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2027 Personal Tax Planning Guide



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Introduction 2027

The KPMG 2027 Personal Tax Planning Guide (the Guide) aims to help you navigate the shifting landscape of US federal tax rules affecting higher-income taxpayers and their closely held businesses. Each chapter in the Guide includes a brief overview of tax rules and planning tips that might be relevant to you.

The Guide provides timely information and planning strategies to help you navigate the evolving landscape of US federal tax rules. This guide is designed to assist high-net-worth individuals, families, and their closely held businesses in making informed decisions in the current tax environment. The content herein is based on tax law in effect as of September 1, 2026.[1]

The new planning environment

Since the passage of the landmark "One Big Beautiful Bill Act" (OB3) in 2025, the tax conversation has shifted from anticipating legislative cliffs to implementing new strategies under a more stable framework. However, it is critical to remember that in the context of tax law, "permanent" simply means that there is no scheduled expiration date. Congress can change these laws at any time.

This reality underscores a key theme for this year: the wisdom of acting on clear opportunities as they exist today. The current environment, particularly with its historically high estate and gift tax exemptions, presents a valuable window to "strike while the iron is hot." Taxpayers should be proactive in capitalizing on these favorable provisions when appropriate, as they may not be available indefinitely.

The past year has been characterized by a wave of regulatory guidance from the Department of the Treasury (Treasury) and the Internal Revenue Service (IRS), providing clarity and uncovering new complexities in areas such as the modified state and local tax (SALT) deduction and the permanent 20 percent qualified business income deduction. Key developments critical for personal tax planning include:

- New regulatory guidance: Significant regulations have been issued interpreting key provisions of the OB3, particularly concerning the phase-down of the increased SALT deduction.
- Economic shifts: A changing economic environment, characterized by shifts in interest rates and market performance, has altered the effectiveness of certain long-standing estate and investment planning strategies.
- End of Deferral for Qualified Opportunity Zones (QOZ): All remaining gains previously deferred under the QOZ program must be recognized on December 31, 2026.
- Increased Gift/Estate and Generation-Skipping Transfer Tax Exemptions: Under OB3, the lifetime gift/estate and generation-skipping transfer tax exemptions were increased to $15 million per donor for 2026, with annual inflation adjustments beginning in 2027.
- Scrutiny of Qualified Small Business Stock (QSBS) Exclusion Stacking: The Treasury and the IRS have indicated an intent to study the use of trusts to multiply QSBS exclusion benefits and may potentially issue restrictive guidance; transfers of

[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended, or to the Treasury Regulations promulgated thereunder.

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QSBS to trusts for estate planning reasons may remain permissible but the specifics should be considered carefully.

Looking ahead

With the core components of the individual tax code now firmly established, sweeping reform appears unlikely in the immediate future. However, this stability does not preclude change. The legislative focus in Washington has pivoted to more targeted proposals, which could alter or eliminate specific planning opportunities currently available.

Prudent planning, therefore, involves a dual approach: implementing long-term strategies based on the current "permanent" law, while remaining nimble enough to react to future legislative shifts. We recommend that individuals consider acting to capitalize on today's opportunities and lock in the benefits of the current law, especially in their estate and gift planning.

At the same time, we also recommend that individuals watch legislative developments closely, as well as how political, economic, and other factors might affect tax policy, and be prepared to react quickly from a tax planning perspective. You can follow unfolding implementation of the new law, as well as future legislative developments by checking the KPMG LLP TaxNewsFlash and TaxNewsFlash Legislative Updates sites.

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Chapter 1

Individual income tax planning



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Tax rates for 2026

The United States imposes a progressive system of federal income tax with seven rate brackets that range from 10 percent to 37 percent. Originally enacted by the Tax Cuts and Jobs Act (TCJA), these brackets were made permanent by the OB3 and are indexed for inflation. The highest rate of 37 percent is applicable to individual income in excess of certain thresholds for 2026; those thresholds are $768,700 for married couples filing jointly, $640,600 for single taxpayers, $384,350 for married couples filing separately, and $640,600 for heads of household.

Because short-term capital gains (those earned on assets held for less than one year) are taxed as ordinary income, taxpayers subject to the 37 percent income tax rate will pay that rate on short-term capital gains.

Long-term capital gains are subject to tax at either 0 percent, 15 percent, or 20 percent depending upon a taxpayer's filing status and taxable income.

A series of tables detailing income tax rates for 2026 and 2025 and other key figures is included below.

Deductions, exemptions, and other threshold amounts	2025	2026
Standard deductions		
Single	$15,750	$16,100
Married filing joint return and surviving spouse	$31,500	$32,200
Married filing separate return	$15,750	$16,100
Head of household	$23,625	$24,150
Additional deduction for over 65 or blind		
Married or surviving spouse	$1,600	$1,650
Single or head of household	$2,000	$2,050
If taxpayer can be claimed as dependent of another, greater of ...	$1,350	$1,350
Or earned income plus	$450	$450
Personal exemptions (other than temporary senior deduction)[2]		
Single	N/A	N/A
Married filing joint return and surviving spouse	N/A	N/A
Married filing separate return	N/A	N/A
Head of household	N/A	N/A

[2] Suspended through tax year 2025 under the TCJA and permanently eliminated for years after 2024 under the OB3. See discussion later in this chapter regarding the new temporary deduction for seniors under the OB3.

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Deductions, exemptions, and other threshold amounts	2025	2026
Adjusted gross income limits for itemized deductions		
Casualty loss[3]	10%	10%
Medical expenses	7.5%	7.5%
Miscellaneous itemized deductions[4]	N/A	N/A
Alternative minimum tax exemptions		
Exemption amounts		
Married filing joint return or surviving spouse	$137,000	$140,200
Single or head of household	$88,100	$90,100
Married filing separate return	$68,500	$70,100
Child subject to "kiddie tax": earned income plus	$9,550	$9,750
Exemption phaseout equals 25 percent of alternative minimum taxable income less		
Married filing joint return or surviving spouse	$1,252,700	$1,280,400
Single or head of household	$626,350	$680,200
Married filing separate return	$626,350	$640,200
Excess taxable income above which 28 percent alternative minimum tax (AMT) tax bracket applies	$239,100	$244,500
Excess taxable income above which 28 percent AMT tax bracket applies for married filing separate return	$119,550	$122,250
Social Security taxes		
Maximum wage base[5]	$176,100	$184,500
OASDI rate	6.2%	6.2%
Medicare rate	1.45%	1.45%
Rate for compensation over threshold amount[6]	2.35%	2.35%
OASDI rate (self-employed)	12.4%	12.4%
Medicare rate (self-employed)	2.9%	2.9%
Rate for self-employment income over threshold[7]	3.8%	3.8%

[3] For years prior to 2026, the personal casualty loss deduction was only available for casualty losses incurred in a federally declared disaster but beginning in tax year 2026, the personal casualty loss deduction may also be available for certain state-declared disasters.

[4] Suspended through tax year 2025 under the TCJA and permanently eliminated for years after 2025 under the OB3 except for certain educator expenses. See discussion under "Educator expenses" below.

[5] US Social Security Administration, contributions and benefit base, https://www.ssa.gov/oact/COLA/cbb.html

[6] See discussion of 0.9 percent additional Medicare tax in Chapter 7, Calculating self-employment taxes.

[7] See discussion of 0.9 percent additional Medicare tax in Chapter 7, Calculating self-employment taxes.

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Capital gains

Tax rates on long-term capital gains and qualified dividends

2025	Single	Married filing jointly	Married filing separately	Head of household
0% if taxable income is less than	$48,350	$96,700	$48,350	$64,750
15% if taxable income is less than	$533,400	$600,050	$300,000	$566,700
20% if taxable income is over the above amounts				
2026				
0% if taxable income is less than	$49,450	$98,900	$49,450	$66,200
15% if taxable income is less than	$545,500	$613,700	$306,850	$579,600
20% if taxable income is over the above amounts				

Other capital gains	2025	2026
Unrecaptured depreciation on real estate	25%	25%
Most collectibles	28%	28%
Small business stock	28%	28%
Exclusion for gain on principal residence	$250,000	$250,000
Exclusion for gain on principal residence—married filing joint return	$500,000	$500,000



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2026 tax rate tables[8]

Married individuals filing separate returns	
If taxable income is	**The tax is**
Not over $12,400	10% of the taxable income
Over $12,400 but not over $50,400	$1,240 plus 12% of the excess over $12,400
Over $50,400 but not over $105,700	$5,800 plus 22% of the excess over $50,400
Over $105,700 but not over $201,775	$17,996 plus 24% of the excess over $105,700
Over $201,775 but not over $256,225	$41,024 plus 32% of the excess over $201,775
Over $256,225 but not over $384,350	$58,448 plus 35% of the excess over $256,225
Over $384,350	$103,291.75 plus 37% of the excess over $384,350

Married individuals filing joint returns and surviving spouses	
If taxable income is:	**The tax is:**
Not over $24,800	10% of the taxable income
Over $24,800 but not over $100,800	$2,480 plus 12% of the excess over $24,800
Over $100,800 but not over $211,400	$11,600 plus 22% of the excess over $100,800
Over $211,400 but not over $403,550	$35,932 plus 24% of the excess over $211,400
Over $403,550 but not over $512,450	$82,048 plus 32% of the excess over $403,550
Over $512,450 but not over $768,700	$116,896 plus 35% of the excess over $512,450
Over $768,700	$206,583.50 plus 37% of the excess over $768,700

Unmarried individuals (other than surviving spouses and heads of households)	
If taxable income is:	**The tax is:**
Not over $12,400	10% of the taxable income
Over $12,400 but not over $50,400	$1,240 plus 12% of the excess over $12,400
Over $50,400 but not over $105,700	$5,800 plus 22% of the excess over $50,400
Over $105,700 but not over $201,775	$17,966 plus 24% of the excess over $105,700
Over $201,775 but not over $256,225	$41,024 plus 32% of the excess over $201,775
Over $256,225 but not over $640,600	$58,448 plus 35% of the excess over $256,225
Over $640,600	$192,979.25 plus 37% of the excess over $640,600

[8] These tables are based on information in Rev. Proc. 2025-32.

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Heads of households	
If taxable income is:	**The tax is:**
Not over $17,700	10% of the taxable income
Over $17,700 but not over $67,450	$1,770 plus 12% of the excess over $17,700
Over $67,450 but not over $105,700	$7,740 plus 22% of the excess over $67,450
Over $105,700 but not over $201,750	$16,155 plus 24% of the excess over $105,700
Over $201,750 but not over $256,200	$39,207 plus 32% of the excess over $201,750
Over $256,200 but not over $640,600	$56,631 plus 35% of the excess over $256,200
Over $640,600	$191,171 plus 37% of the excess over $640,600

Determining your filing status

One of the first considerations when you file your tax return is designating your filing status. Although this selection may seem straightforward, in some instances, you have choices. The filing statuses are single, married filing jointly, married filing separately, head of household, and qualifying surviving spouse.

Filing single

Individuals who were never married or were divorced on December 31 may file a single return. Individuals who were widowed before January 1 and did not remarry before December 31 may file a single return but under certain circumstances may qualify to file as a qualifying surviving spouse as discussed later in this section.

Filing jointly or separately

Married individuals must file as either married filing jointly or married filing separately. Marital status is determined as of the last day of the tax year; if individuals are married on the last day of the year, they are treated as married for the whole year. When divorce proceedings have been initiated, individuals are treated as still married until a final decree of divorce has been issued; couples who are living apart under an interlocutory decree are treated as still married.

