loss is lost).
- If Max sells for $12,000: gain $6,000 − $4,000 = **$2,000**.
- If Max sells for $5,000: his loss is $1,000 (basis $6,000); the $4,000 disallowed loss cannot increase it.

Depreciation recapture

§1245 — personal property (and most amortizable intangibles)

Gain on the disposition of §1245 property is **ordinary income** to the extent of **all depreciation (and §179/bonus) taken**. Any remaining gain is §1231 gain.

Example: Equipment cost $100,000; depreciation taken $70,000; adjusted basis $30,000.

- Sold for $45,000: gain $15,000 → all **$15,000 ordinary** (less than the $70,000 depreciation).
- Sold for $120,000: gain $90,000 → **$70,000 ordinary** (§1245) + **$20,000 §1231 gain**.
- Sold for $25,000: **$5,000 §1231 loss** (no recapture on a loss).

§1250 — real property

Taxpayer	Treatment of gain on depreciable real property placed in service after 1986 (straight-line)
Individuals (and pass-throughs to individuals)	No ordinary recapture (straight-line), but gain up to depreciation taken is **unrecaptured §1250 gain**, taxed at a maximum **25%**; remaining gain is §1231
C corporations (§291)	**20%** of the lesser of depreciation taken or recognized gain is **ordinary** income; the rest is §1231

Example: A building cost $1,000,000; straight-line depreciation taken $300,000; adjusted basis $700,000; sold for $1,200,000. Gain = **$500,000**.

- **Individual:** $300,000 unrecaptured §1250 gain (max 25% rate) + $200,000 §1231 gain (likely 15%/20% LTCG).
- **C corporation:** §291 ordinary income = 20% × $300,000 = **$60,000**; §1231 gain = **$440,000**.

§1231 netting and the lookback

1. Recapture first (ordinary).
2. Net casualty and theft gains and losses on business and investment property held more than 1 year: a net loss is ordinary and leaves the §1231 pot; a net gain joins the §1231 pot.
3. Net all §1231 gains and losses: - **Net §1231 loss → ordinary loss** (fully deductible — not limited to $3,000). - **Net §1231 gain → long-term capital gain**, except that it is **ordinary** to the extent of **nonrecaptured net §1231 losses** deducted in the previous **5 years** (the lookback rule).

Example: In 2025 a sole proprietor has a net §1231 gain of $50,000. In 2022 she deducted a $15,000 net §1231 loss, and she has had no net §1231 gains since. Result: **$15,000 ordinary income** (recapturing the earlier ordinary loss) and **$35,000 long-term capital gain**.

Memory trick: §1231 is "the best of both worlds": gains are capital, losses are ordinary — but the 5-year lookback stops taxpayers from timing gains and losses to get both.

Other recapture and ordinary income rules

- **§1239:** gain on the sale of depreciable property to a more-than-50%-owned entity or other related party is entirely ordinary.
- Recapture also applies on installment sales (recognized in full in the year of sale), §179 property when business use drops to 50% or less, and listed property.
- Gifts and transfers at death do not trigger recapture (the donee inherits the recapture potential on a gift; death wipes it out).

Nonrecognition: like-kind exchanges (§1031)

Requirement	Rule
Property	**Real property only** (since 2018), held for productive use in a trade or business or for investment — not inventory or property held for sale. U.S. and foreign real property are not like-kind
Identification	Replacement property must be identified within **45 days** after transferring the relinquished property
Receipt	Replacement must be received within the earlier of **180 days** or the due date (with extensions) of the return for the year of transfer
Related parties	If either party disposes of the property within 2 years, the deferred gain is triggered
Qualified intermediary	Used for deferred exchanges so the taxpayer never has actual or constructive receipt of the cash

Boot and basis

- **Recognized gain = lesser of realized gain or boot received.** Losses are never recognized.
- **Boot received** = cash + other (non-like-kind) property + **net liability relief** (liabilities the other party assumes minus liabilities the taxpayer assumes).

- Cash **paid** or liabilities **assumed** by the taxpayer offset liabilities relieved — but **liabilities assumed never offset cash received**.
- Giving boot (non-like-kind property) can trigger gain or loss on that boot property itself.
- **Basis of new property = FMV of new property − deferred gain (+ deferred loss).** Equivalent formula: old basis + boot paid + gain recognized − boot received (with liabilities as boot).

Example: Tara exchanges an apartment building (adjusted basis $300,000, FMV $500,000, mortgage $100,000 assumed by the other party) for an office building (FMV $420,000, mortgage $50,000 that Tara assumes) plus $30,000 cash.