To file a joint return, both spouses must generally be US citizens or residents for the entire year. Otherwise, married-filing-separately status must be used. Certain elections are available to enable filing a joint return for a couple who would not otherwise qualify because either spouse was not a full-year US resident.

The changes introduced by the TCJA for tax years 2018 through 2025 substantially reduced the impact of the "marriage penalty," which, in certain situations, had the effect of causing two individuals to pay more tax as a married couple than they would have had they remained unmarried. The OB3 makes the regular income tax rate schedules enacted by the TCJA permanent, thus keeping the substantially reduced impact of the "marriage penalty" intact.

Under the prior law, a couple filing their return as married filing jointly would pay more income tax than they would as two single individuals. This was because the tax rate brackets applicable to married couples filing jointly were less than double the tax rate brackets for single individuals. Because the income tax rates enacted by the TCJA were made permanent, except for the top tax bracket, the married-filing-jointly tax brackets are double the single tax brackets, and for 2026, the marriage penalty will only apply to couples whose combined taxable income exceeds $768,700.

Instead of filing a joint return, you and your spouse may file separate returns on which you would each report only your own income and claim only your own deductions and exemptions. If married, then you should compute your tax liabilities both jointly and separately to determine which method will result in less tax.

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Planning tip

If you file separately, then you may not claim certain benefits, including the American Opportunity Tax Credit and the Lifetime Learning Credit. In addition, other benefits, such as the child and dependent care credit and the earned income credit, may be disallowed unless special "considered unmarried" tests are met. You cannot take a deduction for student loan interest, and your ability to contribute to a Roth Individual Retirement Account (IRA) may also be limited.

All of these factors should be taken into consideration by married individuals in deciding whether to file jointly or separately. Once you file a joint return, you can't choose to file separate returns for that year after the due date of the return. Instead of filing a joint return, you and your spouse may file separate returns on which you would each report only your own income and claim only your own deductions and exemptions. If married, then you should compute your tax liabilities both jointly and separately to determine which method will result in less tax.

Filing as head of household

Individuals who qualify to file as "head of household" are entitled to a higher standard deduction and lower tax rates than individuals who file using single status, although the difference in tax rates between single and head of household status will be significantly less now than it was in previous years.

The conditions for qualifying as head of household are:

- You must be unmarried (or treated as unmarried) and not a surviving spouse at the end of the tax year.
- Your home must serve as the principal place of abode for more than half of the year for either an unmarried child, grandchild, or stepchild; a married child, grandchild, or stepchild who qualifies as a dependent; or another relative who qualifies as a dependent.
- You must contribute more than half of the cost of maintaining the household, including property taxes, mortgage interest, rent, utility charges, upkeep charges, property insurance, domestic help, and food. These costs do not include clothing, education, medical and transportation expenses, vacations, or life insurance.

Filing as qualifying surviving spouse

If you are a widow or widower, then you may file a joint return with your deceased spouse for the year in which he or she died, provided that you do not remarry within that year. If you do remarry within that time, then you may file jointly with your new spouse if all other requirements are met.

Generally, a qualifying surviving spouse with a dependent child is entitled to file a return using the tax tables and standard deduction (if deductions are not itemized) for joint filers for the two years following the year in which his or her spouse died.

Income tax deductions

Personal exemptions

The TCJA suspended the deduction for personal exemptions, and beginning with the 2025 tax year, the OB3 permanently reduces the amount of the personal exemption to $0. For some taxpayers, this will be offset by other TCJA and OB3 changes, including the significant increase in the amount of the standard deduction, the increase in the child tax credit, and an additional provision for a $500 nonrefundable credit for dependents other than qualifying children. The child tax credit is explained in greater detail in Chapter 4.

Standard deduction

The standard deduction is a specified dollar amount, based on your filing status, that reduces the income on which you are subject to tax. In general, taxpayers can choose whether to claim the standard deduction or itemized deductions (as discussed below). However, you are not entitled to the standard deduction if you:

1. Are a married taxpayer who files separately and whose spouse itemizes deductions,
2. Are not a US citizen or resident for the full year,
3. File for a period of less than 12 months due to a change of accounting period.

The standard deduction amounts for all categories of taxpayers were significantly increased by the TCJA. In addition to making those increases permanent, the OB3 also modified the cost-of-living adjustment for the standard deduction. For 2026, the standard deduction is:

- $16,100 for a taxpayer filing as single or married filing separately
- $24,150 for a taxpayer filing as head of household
- $32,200 for taxpayers filing as married filing jointly and surviving spouses.

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The increase in the standard deduction introduced by the TCJA, in conjunction with the repeal of many itemized deductions (as discussed below), was intended to significantly reduce the number of taxpayers who itemize their deductions and, thus, to simplify the tax return preparation process.

Deductions for the elderly or blind

An additional standard deduction is available to taxpayers who are elderly or blind. The additional deduction amounts are $2,050 for single filers and heads of household and $1,650 for married taxpayers (whether filing jointly or separately) and qualifying surviving spouses. These additional amounts are cumulative. Thus, married taxpayers filing jointly who are both over 65 and blind could claim four additional deduction amounts.

Temporary deduction for seniors

A new deduction for seniors of $6,000 for each "qualified individual" was added by the OB3. A "qualified individual" is a taxpayer who has attained age 65 prior to the close of the tax year. The deduction begins to phase out when modified adjusted gross income (AGI) exceeds $75,000 ($150,000 for married filing jointly) and is fully phased out when modified AGI reaches $175,000 ($250,000 for married filing jointly). Married individuals must file jointly to claim this deduction. This new deduction is available for tax years 2025 through 2028.

Itemized deductions

The TCJA made significant changes to the scope of itemized deductions available to individual taxpayers. Under prior law, many individual taxpayers were able to claim itemized deductions to decrease their taxable income. The 2017 law contained a number of provisions that suspended or modified these deductions and many of these suspensions and modifications become permanent under the OB3. As a result, many taxpayers who previously itemized their deductions may now find it more beneficial to claim the standard deduction.

State and local income tax deductions

Under the 2017 law, for tax years 2018 through 2025, itemized deductions for state and local income taxes, property taxes, and sales taxes were limited to $10,000 in the aggregate. Beginning with the 2025 tax year, the OB3 increased this limitation to $40,000 ($20,000 for married filing separately) subject to phase-down based on modified AGI. The SALT deduction is reduced by 30 percent of the excess of modified AGI over a specified threshold, which is $505,000 ($252,500 for married filing separately) for 2026, but will not be reduced below $10,000 ($5,000 for married filing separately). Both the SALT limitation and the modified AGI threshold increase by 1 percent each year for tax years 2026 through 2029. The SALT limitation and the modified AGI threshold for the 2026 tax year are $40,400 and $505,000, respectively. For tax years 2030 and beyond, the limitation reverts to $10,000 and is not subject to a phase down. The SALT limitation does not apply to personal or real property taxes incurred in carrying on a trade or business or otherwise incurred for the production of income.

In addition, foreign real property taxes, other than those incurred in a trade or business (such as a rental activity), are not deductible to any extent.

Prior to the TCJA and the OB3, state and local property taxes and either state and local income or sales taxes were generally deductible in full (subject to the phaseout applicable to taxpayers whose income exceeded prescribed thresholds) and constituted some of the most significant reductions to taxable income.

The TCJA cap on such deductions caused many individuals to claim the standard deduction rather than itemizing. While the cap has been significantly increased, the full benefit of the increase may not be received due to the phase down as well as the new limitation on itemized deductions (as discussed below). In addition, the SALT deduction is an add-back for AMT purposes that could further impact the potential benefit of the increased limitation.



Planning tip

In response to the $10,000 limitation for the SALT deduction, a majority of states have enacted legislation that potentially bypasses the limitation by way of elective income taxes that are imposed directly on pass-through entities and, correspondingly, provide the owners of these pass-through entities with a tax credit or deduction that acts to fully or partially mitigate the additional expense of the pass-through entity tax. There are 37 states with elective pass-through entity taxes that have been enacted since the TCJA.

Interest deductions

Interest deductions fall into one of five categories—investment interest, home mortgage interest, trade or business interest, passive activity interest, or personal interest—depending on the context in which you borrow the funds or the manner in which you use the

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proceeds. To maximize the tax benefit of your interest deduction, you must understand the type of interest expense for which you are planning.

Depending on how you characterize interest, you may be subject to different deduction limitation rules and various restrictions.

If you report your income on a cash basis (as most individuals do), then you may not deduct any accrued but unpaid interest. Likewise, you normally cannot deduct interest paid before it is accrued (prepaid interest).Under most circumstances, you may defer an interest expense deduction until you pay the interest.

Investment interest

Investment interest, as a rule, is any interest you incur to buy or carry investment property—property that produces portfolio-type income such as dividends, interest, annuities, and royalties not derived in the ordinary course of a trade or business. You cannot deduct more than your net investment income (investment income less investment expense). Investment interest that is not fully deductible in the current year may be carried over to the following year and remains subject to the limitation of net investment income.



Home mortgage interest

The TCJA made significant changes to the deductibility of home mortgage interest that are especially likely to affect you if you purchased a new home during the years 2018 through 2025 and incurred a mortgage to finance the purchase.

Prior to the TCJA, qualified residence interest could be claimed as an itemized deduction, subject to certain limitations. Qualified residence interest included interest paid on debt incurred to acquire, construct, or substantially improve your principal or second residence (acquisition indebtedness) and also interest on home equity indebtedness, without regard to how the proceeds of the home equity debt were used (except for purposes of the AMT).

Pre-TCJA, qualified residence interest was deductible on up to $1 million of acquisition indebtedness. For tax years 2018 through 2025, interest on acquisition indebtedness remained deductible, but the amount of debt that qualified as acquisition indebtedness was reduced from $1 million to $750,000 ($375,000 for married filing separately). Under the OB3, the $750,000 limitation on debt qualifying as acquisition indebtedness becomes permanent. In addition, beginning in 2026, the new law classifies certain mortgage insurance premiums as qualified residence interest that could potentially increase the amount of your home mortgage interest deduction.

Any debt you may have incurred before December 15, 2017 is "grandfathered" and, thus, not affected by the reduction. Also, any debt you may have incurred before that date but refinanced later continues to be covered by the prior rules, provided the amount of the refinanced debt does not exceed the mortgage balance at the time of the refinancing.

If your debt is grandfathered and you are considering moving from your home and financing the purchase with a new mortgage, then the reduced deduction for home mortgage interest may affect you.

Interest on home equity loans may also be deductible, but the amount of the loan is subject to the thresholds discussed above. Additionally, the proceeds of the home equity loan must be used to buy, build, or substantially improve the home that is securing the loan. Interest on a home equity loan that was used for personal expenses, such as vacation expenses or to pay off a credit card balance, is not deductible. See Chapter 2 for a discussion of a range of home ownership issues, including the mortgage interest deduction, home sales, rentals, and like-kind exchanges.

Trade or business interest

In most instances, you may deduct interest you incur in connection with a trade or business. However, the TCJA contained provisions that may disallow all or a portion of such business interest expense.

You also may be able to deduct interest expense related to amounts you borrow personally and contribute to a trade or business. However, you must trace the indebtedness to the trade or business using the interest allocation rules. To the extent you do not materially participate in the trade or business, the deductions may be suspended under the passive loss rules (see Chapter 2 for further discussion of passive activity rules and interest deductions).

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Planning tips

If you are considering buying a residence and you have outstanding personal loans, then you may find it advantageous to finance as much of the purchase price as possible, reserving more of your own funds to pay off your personal loans. You may not deduct any of the interest you pay on personal loans. This approach may reduce the effective interest rate that you are paying if it results in a reduction of your nondeductible interest and an increase in your deductible interest. Caution: Taking out a larger mortgage than necessary is not advisable unless you currently have nondeductible interest. In most cases, it is difficult to invest the excess mortgage proceeds in an investment that has a higher after-tax yield than the after-tax rate on the mortgage.

Keep careful records of improvements to your home. The cost of substantial improvements can be financed through mortgage indebtedness and also can be added to the cost basis of your home when you sell, possibly decreasing the taxable gain at that time.

Passive activity interest

A passive activity is any business activity in which you do not materially participate. Most rental activities are also considered passive activities. Deductions for passive losses are limited to passive income. Special rules apply for taxpayers who perform more than half their personal services and more than 750 hours of such services for real property trades or businesses in which they materially participate (see Chapter 2 for further discussion of passive activity rules and the exception applicable to real estate professionals).

Personal interest

Personal interest is any interest that does not fall into one of the other four categories. This includes interest on credit cards, personal loans, automobile loans, and tax underpayments. You cannot deduct your personal interest expenses (except for the temporary "above the line deduction" on certain automobile loans as discussed below). Interest on qualified education loans is deductible, subject to certain limitations.

Keeping track of loan proceeds

As a general rule, how and when you spend the proceeds of a loan will determine whether you receive a deduction. When you use the proceeds of a loan for multiple purposes, you must trace the amounts and allocate them accordingly. The burden of proof on tracing loan proceeds is on you—the taxpayer.

Medical expense deductions

Generally, you may deduct unreimbursed medical expenses that exceed 7.5 percent of your AGI in 2026.

You may also deduct expenses you paid for medical care of a child who receives more than half of his or her support from you.

Deductible medical expenses include certain items specifically prescribed for a medical or physical purpose by a doctor (e.g., the cost of a diet and exercise program undertaken on the advice of a physician for treatment of high blood pressure). Generally, you cannot take a deduction for cosmetic surgery, and reimbursements by your employer for such surgery are taxable. However, the expense of surgery to correct a congenital deformity, a disfiguring personal injury, or disease remains deductible.

Moving expense deductions

For most taxpayers, the deduction for moving expenses was suspended by the TCJA for tax years 2018 through 2025. The OB3 made the TCJA change permanent. However, the TCJA provided that certain qualifying military members may still be eligible to claim a moving expense deduction. Under the OB3, in addition to military members, certain members of the intelligence community (e.g., the Central Intelligence Agency or National Security Agency) may now be eligible to claim a moving expense deduction.

This deduction, which was allowed "above the line" and therefore available to individuals regardless of whether they itemized their deductions, was a significant benefit to employees who moved to a new place of work. If you have moved to a new place of work or plan to do so, then you (and your employer) should be aware that any moving expenses you pay are not deductible, and any reimbursement of such expenses from your employer is not excludable from your income.

Miscellaneous itemized deductions

The TCJA suspended the deduction for miscellaneous itemized deductions for tax years 2018 through 2025. Previously, miscellaneous itemized deductions included deductions for expenses of unreimbursed

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employee travel and transportation, meals and entertainment, certain job-related uniforms and tools, dues to professional organizations, subscriptions to professional journals, job-hunting costs, and professional tax return preparation.

In addition, the deduction for expenses paid or incurred for the production of income or maintenance of income-producing property is suspended These expenses include certain investment fees; subscriptions to investment publications; safe deposit box rental; and certain legal, accounting, and custodial fees.

Educator expenses

The OB3 makes the temporary suspension of miscellaneous itemized deductions permanent but removes certain unreimbursed employee expenses for eligible educators from the list of miscellaneous itemized deductions. Under the new law, beginning in 2026, eligible educators will be permitted to claim an itemized deduction for unreimbursed employee expenses such as books, supplies, computer equipment, and supplementary materials used for instructional activity as well as certain professional development expenses incurred by the educator. This itemized deduction is separate from the $350 "above the line" deduction that is allowable to eligible educators. This new itemized deduction may be beneficial for educators who have significantly more than $350 of out-of-pocket education expenses and are already itemizing deductions because of other items such as mortgage interest, state taxes, or charitable contributions.

Employee education expenses

Under prior law, it was possible to deduct education expenses, including tuition, books, supplies, transportation, and parking, provided they maintained or improved your skills in a job you already had or enabled you to satisfy express requirements for keeping an existing job. Away-from-home expenses incurred in pursuit of such studies could also be deducted.

The TCJA suspended the deduction for these expenses as miscellaneous itemized deductions for the 2018 through 2025 tax years. The OB3 makes the suspension permanent beginning in the 2026 tax year. However, if your employer pays the expenses or reimburses you for expenses that you substantiate under an accountable plan, then your employer can exclude this amount from your income reported on Form W-2.

Phaseout of itemized deductions

Before the TCJA, allowable itemized deductions (with the exception of medical expenses, investment interest, and theft or gambling losses) were subject to phaseout for taxpayers whose income exceeded certain thresholds (referred to as the "Pease limitation").

The TCJA abolished this limitation on itemized deductions for tax years 2018 through 2025, but the Pease limitation was scheduled to resume for the 2026 tax year. The OB3 replaces the Pease limitation with a new limitation that is effective beginning with the 2026 tax year. The new limitation reduces the amount of otherwise allowable itemized deductions (other than medical expenses; investment interest; and casualty, theft, or gambling losses) by 2/37 of the lesser of allowable itemized deductions or the amount that your taxable income (without regard to itemized deductions) exceeds the threshold at which the top tax bracket of 37 percent applies.

Above-the-line deduction for auto loan interest

The OB3 provides a new, but temporary, deduction for interest on certain car loans. A deduction may be taken in tax years 2025 through 2028 for interest paid on loans to purchase qualified personal passenger vehicles. To qualify for the deduction, the loan must be for a car, minivan, van, SUV, pickup truck, or motorcycle purchased after December 31, 2024, and the vehicle's final assembly must occur in the United States. In addition, the vehicle's original use must start with you (used vehicles do not qualify) and be for your personal use. The deduction is limited to $10,000 per year and begins to phase out when modified AGI exceeds $100,000 ($200,000 for married taxpayers filing jointly). Since the deduction is "above the line," it is available for taxpayers even if they do not elect to itemize deductions on their tax return.

Alternative minimum tax

The AMT is a separate and parallel tax system originally introduced to target taxpayers who might otherwise pay little or no regular tax because of the use of certain deductions.

The 2017 tax law significantly increased the exemption amounts and the phaseout thresholds for AMT. Effective for the 2026 tax year, the OB3 makes the increased exemption amounts permanent but reverts the exemption phaseout thresholds to the 2018

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amounts of $500,000 ($1 million for married filing jointly) indexed for inflation. Additionally, the OB3 makes modifications to inflation indexing that take effect in tax year 2027 and are expected to result in lower phaseout thresholds for taxpayers filing joint returns than what would have occurred if the TCJA had been extended or made permanent without the OB3 inflation modifications.

For 2026, the exemption and phaseout thresholds, indexed for inflation, are as follows:

- For married taxpayers filing jointly, the exemption amount increased from $137,000 to $140,200, and the phaseout threshold increased from $1,252,700 to $1,280,400.
- For married taxpayers filing separately, the exemption amount increased from $68,500 to $70,100, and the phaseout threshold increased from $626,350 to $640,200.
- For all other individuals, the exemption amount increased from $88,100 to $90,100, and the phaseout threshold increased from $626,350 to $680,200.

Certain situations, including the exercise of incentive stock options (ISOs), can trigger AMT liability for taxpayers who would not ordinarily be subject to it.

Your alternative minimum taxable income, less any applicable AMT exemption, is multiplied by 26 percent and reduced, within certain limitations, by any allowable foreign tax credit. The AMT rate increases to 28 percent for married taxpayers filing separately with AMT income in excess of $122,250 and for all other taxpayers whose AMT income exceeds $244,500. If the resulting minimum tax exceeds your regular tax, then you are subject to an AMT liability equal to the difference.

The 3.8 percent tax on an individual's net investment income—also known as the "net investment income tax," discussed in Chapter 2—is not taken into consideration in determining whether, and how much, AMT liability is imposed.

Minimum tax credit

If you have an AMT liability because of certain deductions or credits not fully allowed for AMT (nonexclusion preferences), then you may be able to use the minimum tax credit to decrease your regular tax liability in a later year. In most cases, this credit reduces the impact of the AMT by effectively refunding some or all of the AMT paid in prior years. Thus, in some cases, AMT planning may be a matter of timing—payment of AMT now and reduction of regular tax in the future.

Estimated taxes

Generally, you must pay estimated tax in equal installments on a quarterly basis unless you have a sufficient amount of taxes withheld from your compensation. If you underpay any installment, then you may be subject to a penalty, even though your total estimated tax payments for the year are adequate.

For calendar-year taxpayers, the due dates for making quarterly estimated tax payments are April 15, June 15, September 15, and January 15 of the following year. If the due date for an estimated payment falls on a Saturday, Sunday, or legal holiday, then the payment is due on the next day that is not a Saturday, Sunday, or legal holiday.

Planning tips

As a result of the significant increases in the AMT exemption amounts and the raising of the phaseout threshold, fewer individuals may find themselves paying AMT as compared to prior years.

If you are paying AMT as a result of exclusion preferences such as itemized deductions that are disallowed for AMT purposes (which do not generate a minimum tax credit), then you should consider whether it is advantageous to accelerate income or defer deductions to "bunch" them into one year.

Your expected future regular tax rate and whether or not you will continue to be subject to AMT should be considered in making that determination.

When you exercise an ISO, you create an AMT adjustment that in turn increases your potential exposure to the AMT. You may want to avoid exercising ISOs if you are, or are close to being, subject to the AMT. Alternatively, you may choose to exercise only the amount of ISOs that will result in no AMT liability. In some cases, it may make economic sense to exercise ISOs and sell the stock in the same year to negate the effect of the AMT adjustment.

Consult your tax adviser to ensure you properly evaluate all scenarios.

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The underpayment penalty will not be imposed if you pay at least 90 percent of your tax liability through withholding or timely quarterly estimated tax payments. Tax liability for this purpose includes not only the regular income tax but also any liability for AMT, self-employment tax, household employment tax, the additional 0.9 percent Medicare tax on compensation above $200,000 for single or married-filing-separately filers and above $250,000 for married filing jointly filers, and the 3.8 percent tax on an individual's net investment income.

This penalty will not be applicable if your tax liability, reduced by withholding and estimated tax payments, is less than $1,000. Additionally, except for certain high-income taxpayers (as explained below), you will avoid a penalty if your current-year estimated tax payments or withholding is at least equal to the tax liability shown on your preceding-year return,provided your preceding-year return covered a full tax year. You generally do not have to make estimated tax payments for the current year if you are a US citizen or resident who filed an income tax return for the preceding year but had no tax liability. If your 2026 AGI exceeded $150,000 ($75,000 for married individuals filing separately), then your 2027 estimated tax payments or withholding must equal at least 110 percent of your prior-year tax liability, instead of the 100 percent required for other taxpayers.