1. Amount realized = $420,000 + $100,000 + $30,000 − $50,000 = **$500,000**.
2. Realized gain = $500,000 − $300,000 = **$200,000**.
3. Boot received = $30,000 cash + net liability relief ($100,000 − $50,000 = $50,000) = **$80,000**.
4. Recognized gain = lesser of $200,000 or $80,000 = **$80,000**.
5. Basis in office building = $420,000 − ($200,000 − $80,000) deferred gain = **$300,000**.
6. Check: $300,000 old basis + $50,000 liability assumed + $80,000 gain − $30,000 cash − $100,000 liability relieved = $300,000 ✔.

Involuntary conversions (§1033)

When property is destroyed, stolen or condemned and the taxpayer receives insurance or condemnation proceeds:

- Gain is recognized only to the extent the **proceeds exceed the cost of qualified replacement property** (if the taxpayer elects deferral). Losses are recognized normally.
- Replacement property must be **similar or related in service or use** (for condemned business or investment real property, like-kind is enough).
- Replacement period: **2 years** after the end of the tax year in which gain is realized; **3 years** for condemned business or investment real property; 4 years for a principal residence in a federally declared disaster area.
- Basis of replacement property = cost − deferred gain.

Example: A warehouse with a basis of $250,000 is destroyed by fire; insurance pays $400,000. The owner buys a replacement warehouse for $370,000 within the replacement period.

1. Realized gain = $150,000.
2. Recognized gain = $400,000 − $370,000 = **$30,000** (the proceeds not reinvested).
3. Deferred gain = $120,000; basis of new warehouse = $370,000 − $120,000 = **$250,000**.

Sale of a principal residence (§121)

- Exclude up to **$250,000** of gain (**$500,000** for married filing jointly) if the taxpayer **owned and used** the home as a principal residence for at least **2 of the 5 years** before the sale. For the $500,000 amount, either spouse may meet ownership, both must meet use, and neither may have used the exclusion in the past 2 years.
- Available once every 2 years.
- **Reduced exclusion** for failing the 2-year tests because of a change in employment, health or unforeseen circumstances: maximum × (months qualifying ÷ 24).
- Gain attributable to depreciation after May 6, 1997 (e.g., a home office or prior rental) is not excludable; **nonqualified use** periods after 2008 (such as renting before moving in) reduce the excludable gain proportionally.
- Losses on a personal residence are not deductible.

Example: A married couple filing jointly sells their home of 10 years for a $620,000 gain. Excluded **$500,000**; taxable LTCG **$120,000**.

Example: Ella, single, owned and lived in her home for 15 months before her employer transferred her to another state. Reduced maximum exclusion = $250,000 × 15/24 = **$156,250**.

Installment sales (§453)

A sale with at least one payment received after the year of sale is reported on the installment method unless the taxpayer elects out.

Term	Definition
Gross profit	Selling price − adjusted basis (and selling expenses)
Contract price	Selling price − seller's mortgage assumed by the buyer (to the extent not exceeding basis)
Gross profit percentage	Gross profit ÷ contract price
Gain each year	Principal payments received × gross profit percentage (interest is separately taxed as ordinary income)

Not available for: sales of inventory, dealer dispositions, publicly traded stock and securities, or losses. **Depreciation recapture** is recognized **in full in the year of sale** (and added to basis before computing the gross profit percentage). Sales to related parties that resell within 2 years accelerate the seller's gain. Interest may be charged on deferred tax for large installment obligations (over $5 million).

> **Example:** Noor sells land (basis $60,000) for $200,000: $40,000 down and a $160,000 note payable $40,000 per year plus interest.
>
> 1. Gross profit = $200,000 − $60,000 = $140,000.
> 2. Gross profit percentage = $140,000 ÷ $200,000 = **70%**.
> 3. Gain recognized in the year of sale = 70% × $40,000 = **$28,000**; the same each year the $40,000 principal payments are collected.
>
> If the buyer instead assumed Noor's $50,000 mortgage as part of the $200,000 price, the contract price would be $200,000 − $50,000 = $150,000 and the gross profit percentage $140,000 ÷ $150,000 = **93.33%**.

Common traps

- Offsetting **cash received** with liabilities assumed in a §1031 exchange.
- Exchanging personal property (equipment, vehicles) in a §1031 exchange after 2017.
- Spreading depreciation recapture over installment payments.
- Treating a net §1231 loss as a capital loss limited to $3,000.
- Forgetting the 5-year §1231 lookback.
- Letting a related buyer deduct the seller's disallowed loss as a loss (it only reduces later gain).
- Applying §1245 recapture to an individual's straight-line real property (it is unrecaptured §1250 gain at 25%).