Planning tips

- Note that no penalty will be imposed for failure to make the fourth quarter estimated tax payment if you file your tax return on or before January 31 and pay the balance of the tax due by that date.
- Make quarterly "annualization" calculations if you are subject to these rules (i.e., you do not receive your income evenly throughout the year). This method will help you determine the minimum payments required to avoid a penalty. When an annualization method is used for a quarter, the estimated payment must be increased by any shortfall that resulted in prior quarters from the method used in those quarters. Making estimated tax payments based on annualized income may be particularly appropriate if you expect to receive significant income later in the tax year (e.g., if you receive commissions or bonuses near the end of the calendar year).
- You can reduce or eliminate an underpayment of estimated tax by making an additional payment at any time during the year. Alternatively, you can request that your employer withhold additional tax from your wages for the remainder of the year. Any additional withholding tax will be treated as having been paid equally throughout the year for purposes of determining the underpayment penalty. If you choose this option, then your increased withholding will continue until you notify your employer to revise the amount.
- Plan appropriately so that you do not significantly overpay your taxes. Overpayments are essentially interest-free loans to the government, and such amounts, although returned, are dollars not working for you in the interim. To avoid overpayments, calculate your estimated payments and withholding exemptions carefully, adjusting them if your circumstances change.
- If you are required to make estimated payments, then it may be preferable to make the payments instead of increasing the amount of withheld tax since the payments are made later than the withholding. However, increasing your withholding amount may be preferable if you have underpaid your quarterly estimated tax payments, as the withheld amount is assumed to have occurred evenly throughout the year.
- Caution: If you receive taxable fringe benefits, such as imputed income from group term life insurance or the use of your employer's automobile for personal purposes, be careful to consider the effect of this additional compensation on your total tax liability. Your employer may not have withheld income tax or may have withheld tax at the rate, which normally applies to supplemental wages, of 22 percent. Whatever your employer's practice, it is your responsibility to make proper estimated tax payments.

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Chapter 2

Investment-related tax issues



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Net investment income tax

Individuals, estates, and trusts with income above certain thresholds are subject to an additional 3.8 percent tax—also known as the "net investment income tax" (NIIT)—on their net investment income, which includes:

- Most interest, dividends, annuities, royalties, and rents
- Income from the business of trading in financial instruments and commodities (trading business)
- Income from a trade or business that is a passive activity as defined in the Internal Revenue Code
- Net gain from the sale of all property other than property held in a trade or business in which the owner materially participates (other than a trading business).

Certain expenses and losses that are allowed as a deduction for income tax may also be allowed as deductions in determining the amount of net investment income. The tax on net investment income is not subject to withholding but should be considered in determining the amount of your estimated tax payments.

The following items of income and gain are excluded from net investment income:

- Income from self-employment that is subject to self-employment tax
- Wages that are subject to federal payroll taxes
- Tax-exempt income (such as municipal bond interest)
- Income of nonresident aliens
- Distributions from qualified retirement plans
- Income and gain from a trade or business in which the owner materially participates.

Generally, portfolio income and passive investment-type income are included as net investment income, but if an individual, estate, or trust is sufficiently involved in the operations of a trade or business, then the income and gain from that business are generally excluded from net investment income even if they are not otherwise subject to self-employment or federal payroll taxes.

If you or your S corporation or partnership own portfolio investments such as stock in a C corporation or debt securities, then your share of the income from the investments and gain or loss on sale of the investment assets is net investment income. If you own rental property, then the rental income and gain on the sale of the property are generally net investment income. There are very limited exceptions under the passive loss rules that may result in exclusion of some rental income and gain on the sale of rental assets from net investment income.

Income and gain from stock in a controlled foreign corporation (CFC) or a passive foreign investment company (PFIC) will generally be included in net investment income, but the timing of the inclusion may vary from the general rules applicable to CFCs and PFICs.

Planning tip

- If you own a trade or business directly or through an S corporation or a partnership, then your income and gain on the sale of the business assets are net investment income unless you materially participate in the trade or business under the passive activity rules. You should consider grouping your trades or businesses. See the discussion under "Understanding passive activity rules" for additional information.
- Be sure to consider the tax on your net investment income when making estimated tax payments.

Gains and losses from the sale of capital assets

Almost everything you own and use for investment and for personal purposes (i.e., not for trade or business) is a capital asset. For example, if you own shares in Company X, then those shares are capital assets. If you were to sell those shares (or any other capital asset), then the resulting gain or loss from the sale would be either a capital gain or capital loss.

A capital gain occurs when you sell a capital asset for more than its basis (generally, the cost of the asset), and a capital loss occurs when you sell a capital asset for less than its basis. If you purchased 500 shares of Company X for $1 per share, then your basis in each share would be $1. If you were to sell those 500 shares for $2 per share, then the $500 in "profit" from the

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sale would be a capital gain. Alternatively, if you sold those same 500 shares for $0.50 per share, then the $250 loss would be a capital loss.

Capital gains and capital losses are either short term or long term, depending upon the length of time you held the capital asset prior to selling it. A capital gain or loss is short term if you held the capital asset for one year or less. If you have held an asset for more than one year, then any capital gain or loss would be long term.

Whether a capital gain or loss is classified as short term or long term can have significant tax implications. Whereas a short-term capital gain is taxed as ordinary income, a long-term capital gain is taxed at a preferential rate lower than your ordinary income tax rate. Long-term capital gains are subject to tax at either 0 percent, 15 percent, or 20 percent, depending upon your filing status and taxable income. See the table in Chapter 1 for the income levels at which the different long-term capital gain rates apply.

If you sold multiple capital assets during the course of a tax year, then it is likely that some of your transactions resulted in losses and others in gains and that some of these gains or losses were short term while others were long term.

To determine the tax impact of your capital transactions, you must first net your short-term gains against your short-term losses and your long-term gains against your long-term losses.



If you have both a net short-term gain and a net long-term gain:

- The short-term gain is taxed as ordinary income at your marginal rate.
- The long-term gain will be taxed at a preferential rate.

If you have both a net short-term loss and a net long-term loss:

- You can deduct up to $3,000 ($1,500 if married filing separately) on your tax return.
- If your total loss is more than $3,000 ($1,500 if married filing separately), then the excess loss can be carried over to the next year.

If you have a net short-term loss and a net long-term gain, net the two positions:

- If the gain is bigger than the loss, then you have a long- term gain, which is taxed at the preferential rate.
- If the loss is bigger, then you have a net short-term loss, of which you can deduct up to $3,000 ($1,500 if married filing separately) and carry forward any excess to the next year as a short-term capital loss carryforward.

If you have a net short-term gain and net long-term loss, net the two positions:

- If the gain is bigger than the loss, you have a short-term gain, which is taxed as ordinary income at your marginal rate.
- If the loss is bigger, you have a long-term loss, of which you can deduct up to $3,000 ($1,500 if married filing separately) and carry forward any excess to the next year as a long-term capital loss carryforward.

If you purchased all 500 shares of Company X stock at the same time and sold them all at the same time, then determining whether you have a capital gain or capital loss and whether your gain/loss is short term or long term is straightforward. But what if you purchased half of the shares on January 1 of last tax year for $1, and the other half on January 1 of the current tax year for $2, and sold 100 shares today for $1.50? How do you determine whether you have a gain or loss on the sale and whether that gain or loss is long term or short term? That all depends upon the

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cost basis method you tell your broker to use.

Each time you purchase shares of stock (regardless of the number of shares you purchase or the amount of time in between purchases), your broker assigns your purchase a unique tax lot ID. When you sell shares of stock, your broker uses this tax lot ID to determine the basis of the sale. This determination is often based upon the default cost basis method used by your broker. By default, most brokers use the first in, first out (FIFO) cost basis method, which means that the oldest shares are treated as being sold first. If, in the above example, your broker employed the FIFO cost basis method, then 100 of the 250 shares of stock in Company X that you purchased for $1 would have been sold for $1.50, resulting in a long-term capital gain of $50. However, you are not limited to the default cost basis method selected by your broker. You may instruct your broker to use an alternative cost basis method or select specific tax lots to sell. In this way, you can exercise a large degree of control over your yearly short- and long-term capital gains and losses.

Not all losses from the sale of stocks or securities may be deducted in the year the loss is realized. Under the so-called "wash sale rules," a loss on the sale of stock or securities is disallowed if you purchase substantially identical stock or securities or enter into a contract or option to acquire substantially identical stock or securities, within the 61-day period straddling the sale date (i.e., the period starting 30 days before the sale date and ending 30 days after the sale date). Any loss disallowed under the wash sale rules is added to the basis of the replacement position, and the holding period of the replacement position is also increased by the holding period of the loss position. Thus, the wash sale rules generally result in a temporary deferral of the loss.

Brokers generally apply the wash sale rules when reporting gains and losses on a Form 1099-B; however, the broker's application of the wash sale rules may be different than the substantive rules in certain cases (e.g., a broker is only required to consider positions held in a particular account and is not required to treat options as creating wash sale transactions). As a result, you may be required to make adjustments to broker-reported gains and losses on your tax return.

If certain requirements are met, then taxpayers may be eligible to exclude capital gains resulting from the sale of qualified small business stock (QSBS). There are requirements on both the issuer and the investor side that must be met in order to take advantage of the QSBS gain exclusion. On the issuer side, the company must be a C corporation so stock issued by S corporations would not be eligible. In addition, there are restrictions on the types of trades or businesses that qualify and there are dollar limitations on the company's assets. Any type of shareholder, other than a C corporation, can qualify for the exclusion, if all of the issuer and shareholder requirements are met. Prior to the OB3, no gain exclusion was available if the QSBS had not been held for at least five years. The new law provides for the exclusion of 50 percent of the gain on QSBS held for at least three years, exclusion of 75 percent of the gain on QSBS held for at least four years, and a 100 percent exclusion of the gain on QSBS held for at least five years. In addition, the new law increases the per-issuer limitation and the gross assets threshold for a corporation's stock to qualify as QSBS. Under the new law, more businesses can satisfy the QSBS requirements, and more taxpayers can benefit from QSBS dispositions, even if it is only a partial benefit.

Planning tips

- Analyze your current capital gains and capital loss carryforwards to ensure you are aligning them to the fullest extent possible.
- Consider selling assets in taxable accounts that have losses at the end of the year to offset capital gains and potentially offset $3,000 of ordinary income.
- Consult your tax adviser to determine which cost basis method optimizes your capital gains and losses.

Home ownership

You may fully deduct mortgage interest paid on your principal residence and a second residence to the extent that:

1. You use the mortgage proceeds in the acquisition, construction, or substantial improvement of the residence
2. The total indebtedness does not exceed $750,000 (or $1 million if the mortgage debt was incurred before December 15, 2017, or if you entered into a written binding contract before December 15, 2017, to close on the purchase of a principal residence before January 1, 2018, and you purchased the residence before April 1, 2018).

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Prior to 2018, you were able to deduct the interest paid on a home equity loan secured by your residence of up to either $100,000 or the value of your home reduced by any outstanding mortgage, whichever was less. Interest on home equity indebtedness was excluded from the definition of "qualified residence interest" and was not deductible for tax years 2018 through 2025 under the TCJA. The deduction is now permanently disallowed under the OB3. However, if you used the proceeds from your home equity loan to acquire, construct, or substantially improve your home, then the interest payments may still be deductible subject to the limitations discussed above.

If you refinance your mortgage, then you can continue to deduct the interest on the new loan but only up to the balance of the old loan immediately before the refinancing.

You may be able to immediately deduct "points" paid on the debt you incurred in connection with the purchase or improvement of a principal residence. The deduction of points in the year paid is available if you meet all of the tests specified by the IRS, including, among other things, the payment of points being an established business practice in the area in which the indebtedness was incurred and the amount of the payment not being excessive. If all of the specified IRS tests are not met, then the points must be deducted ratably over the term of the mortgage. Generally, points paid by a borrower in connection with the refinancing of a mortgage must be deducted over the term of the loan.

Interest paid on a loan secured only by land does not qualify as mortgage interest. However, you may treat a residence that is under construction as your principal or second residence for up to two years, provided you move into it and occupy it as your principal residence when the construction is complete. (For further explanation of the residential interest deduction rules, see "Home mortgage interest" in Chapter 1.)

When you sell your residence

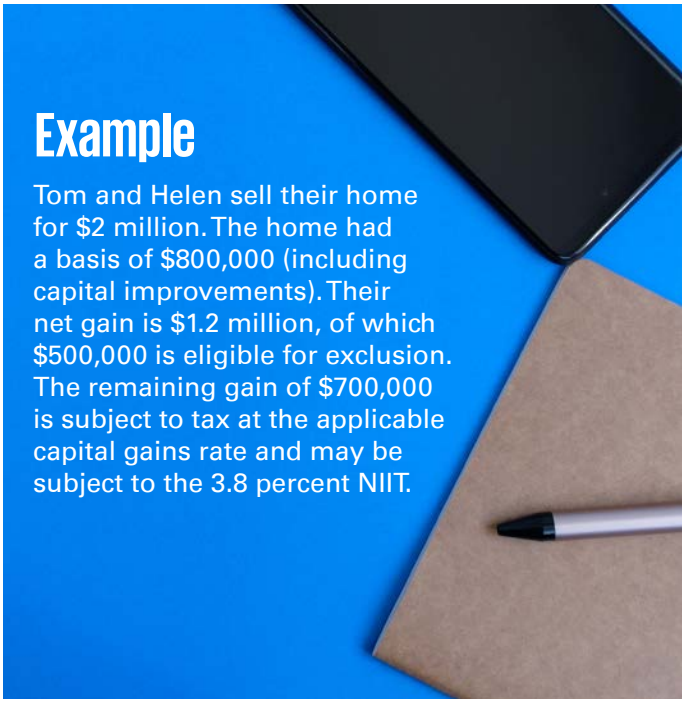
If you sell your principal residence at a gain, then some or all of the gain may be exempt from tax. However, if you incur a loss on the sale, you may not deduct that loss.

If you and your spouse file a joint return, then you can exclude a gain of up to $500,000 from the sale of your principal residence. Other taxpayers can exclude up to $250,000. The following conditions must be met:

- You must have owned and lived in the property for at least two years during the previous five years (if filing a joint return, then only one spouse has to meet the ownership test).
- You must not have claimed the exclusion within the past two years. (If filing a joint return,then this requirement applies to both spouses.)

A reduced exclusion amount may still be available if you fail to meet these requirements because of a change in place of employment, health issues, or another unforeseen event such as losing your job, getting divorced, an involuntary conversion of the residence, or another similar adverse circumstance that could not have been anticipated before buying and occupying the house. The amount of gain eligible for the exclusion can also be reduced under the "nonqualified use" rules if you have rented out your home (or left it vacant) at any time after 2008 and subsequently reoccupied the house before selling it.

Any gain from the sale of a principal residence that is not excludable under these rules is subject to tax as capital gain and, as explained earlier, may be subject to the 3.8 percent NIIT if modified AGI is above a certain threshold.



Example

Tom and Helen sell their home for $2 million. The home had a basis of $800,000 (including capital improvements). Their net gain is $1.2 million, of which $500,000 is eligible for exclusion. The remaining gain of $700,000 is subject to tax at the applicable capital gains rate and may be subject to the 3.8 percent NIIT.

Planning tip

If you moved out of your house within the last five years, whether it has been rented or left vacant, then avoid reoccupying the property before selling it, as doing so could trigger the "nonqualified use" rules, which could cause part of any gain realized on sale to be ineligible for exclusion.

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Second homes and rental property

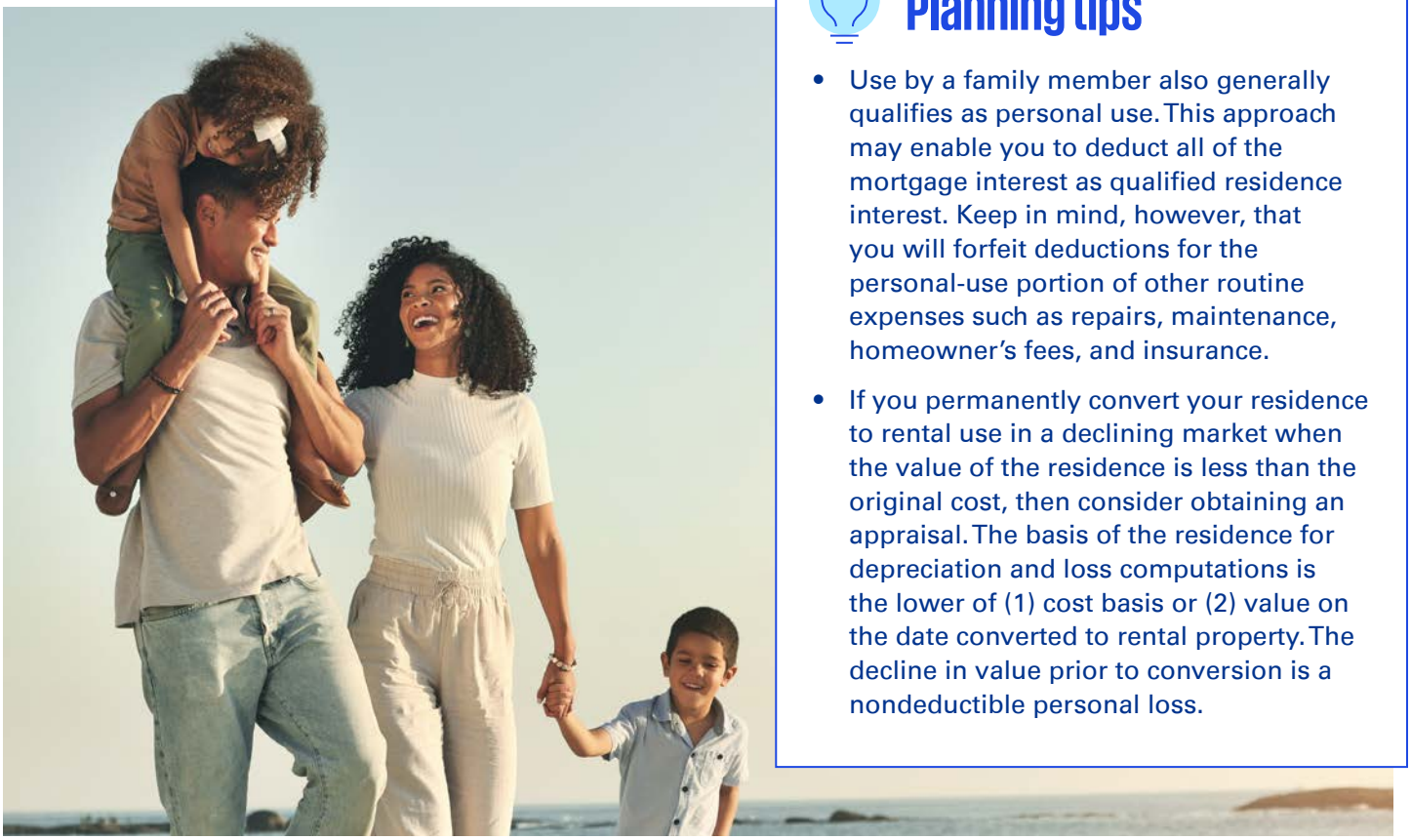
Depending on its usage, property you own—such as a house, condominium, or dwelling unit—that is not your principal residence may be classified as a second residence or as rental property. The classification affects the deductibility of interest, taxes, casualty losses, and other expenses, as well as whether you have to report any rental income from the property.

You do not have to report the rental income you receive on property you used as a home if you rent it to others for fewer than 15 days a year. However, you may not take any deductions for rental expenses for that property other than mortgage interest, taxes, and casualty losses resulting from federally or certain state-declared disasters.

Property may be considered your second residence if you or a family member use it personally for more than the greater of 14 days or 10 percent of the number of days it is rented at fair market value (FMV). In this situation, you must apportion expenses such as utilities, repairs, and insurance between rental and personal use. You can deduct these and other rental expenses only up to the excess of gross rental income over the rental-use portion of interest, taxes, and casualty losses. Although you must divide the interest expense between personal and rental use, you can deduct the personal use interest subject to the home mortgage interest expense limitations. Real estate taxes must also be allocated between rental and personal use, and the personal use portion can be deducted on Schedule A (subject to the limitation discussed in "State and local income tax deductions" in Chapter 1).

If you use a home for less than the greater of 14 days or 10 percent of the days the property is rented at FMV, then it is considered a rental property. You must still apportion all expenses between rental and personal use if both occur during the tax year, but the ordering and limitations discussed above for "second residences" are not applicable. Special rules apply in the year you convert a rental property to or from your principal residence.

Income and deductions allocable to any rental activity generally are subject to the passive loss rules (see "Understanding passive activity rules" discussed later in this chapter).



Planning tips

- Use by a family member also generally qualifies as personal use. This approach may enable you to deduct all of the mortgage interest as qualified residence interest. Keep in mind, however, that you will forfeit deductions for the personal-use portion of other routine expenses such as repairs, maintenance, homeowner's fees, and insurance.
- If you permanently convert your residence to rental use in a declining market when the value of the residence is less than the original cost, then consider obtaining an appraisal. The basis of the residence for depreciation and loss computations is the lower of (1) cost basis or (2) value on the date converted to rental property. The decline in value prior to conversion is a nondeductible personal loss.

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However, if you actively participate in a rental real estate activity and if your AGI, subject to certain modifications, is less than $150,000 before any passive losses, then you may be able to deduct up to $25,000 of net losses from the rental activity. Rental real estate participation that is considered active includes approving new tenants, deciding on rental terms, approving capital or repair expenditures, and making similar decisions.

The $25,000 rental real estate exception phases out as your modified AGI rises from $100,000 to $150,000 for single taxpayers as well as for married individuals filing joint returns. (Special rules apply to married taxpayers who file separately.) Any additional net losses from rental real estate are subject to the general passive loss rules (discussed later in this chapter).

Rental real estate activities are not treated as passive if you qualify as a "real estate professional" and you materially participate in the rental activity. (Note that the threshold for material participation is significantly higher than that for active participation, outlined above.) You may qualify as a real estate professional if you (1) devote more than half your time to one or more real estate trades or businesses in which you materially participate and (2) perform more than 750 hours of service during the year in the real estate trades or businesses in which you materially participate.

If the average stay at the rental property is fewer than 8 days or if the average stay is less than 31 days and significant services are provided, then income will be treated as trade or business income rather than passive rental income. Losses realized in a nonpassive trade or business generally are fully deductible if you materially participate in the trade or business. This rule is especially useful for some vacation properties. There are a limited number of other exceptions to the rule that rental activities are generally passive that may be relevant in specific situations.



Planning tip

Because the passive loss rules are so restrictive, you should consider personally using vacation rental property enough to qualify it as a second residence.

Exchanging properties of like kind

Before 2018, it was possible to defer paying tax on gain realized on the disposition of certain property by arranging the transactions as an exchange. Rather than selling your property and reinvesting the proceeds in new property, you were able to "exchange" your property for property of a "like kind" within certain time limits. If you met the requirements for such a like-kind exchange, then the gain or loss on the disposition of your old property was deferred until you sold the new property in the future.

Currently, the like-kind exchange rules are limited to exchanges of real property (other than real property held for personal use or primarily for sale). Although the like-kind exchange rules include a broad definition of the term "real property" for purposes of the exchange rules, the limitation on like-kind exchanges eliminates deferral for exchanges of many types of tangible personal property and intangible property.