Key takeaways

- Realized gain = amount realized − adjusted basis; then decide recognition, character and timing.
- §1245: ordinary to the extent of depreciation; §291: corporations treat 20% of real property depreciation as ordinary; individuals have unrecaptured §1250 gain at up to 25%.
- §1231: net gain → LTCG (except 5-year lookback); net loss → ordinary.
- §1031: real property only; 45/180 days; boot = cash + net liability relief; basis = FMV − deferred gain.
- §1033: recognized gain = proceeds not reinvested; 2-year replacement (3 for condemned business real property).
- §121: $250,000/$500,000; own and use 2 of 5 years; reduced exclusion by months ÷ 24.
- Installment method: gain = principal × gross profit ÷ contract price; recapture recognized in the year of sale.
- Related-party losses disallowed (§267); wash sales 30 days before or after; individuals deduct $3,000 of net capital loss per year.

Final Review Checklist

Use this checklist in the last week before your exam. For each line, ask yourself whether you could explain the rule and work a numeric example without notes. Anything you cannot do quickly, reread in its chapter and drill in the matching bank chapter.

2025 numbers sheet

Item	2025 amount
Standard deduction (OBBBA)	$15,750 single / $31,500 MFJ / $23,625 HOH
SALT cap	$40,000, less 30% of MAGI over $500,000, floor $10,000
Child tax credit	$2,200 per child (up to $1,700 refundable); phase-out $200,000 / $400,000
Senior deduction	$6,000 per person; reduced 6% of MAGI over $75,000 / $150,000
Tips / overtime deductions	$25,000 / $12,500 ($25,000 MFJ); phase-out over $150,000 / $300,000
AMT exemption	$88,100 / $137,000; phase-out 25% over $626,350 / $1,252,700; 28% above $239,100
NIIT and Additional Medicare thresholds	$200,000 single / $250,000 MFJ
Kiddie tax	Net unearned income over $2,700
Social Security wage base	$176,100
QBI thresholds	$197,300 / $394,600; ranges $50,000 / $100,000
§179	$2,500,000; phase-out over $4,000,000
Bonus depreciation	100% for property acquired after January 19, 2025
Excess business loss	$313,000 / $626,000
§448(c) gross receipts	$31,000,000
IRA / 401(k) / SIMPLE	$7,000 (+$1,000) / $23,500 (+$7,500; $11,250 at 60–63) / $16,500
Gift annual exclusion / basic exclusion	$19,000 / $13,990,000
Trust top bracket	37% over $15,650
Corporate rate	21%

Individuals (Chapters 1–6)

☐ I can list the major exclusions and their 2025 limits (dependent care, transit, educational assistance, FEIE, group-term life).

☐ I can compute taxable Social Security benefits using provisional income.

☐ I can compute ordinary income, basis and capital gain for NQSOs, ISOs (qualifying and disqualifying) and restricted stock with and without an §83(b) election.

☐ I can apply basis → at-risk → passive → excess business loss in order.

☐ I can compute the $25,000 rental allowance phase-out and know what frees suspended losses (sale, death, gift).

☐ I can compute regular tax with qualified dividends and LTCG stacked on top.

☐ I can compute the SALT cap phase-down, CTC phase-out and senior deduction phase-out.

☐ I can build the AMT computation and say which items generate a minimum tax credit.

☐ I can compute SE tax with and without W-2 wages, and half of SE tax.

☐ I can compute the QBI deduction below, inside and above the threshold range, and handle SSTBs.

☐ I can compute §179 limits, start-up cost deductions and know the 50% meals / no entertainment rules.

☐ I can compute IRA deduction and Roth contribution phase-outs.

☐ I can apply the 10% early-distribution exceptions (IRA-only vs. plan-only) and Roth ordering rules.

☐ I can compute the AOTC with phase-out and its refundable portion, and the taxable portion of a nonqualified 529 distribution.

☐ I can compute taxable gifts with gift splitting and exclusions for tuition and medical payments.

☐ I can compute the gross estate, taxable estate and estate tax, including adjusted taxable gifts.

☐ I can apply gift (carryover/dual) and inheritance (step-up) basis rules.

Entities (Chapters 7–13)

☐ I can reconcile book income to taxable income on Schedule M-1 and classify permanent vs. temporary differences.