Although like-kind exchanges offer many advantages, numerous requirements must be met before an exchange can qualify for tax-free treatment. Here are just a few:

- Both the real property you dispose of and the real property you acquire must be held by you for productive use in a trade or business or for investment, and neither property can be held primarily for sale.
- You must not have actual or constructive receipt of the sales proceeds or any discretionary control over those proceeds during the transaction. It is extremely important to have an airtight written escrow or exchange agreement that includes certain restrictions on you for the transaction to qualify as an exchange of property.
- The expected replacement property must be specifically identified in writing within 45 days after the date on which you dispose of the first property in the exchange. Certain limitations apply as to the properties that may be identified.
- You must acquire the identified replacement property no later than 180 days after the date you disposed of the first property in the exchange or the due date (including extensions) of your tax return for the year in which the transfer of the first property occurred, whichever comes first.

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- Special considerations apply if an exchange involves related parties. For example, if you swap properties directly with someone related to you, then both of you generally must retain the exchanged properties for at least two years. If either property is transferred within two years, then you must recognize any gain you deferred on the swap, unless the second transfer occurs because of death or involuntary conversion or if both transfers qualify as non-tax-avoidance transactions. In addition, you generally may not purchase replacement property from a related party for cash in an exchange.

Many special rules apply in a like-kind exchange, and not all real property is eligible for deferral. As a result, you should consult your tax adviser before entering into such a transaction.

Planning tip

Exchanges of like-kind property are not limited to transactions directly between two parties. If you cannot reach agreement with an exchange candidate, then you may benefit from a multiparty exchange—that is, a transaction in which you dispose of your real property to one person and acquire your new real property from someone else. This option may be a possible solution that may satisfy all parties' objectives and still allow you to achieve tax deferral.

At-risk rules

The "at-risk" rules limit your deductible losses to the amount for which you are economically at risk, that is, the amount you could actually lose in a trade or business or a for-profit activity. The rules on what constitutes an activity for at-risk purposes differ and are more restrictive than similar rules under the passive activity loss provisions. Generally, each trade or business activity is treated as separate for purposes of the at-risk rules, with limited exceptions for certain activities conducted through partnerships and S corporations.

The at-risk amount generally includes the cash and adjusted basis of property you contributed to, and the amount you paid for an interest in, the business or for-profit activity. This includes amounts borrowed for use in the activity but only to the extent you are personally liable for repayment. For example, if you make a loan to the activity or are personally liable through an enforceable guaranty of debt incurred by the business (for which you have no right to reimbursement), then your at-risk amount is increased by the amount of the debt and the amount of the guaranty. In addition, there is a special rule that allows inclusion of "qualified nonrecourse financing" in your at-risk amount for real estate activities.

The at-risk amount is increased by income and gain recognized and is decreased by losses and distributions. At the end of the year, if you do not have a positive at-risk amount, then some or all of the deductions or losses generated by the business or for-profit activity may be suspended. In addition, if your at-risk amount is less than zero because of distributions, then the rules require you to "recapture" (include in gross income) a portion of previously allowed losses or deductions.

Finally, when you dispose of the activity, any gain recognized will increase the at-risk amount and allow use of suspended losses to that extent.

The at-risk rules apply to individuals, trusts, estates, and certain closely held C corporations. If a loss or deduction is suspended under the at-risk rules, then the loss or deduction cannot be used for any purpose in that tax year. Once the loss or deduction is allowed under the at-risk rules, however, then the rules relating to passive activities and excess business loss limitations (described under "Understanding passive activity rules") are applied to determine whether you can obtain the benefit of the loss or deduction for tax purposes.

Planning tip

Individuals should maintain records of the amount they have at risk in each of their business and for-profit activities to avoid unexpected recapture and to allow use of losses and deductions incurred in the activity.

If the at-risk amount approaches zero, consider ways to increase the amount at risk and weigh that against the possible economic exposure involved in personal liability on a loan or a guaranty of debt.

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Understanding passive activity rules

The passive activity rules, also called passive loss rules, are designed to prevent individuals (as well as estates, trusts, and certain corporations) from using losses from passive investments to reduce other taxable income.

In general, the passive loss rules classify income, gain, loss, and deductions as either portfolio items or trade or business items. Portfolio income (such as interest, dividends, royalties, annuities, and gain or loss from the sale of portfolio assets) is excluded from the passive activity rules. Trade or business activities are classified annually as either passive or nonpassive based on your level of participation during the year. Rentals are treated as trade or business activities that are generally passive under the passive loss rules, regardless of your level of participation. (Certain exceptions to this general passive treatment of rentals were discussed previously in this chapter under "Second homes and rental property.") Trade or business activities may, in some cases, be grouped together if the activities form an appropriate economic unit and satisfy other rules. In this case, your level of participation is determined for the grouped activity, rather than for each trade or business activity within the group. In addition, it is important to note that trade or business activities conducted by partnerships and S corporations you own are classified annually as passive or nonpassive based on the participation in the activity by the individual, trust, or estate that is the partner or S corporation shareholder.

Once passive trade or business activities are identified for the tax year, you aggregate all income, gain, loss, and deductions from all passive activities. If the total is net passive income, then the passive loss rules do not restrict use of any of the losses generated by passive activities.

If the total is a net passive loss, then the net passive loss cannot be used for any purpose in that tax year. The suspended passive losses are reallocated among your passive activities and are treated as though incurred in that activity during the next tax year. The effect of the passive loss rules is to suspend net losses from passive activities until you have passive income or dispose of substantially all of the activity in a fully taxable sale to an unrelated buyer. Upon such a disposition, all suspended passive losses from that activity become deductible against nonpassive income.

Planning tips

- If you intend to establish that one or more of your trade or business activities is nonpassive, then you should keep accurate and contemporaneous records of the time you spend and of the nature of your work in the trade or business.
- Because the additional 3.8 percent NIIT also applies to passive income, consider the groupings that you are using for purposes of the passive loss rules. The NIIT rules allow taxpayers who would be subject to this additional 3.8 percent tax a onetime opportunity (either in 2013 or, if later, the first year that the NIIT applies) to regroup their trade or business activities, using the grouping rules that apply for regular income tax purposes. The regrouping applies for both regular and NIIT purposes. Note that subsequent changes to your groupings must be disclosed.
- Consider the impact of the passive loss rules when making investments.
- Generally, making investments that generate passive losses or passive credits is unwise unless you have sufficient passive income to offset the credits or losses. Note that the passive loss rules may recharacterize passive income from certain activities as active, so you should confirm if an income-generating investment would be properly treated as passive.
- Consider the timing of the disposition of passive assets for purposes of both the passive loss rules and the NIIT rules. Sales of passive assets can allow use of certain suspended losses, which can then reduce other income or gain under the general income tax rules (including, for example, the restrictions on use of capital losses).

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Excess business loss limitation

Noncorporate taxpayers, such as individuals, trusts, and estates, may be significantly impacted by a limitation imposed on the deductibility of trade or business losses. Originally enacted under TCJA and set to expire after 2028, the limitation was made permanent by OB3. For additional information about the limitation, see the KPMG report, Excess Business Losses: The CARES Act Sequel.

Under the "excess business loss" limitation, your deduction for certain trade or business losses may be limited. The limitation amounts are indexed for inflation. For 2026, you may not deduct business losses that exceed $256,000 (or $512,000 if you are married and file jointly). Due to changes in the inflation-indexing methodology under OB3, the 2026 thresholds are notably lower than those in 2025 and, as a result, more losses may need to be deferred than in the prior year.

With respect to losses allocated from a pass-through entity, the excess business loss limitation is applied at the individual level after application of both the at-risk and passive loss rules discussed previously. Excess business losses that are disallowed may be carried forward and are treated as a net operating loss carryforward in subsequent tax years. The OB3 makes the excess business loss limitation rules permanent and maintains the current manner in which the excess business loss is carried over to a subsequent year as a net operating loss.

It has been almost a decade since the excess business loss limitation provision was enacted, but the IRS has still not issued regulations and there is very little guidance on the provision. Given the limited points of reference regarding excess business loss limitations, we suggest you consult your tax adviser as to how this limitation may impact you.

Qualified Opportunity Zones

The TCJA established a unique opportunity for taxpayers with capital gains to potentially defer these gains if they reinvest in a QOZ. To qualify for the program, you must generally reinvest your qualifying capital gains within 180 days of the sale or exchange of such item into a Qualified Opportunity Fund (QOF), which must, in turn, invest the gains in a business within a QOZ. An individual is eligible to defer their capital gain as long as the property was sold to an unrelated party. There are no requirements that the gain be attributable to any specific type of asset, and there is no limit on the amount of gain that can be deferred.

The TCJA program provided for three distinct benefits. The qualifying capital gain is deferred until the investment is either sold or exchanged, or December 31, 2026, whichever is earlier. Accordingly, all gains that have been deferred under the TCJA program will be recognized no later than December 31, 2026. In addition to the deferral of gain, after a taxpayer has held the QOZ investment for five years, they are able to increase their basis in the QOZ by 10 percent of the original deferred gain. The five-year holding period must be met by the deferral date (December 31, 2026), so in order to receive the 10 percent basis increase, the QOZ investment must have been acquired by December 31, 2021. An additional 5 percent basis increase is available with respect to QOZ investments that were acquired by December 31, 2019 and held for seven years. And lastly, if you hold the QOZ investment for more than 10 years, then any gain related to the appreciation of the investment above the originally invested amount may be permanently excluded from federal capital gains tax.

A QOZ investment made in 2026 would not benefit from the gain deferral or basis increase provisions but the permanent federal capital gains tax exclusion on appreciation over the originally invested amount is still available for QOZ investments that are made by the end of 2026 and held for 10 years.

The government issued final regulations in 2019. In addition to addressing the taxpayer's ability to increase basis in the QOZ investment (as discussed above), the final regulations also provided an expanded list of events (i.e., inclusion events) that would result in recognition of all or part of the deferred gain before December 31, 2026.

While time may be running out to invest under the TCJA program, a new permanent QOZ program applicable to QOF investments made after December 31, 2026 was created under the OB3. The new program builds on the original framework but provides greater flexibility and enhanced benefits. Designations of QOZs will now be made every 10 years, beginning in the second half of 2026, and will apply to QOF investments made after December 31, 2026. Under the OB3 program, there is no fixed date for gain deferral. The capital gain that was deferred is recognized on the earlier of the disposition of the QOF investment or five years after the date of the investment. If a taxpayer holds their investment in the QOF for at least five years from the date of investment, then the basis of the investment will be increased by 10 percent of the deferred gain (30 percent for investments in a "qualified rural opportunity fund"). If the taxpayer holds their QOF investment for at least 10 years, then

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all of the post- nvestment appreciation (up to 30 years from the date of the investment) is excluded from federal capital gains tax. Any appreciation that occurs beyond the 30-year holding period will be subject to tax.

Cryptocurrency transactions

US taxpayers are required to report income from cryptocurrency sales, exchanges, payments, conversions, and other taxable transactions to the IRS and state tax authorities (where applicable). However, IRS guidance on cryptocurrency transactions is limited, and the tax consequences of some transactions are not entirely clear. In addition, cryptocurrency transactions undertaken through decentralized exchanges (DEXs) are generally not subject to Form 1099-DA reporting and, for transactions undertaken through more traditional brokers, cost basis reporting for cryptocurrencies on Form 1099-DA is only required for cryptocurrencies acquired after 2025. Thus, as compared to other asset classes, digital asset tax compliance may be more complex and time consuming.

Cryptocurrencies are frequently acquired for investment or short-term trading and are generally capital assets in the hands of most taxpayers, such that gain or loss from the sale or exchange of cryptocurrencies is characterized as capital gain or loss (see previous discussion of capital asset transactions under "Gains and losses from the sale of capital assets"). In determining the gain or loss on the sale of cryptocurrency, the specific identification lot-relief methodologies commonly used for stock and securities dispositions may be applied.

Cryptocurrencies are different from traditional investment assets in a number of respects. For one, cryptocurrencies are sometimes used as a medium of exchange. The IRS has indicated that paying for property or services with cryptocurrency is a taxable disposition of the cryptocurrency, and unlike foreign currency payments, there is not a de minimis threshold for personal use under which gains on the use of cryptocurrency for payment are not required to be reported. Cryptocurrencies are also unique in that they are not subject to certain tax rules that apply to other investment assets, such as the wash sale rules and constructive sale rules.

There are a number of transactions that are unique to cryptocurrency, including:

- **Hard forks:** A "hard fork" occurs when a cryptocurrency goes through a protocol change that results in a permanent division from the legacy distributed ledger, which results in the creation of a "new" cryptocurrency (in addition to the "old" cryptocurrency). The IRS has ruled that the value of the cryptocurrency received as a result of a hard fork is taxable as ordinary income in the year of receipt.
- **Soft forks:** If the change in the protocol does not result in a division of the blockchain, then there is a "soft fork," which has no tax effect at all because no new cryptocurrency is created or added to the user's wallet. A soft fork generally brings new functionality to a software's blockchain via software upgrades.
- **Air drops:** An "air drop" occurs when a coin or token is sent to various wallet addresses, free of charge (usually for promotional purposes). The IRS has indicated that the value of the cryptocurrency received as a result of an airdrop is taxable as ordinary income in the year of receipt.
- **Mining/Staking:** Mining and staking are the two methods by which blockchains achieve consensus on the ownership of various blockchain assets. Although the mechanics of mining and staking vary by blockchain, the two systems generally reward miners and stakers with additional units of the blockchain's native cryptocurrency (e.g., miners on the Bitcoin blockchain receive rewards denominated in bitcoin). The IRS has indicated that the FMV of cryptocurrency received as a mining or staking reward must be included in gross income upon receipt.
- **DeFi:** Decentralized finance (DeFi) comprises a number of different protocols and transactions, including DEXs and borrowing/lending platforms. Taxpayers can use DEXs to exchange cryptocurrency on a peer-to-peer basis and can also participate as a "liquidity provider" to earn fees on contributed cryptocurrency. Cryptocurrency lending platforms generally allow users to post cryptocurrency as collateral, earn fees on posted collateral, and, if desired, borrow against such cryptocurrency. The IRS has not directly addressed the treatment of liquidity providers, but the use of a DEX to effectuate an exchange is a taxable transaction. The taxation of cryptocurrency-denominated loans has also not been addressed by the IRS.

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Planning tips

- You may reduce gain or increase losses by selecting higher basis lots of cryptocurrency for sale. If you specifically identify the lots of cryptocurrency sold, then you should ensure that you maintain adequate records to support the intended treatment of the transactions.
- The inapplicability of the wash sale and constructive sale rules may present tax planning opportunities not available to other investment asset classes and eliminates significant traps for the unwary. However, you should be mindful of other rules that could limit the tax benefits of transactions that do not have sufficient economic substance.

Derivative transactions

Derivatives, such as options, futures, forwards, and swaps, can be used to monetize gains in other positions, hedge against risk, generate yield, or simply gain exposure to an underlying asset at a reduced cost.

The timing and character of gain or loss on a derivative generally depend on its classification. Certain derivatives, known as "Section 1256 contracts," are generally subject to a mark-to-market method of accounting, and gain or loss recognized under this mark-to-market method of accounting is generally characterized as 60 percent long-term and 40 percent short-term. Gain or loss on most other derivative contracts is recognized when the contract settles, unless an anti-abuse rule or other taxpayer-specific circumstances result in a change to the base-case treatment. In addition, certain taxpayer elections can alter the timing and character of gain or loss. For example, foreign currency contracts are required to be marked-to-market at the taxpayer's year-end, but the gain or loss recognized is ordinary in character, unless an election is made and certain requirements are met to treat gain or loss as capital. Note that certain derivative instruments (particularly swaps) may produce miscellaneous itemized deductions rather than capital losses. As described in Chapter 1, miscellaneous itemized deductions are no longer deductible by individual taxpayers.

Monetizing gains

Derivatives and other financial transactions can be used to monetize gains in existing positions. For example, if you wanted to monetize gain on stock without divesting the shares (e.g., because you wanted to maintain voting rights), then you could enter into a short sale on the same stock and would receive the FMV of the shares in cash upon entering the short sale. Going forward, you would not have a net economic exposure to the stock by virtue of having offsetting long and short positions. Such transactions, known as a "short against the box," are generally treated as a constructive sale of the long shares, resulting in the recognition of any previously unrecognized gain on the appreciated position. When a constructive sale occurs, the holding period is reset and any future gain or loss on the position is adjusted by the amount of gain recognized on account of the constructive sale. Note that the constructive sale rules only apply to appreciated positions.

In addition to short against the box transactions, the constructive sale rules apply to various derivatives and other financial transactions, if they result in a divesture of the risk of loss and opportunity for gain on appreciated stock, partnership equity, certain types of debt, or a derivative position referencing one of these asset classes. However, the constructive sale rules are subject to a number of exceptions and scope limitations, and if structured properly, certain derivatives can be used to monetize a portion of the unrealized gain on an appreciated financial position without triggering a constructive sale.

Mitigating risk

Derivatives can be used to economically hedge against downside risk on financial positions. For example, if you held shares and wanted to minimize downside risk, you could purchase a put option that would allow you to sell the shares for a fixed price. By doing so, you would be protected against any decline in the share price below the put option strike price. When using derivatives to manage risk, you should be mindful of the constructive sale rules described above and the straddle rules described below.

A "straddle" is defined as offsetting positions with respect to "actively traded" personal property, as defined in the Internal Revenue Code and the regulations governing straddles. For this purpose, you are considered to hold any position held by your spouse in determining whether you hold any offsetting positions. Special rules may also apply to a position

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held through a partnership or pass-through entity such as a trust. If gain or loss on the position would flow through and be reported to you, such as on a Schedule K-1, then the position is treated as held by you when determining whether a straddle exists.

Under the straddle rules, losses can only be recognized to the extent they exceed the amount of unrecognized gain on offsetting positions. Disallowed losses are carried forward and treated as sustained in the following year, and the test described above is reapplied. Thus, if the stock in the example above was sold at a loss but the put option continued to be held, the loss on the stock would only be deductible in the year sustained to the extent it exceeded any unrecognized gain on the put option. In addition to loss deferral, the straddle rules can also affect the holding period of positions in a straddle and, in some cases, may require the capitalization of interest and carrying charges incurred to acquire or carry positions in a straddle. Special rules also apply to "mixed straddles" where one position in the straddle is a Section 1256 contract.

You may be able to make various elections and identifications to mitigate some of the negative consequences of straddle positions.

Generating yield

A common yield-generating transaction is a "covered call" where a call option is written on stock you already own. If the option remains out of the money and expires unexercised, then you will have a gain equal to the premium you received when you granted the option. If the stock appreciates and the option is exercised, then you could settle the option by delivering the stock. Thus, a covered call transaction allows you to generate yield (premium income) at the cost of limiting the potential upside of your stock position.

Even if the stock is appreciated, a covered call transaction does not create a constructive sale because it does not transfer downside risk with respect to the stock. In addition, the straddle rules contain an exception for "qualified covered call options." For this purpose, a qualified covered call option is an option granted by you to purchase stock that you hold (or acquired in connection with granting the option) if (1) the option is traded on a national securities exchange or meets certain exceptions for over-the-counter options, (2) the option term is at least 30 days but not more than 12 months (subject to certain exceptions), (3) the option is not "deep in the money," (4) you are not granting the option in connection with an options dealing business, and (5) gain or loss on the option would not be classified as ordinary gain or loss.



Gaining exposure

Equity swaps can provide a simulated effect of the economic returns of holding stock, a group of stocks, or a stock index at a lower cost than the investment required to actually purchase the stock(s). For example, a swap contract could be structured so that you receive amounts equal to the dividend payments and any appreciation in the value of the underlying equity, and in exchange, you make interest payments and pay for any depreciation in the value of the underlying equity. The notional principal amount, upon which payments are based, could be referenced to a certain number of shares or a fixed dollar amount of the underlying equity. However, since the investment in the equities is synthetic, a swap holder has no right to vote on the underlying shares.

In another example, you could enter a swap contract to receive payments that replicate returns on a specific group of equities or equity index, and in exchange, you would make payments that replicate the returns on a different group of equities. Accordingly, you can gain exposure to diversify your portfolio without having to sell your underlying assets by making payments tied to the returns on the stock you own. Note that constructive ownership transactions rules, which impose an interest charge and require reclassification of long-term capital gain to ordinary income, may apply to gains on swaps relating to an equity interest in a "pass-through entity," which includes a mutual fund (regulated investment company), real estate investment trust (REIT), S corporation, partnership, trust, common trust fund, PFICs, and a real estate mortgage investment conduit. These rules prevent delay in timing and change in character of income that would otherwise be recognized from a direct investment in the pass-through entity.

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Planning tips

- Properly structured, variable prepaid forward contracts can be used to obtain an up-front payment and simultaneously divest a portion of an appreciated financial position's economics without triggering a constructive sale. Similarly, properly structured option "collar" arrangements can be used to hedge risk on an appreciated financial position without triggering a constructive sale.
- Constructive sales can be "cured" if the transaction that would otherwise have triggered the constructive sale is closed by the 30th day after the close of your tax year and the appreciated financial position remains held and left unhedged for 60 days following the date on which that transaction is closed. This exception can be used to hedge a position for a significant portion of the year without triggering a constructive sale.
- Constructive sale transactions can be used to trigger gains inherent in a position if it would be beneficial to do so. However, you must be mindful of the "cure" provision noted above.
- Under the identified straddle regime, offsetting positions can be identified as a straddle and will not create a straddle with other positions held in a portfolio. This can be especially beneficial in the case of unbalanced straddles (e.g., where only a portion of a particular position is hedged). Mixed straddle positions can also be identified or, alternatively, placed in a "mixed straddle account" to mitigate some of the adverse tax consequences of a straddle.



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Chapter 3
Charitable tax planning



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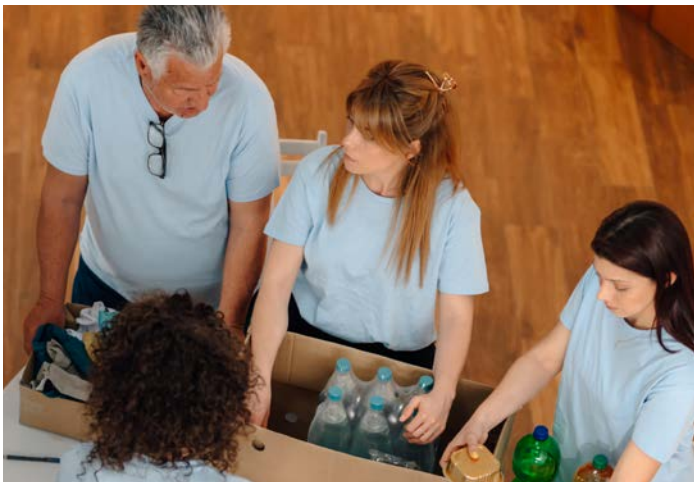
Charitable contributions of money or property may entitle you to an income tax deduction in the year of the gift.