☐ I can compute the DRD with the taxable income limit and the NOL exception.

☐ I can compute the 10% charitable limit and the 80% NOL limit.

☐ I can compute current E&P from taxable income.

☐ I can source multiple distributions (current E&P pro rata, accumulated E&P chronologically).

☐ I can compute a property distribution's effect on the corporation and the shareholder.

☐ I can test a redemption under §302(b) with §318 attribution.

☐ I know the consolidated return 80% vote-and-value test and intercompany deferral.

☐ I can list S corporation eligibility rules, election deadlines and termination events.

☐ I can allocate S corporation items per share per day.

☐ I can roll forward S corporation stock and debt basis in the correct order.

☐ I can apply AAA → E&P → basis → gain ordering and compute the built-in gains tax.

☐ I can compute a partner's initial basis with liabilities, including gain when liability relief exceeds basis.

☐ I can compute partnership ordinary business income and identify separately stated items.

☐ I can allocate §704(c) built-in gain to the contributing partner.

☐ I can roll forward a partner's outside basis.

☐ I can treat guaranteed payments correctly (deductible, ordinary SE income, not QBI).

☐ I can compute current and liquidating distribution results, including §732(c) basis allocation.

☐ I can compute gain on the sale of a partnership interest, split into §751 ordinary and §741 capital.

☐ I can compute a §743(b) adjustment and know when it is mandatory.

☐ I can compute DNI, the distribution deduction, beneficiary inclusion and trust taxable income and tax.

☐ I know the fiduciary exemptions ($600 / $300 / $100) and the 2025 trust brackets.

☐ I know §501(c)(3) requirements, Form 990 thresholds and the 27-month Form 1023 rule.

☐ I can compute UBTI with the silo rule, debt-financed income and the $1,000 specific deduction.

☐ I know private foundation excise taxes and §4958 intermediate sanctions.

Planning (Chapters 14–15)

☐ I can compare total tax under a C corporation vs. a pass-through for the same income.

☐ I can apply the §351 control test and know how service shareholders are treated.

☐ I can compute recognized gain, shareholder stock basis and corporate asset basis in a §351 exchange with boot and liabilities (§357(b), §357(c)).

☐ I can contrast §351 with §721.

☐ I know §1244 ordinary loss limits and the QSBS rules for stock issued before and after July 4, 2025.

☐ I can compute the double tax in a §331/§336 liquidation and apply the §336(d) loss limits.

☐ I know the §332/§337 subsidiary liquidation rules, including distributions to minority shareholders.

☐ I can identify reorganization types A–G and their consideration requirements.

☐ I can compute a shareholder's recognized gain and new basis in a reorganization with boot.

☐ I can compute the §382 annual limitation.

Property (Chapter 16)

☐ I can compute amount realized and adjusted basis.

☐ I can apply §1245, §1250 (unrecaptured gain) and §291 recapture.

☐ I can perform §1231 netting with the 5-year lookback.

☐ I can compute recognized gain and replacement basis in a §1031 exchange with cash and liabilities.

☐ I can apply §1033, §121 (including reduced exclusions) and the installment method.

☐ I can apply the related-party (§267) and wash sale (§1091) rules.

Filing deadlines at a glance (calendar-year filers)

Return	Due date	Extension
Form 1040	April 15	6 months
Form 1065 (partnership)	March 15	6 months
Form 1120-S (S corporation)	March 15	6 months
Form 1120 (C corporation)	April 15	6 months
Form 1041 (trust or estate)	April 15	5½ months
Form 990 series	May 15 (15th day of 5th month)	6 months
Form 709 (gift tax)	April 15	With Form 1040 extension
Form 706 (estate tax)	9 months after death	6 months
Form 2553 (S election for current year)	15th day of 3rd month	Late-election relief only
Form 966 (plan of liquidation)	Within 30 days of adopting the plan	—
§83(b) election	Within 30 days of transfer	None

The night before the exam

- Reread the **Key takeaways** at the end of each chapter.
- Review your one-page numbers sheet, especially the OBBBA changes for 2025 and which changes start only in 2026.
- Plan your time: about 1.5 minutes per MCQ, the rest for simulations.
- Sleep. A rested mind finds the trap answers faster than a tired one.

> **Exam tip:** On test day, when two answers look right, check which one uses the correct **year's** amount and the correct **order** of operations (basis before at-risk; current E&P before accumulated; distributions before losses). Those are the details the distractors are built on.

Now practice it

Every chapter in this guide has matching practice tests, simulations and mock exams at **UPractice.org**.