The deduction generally is equal to the amount of cash or the FMV of property contributed. The deduction may be limited based on the type of contribution (cash or property) and the nature of the organization to which you make the contribution (e.g., a public charity or private foundation). Excess charitable contribution deductions generally may be carried forward for five years subject to applicable limits.

In addition, beginning in 2026, individuals will be able to claim a deduction for charitable contributions only if, and to the extent that, the aggregate of such contributions exceeds 0.5 percent of their AGI. Total deductions for charitable contributions by an individual continue to be subject to the current limitations (which depend upon the type of contribution and recipient), with the excess (as well as the contributions disallowed by the 0.5 percent floor) carried forward up to five years. However, if the individual's aggregate contributions do not result in a carryover, then there is no carryover of contributions disallowed due to the 0.5 percent floor.

Most deductible contributions are made to US organizations described in Section 501(c)(3) of the Internal Revenue Code, which generally describes nonprofit entities that are organized and operated exclusively for religious, charitable, scientific, educational, and certain other exempt purposes.

These organizations are classified as either public charities or private foundations. In addition, contributions to government entities may be deductible. Note, however, that contributions to noncharitable organizations generally are not deductible. Further, with certain treaty-based exceptions, contributions to organizations formed outside the United States generally are not deductible.



Deduction limitations

Limits on charitable contribution deductions vary depending on whether you are contributing to a public charity or a private foundation.

Public charities generally include:

- Churches, schools, hospitals, qualified medical research organizations, and qualified agricultural research organizations
- Organizations that have active fundraising programs and receive contributions from a broad cross-section of sources
- Organizations that receive income from a broad cross section of sources for the conduct of activities in furtherance of their exempt purposes.

Generally, gifts of cash to public charities are fully deductible up to 60 percent of a donor's AGI (a limitation that was made permanent by the OB3) and gifts of appreciated property to public charities or gifts "for the use of" public charities are deductible up to 30 percent of a donor's AGI. Gifts of property to public charities, when the deduction is limited to the donor's basis, are deductible up to 50 percent of a donor's AGI.

Private foundations typically have a single major source of funding (usually gifts from one family or corporation rather than funding from the general public). Private foundations generally belong to one of two categories:

- "Nonoperating" or "grant-making" foundations (those that make grants to other organizations or individuals)
- "Operating" foundations (those that directly operate charitable programs).

Generally, gifts of cash to nonoperating private foundations are fully deductible up to 30 percent of a donor's AGI, and gifts of appreciated property to nonoperating private foundations are deductible up to 20 percent of a donor's AGI. Gifts to operating foundations, meanwhile, are subject to the same limits as gifts to public charities. Gifts to nonoperating private foundations can also be subject to the same limits as gifts to public charities if the foundation distributes "out of corpus" all contributions it receives in a tax year within 2.5 months of the end of that tax year.

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	60% AGI	50% AGI	30% AGI	20% AGI
Cash	• Public charities • Private operating foundations	N/A	• Private nonoperating foundations	N/A
Property (when deduction limited to basis)	N/A	• Public charities • Private operating foundations	• Private nonoperating foundations (when sale would not generate long-term capital gain)	N/A
Long-term capital gain property	N/A	N/A	• Public charities • Private operating foundations (when deduction is FMV)	• Private nonoperating foundations
"For the use of" contributions	N/A	N/A	• Public charities • Private operating and nonoperating foundations	• Private nonoperating foundations (when long-term capital gain property)

As a reminder, beginning in 2026, individuals may only take a charitable contribution deduction if, and to the extent that, their aggregate contributions exceed 0.5 percent of AGI. Accordingly, the various percentage limitations described in the chart above only become relevant once that 0.5 percent threshold is crossed. If a donor makes contributions that are subject to different percentage limitations (e.g., cash and noncash contributions or contributions to public charities and private foundations), then the 0.5 percent floor is generally applied to the category with the lowest percentage limit first.

Example: Adav has AGI of $1,000 in 2026. If he contributes $5 or less to charitable organizations in 2026, then Adav may claim no charitable contribution deduction in that year. If he donates more than $5, he may claim a charitable contribution deduction only for the excess over $5 and only up to the applicable limitation. Thus, if Adav contributes $605 in cash to public charities in 2026, then he may deduct only $600 and a deduction for the additional $5 will be permanently disallowed. However, if Adav contributes enough in 2026 to generate a carry over—e.g., $610 in cash to public charities—then he may carry over both the $5 in excess of the 60 percent limit and the $5 that was disallowed by the 0.5 percent floor. The $10 carryover would be treated as a charitable contribution (and thus potentially subject to the 0.5 percent floor and 60 percent limit) in 2027 (Note, however, that the provision governing the 0.5 percent floor is subject to different interpretations and, under an alternative interpretation, Adav's deduction in 2026 would be limited to $595 and aggregate contributions in excess of $600 would trigger a carryover.).

Tax Exempt Organization Search, updated monthly, lists most charitable organizations to which contributions are deductible, in addition to the deductibility limitations applicable to such organizations. Unfortunately, certain organizations, such as churches, normally do not appear in Tax Exempt Organization Search—even though they are eligible to receive tax-deductible contributions. Tax Exempt Organization Search can be found on the IRS website at Tax Exempt Organization Search (irs.gov).

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Planning tips

- Evaluate both your tax and philanthropic goals when making charitable contributions. Although contributions to public charities have a higher deductibility limitation than contributions to private foundations, contributions to a private foundation may afford you greater control over the use of the funds. Alternatively, you may consider establishing a "donor-advised fund" (DAF) through a local community foundation or a national DAF sponsoring charity (often they are affiliated with a mutual fund, investment firm, or bank). The public charity sponsoring the DAF owns and controls the fund, but you are able to advise the charity on how you would suggest the funds be invested and/or distributed. Currently, the more favorable public charity deduction limitations apply to contributions of cash and appreciated property (including cryptocurrency contributions) to DAFs.
- To avoid being subject to the new 0.5 percent floor every year, donors may want to consider making several years' worth of contributions in one year. Such "bunched" contributions could be made to a DAF or private foundation, such that distributions to the ultimate charitable recipients could be made over several years and returns could be earned on the contributed amounts until distributed to the ultimate charitable recipients.
- To ensure the deductibility of your contribution, confirm that the intended recipient organization appears in Tax Exempt Organization Search (Pub. 78 data) or is shown as eligible to receive tax-deductible contributions in the IRS electronic Business Master File. In addition, confirm that the IRS has not revoked the organization's exempt status, including by ensuring that the organization does not appear on the "Auto-Revocation List," also found within Tax Exempt Organization Search.

Types of contributions

After evaluating your tax and philanthropic goals and selecting a charitable organization, you will need to decide whether to contribute cash, services, or property. As discussed above, donations of cash generally are straightforward and limited only by the percentage of AGI deduction limitations and the 0.5 percent floor.

Conversely, deductions for services (e.g., time incurred, expertise rendered, or use of property) usually are not permitted. That said, unreimbursed out-of-pocket expenses incurred incident to rendering services to a charitable organization are deductible.

Example: Contributing stock versus sales proceeds

Jeanne wishes to contribute $4,000 to a public charity. She owns $4,000 of publicly traded stock originally purchased more than a year ago for $1,000. She weighs her contribution alternatives:

	Sell stock; contribute proceeds	Contribute stock outright
Value of stock	$4,000	$4,000
Tax on gain (at 20%)	$(600)	—
Available for contribution	$3,400	$4,000
Add other cash	$600	—
Gift to charity	$4,000	$4,000
Out-of-pocket cost	$4,600	$4,000

Regular tax savings by giving stock outright: $600

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Deductibility of payments for certain state or local tax credits

Current regulations require you to reduce your charitable contribution deduction by the amount of any state or local tax credit you receive or expect to receive as a result of your contribution. There are, however, two exceptions to this general rule:

- If the state tax credit you receive or expect to receive does not exceed 15 percent of the cash contribution or of the FMV of the property contributed, than you do not need to reduce the value of your deduction.
- If you receive or expect to receive a state or local tax deduction in exchange for the contribution, then you would only reduce the value of your charitable contribution deduction if the state or local tax deduction exceeds the cash contribution or the FMV of the property contributed.

A safe harbor allows an individual who itemizes deductions to treat, in certain circumstances, payments that are or will be disallowed as charitable contribution deductions under the above rules as state or local taxes for federal income tax purposes.



Special rules for certain property

Special rules apply to contributions of tangible personal property and certain other types of property, such as:

- Clothing or household items
- A car, boat, or airplane
- Taxidermy property
- Property subject to a debt
- A partial interest in property
- A conservation easement
- Inventory from your business
- A patent or other intellectual property

Contributions of future interests

Certain gifts of future interests in property will result in a current tax deduction. By giving future interests, you can accelerate deductions to the year of the gift while maintaining an income stream or the property for you or your beneficiaries. Charitable remainder trusts (CRTs), pooled income funds, gift annuities, and remainder interests in a personal residence each afford this type of treatment (see Chapter 6, "Transfer tax planning").

Contributions of cryptocurrency

Cryptocurrency is treated as property for federal tax purposes, and, therefore, tax principles applicable to property transactions are also applicable to transactions using cryptocurrency, including charitable contributions. Note that cryptocurrency is not considered publicly traded stock or securities for purposes of certain favorable rules that apply to such publicly traded assets.

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Planning tips

- Although you cannot deduct the services you donate to a charitable organization, you can deduct unreimbursed out-of-pocket expenses incurred incident to rendering these services, including mileage for your use of a passenger automobile.
- Deductions for contributions of property are complicated. The amount of the charitable contribution deduction generally is the FMV of the property on the date of the contribution. However, your deduction for property gifted to a private foundation may be limited to your basis in that property, unless that property is publicly traded stock. Additionally, if the property has increased in value, then you may have to make some adjustments to the amount of your deduction. You should consult your tax adviser for assistance in determining the amount of your deduction for a contribution of property.
- A gift of appreciated property (including company stock) that has been held for more than one year generally can provide a double benefit: You obtain a charitable contribution deduction equal to the property's FMV on the date of the contribution, and you are not taxed on the built-in gain (as you would be if you sold the property). There are special rules for contributions of property to private nonoperating foundations; consult your tax adviser.
- In the case of publicly traded stock that you currently hold and in which you want to continue investing, consider making a donation of that stock rather than an equivalent amount of cash. If you make a charitable contribution of appreciated stock and use the cash that you otherwise could have contributed to purchase replacement stock, then you may have the same charitable contribution deduction and get a stepped-up basis in the replacement stock, thus potentially reducing your taxable gain when you eventually sell the new stock.
- If you own investment or business property that has declined in value, consider selling the property and donating the proceeds of the sale. You may be able to recognize a loss deduction on the sale in addition to taking a charitable contribution deduction for the donation of the cash proceeds. By contrast, if you donate the property, then your deduction is limited to FMV, and you cannot claim a loss deduction.
- If you are planning a large gift, then contact your tax adviser to learn more about these and other alternatives for charitable giving.



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Recordkeeping requirements

You must keep records to prove the amount of the contributions you make during the year. The kind of records you must keep depends upon the amount of your contributions and whether they are contributions of cash, property, or out-of-pocket expenses.

If you make a contribution through cash, check, electronic funds transfer, debit card, credit card, or payroll deduction, then you must maintain a bank record or written receipt or acknowledgment from the charitable organization showing the name of the organization, the date of the contribution, and the amount of the contribution. For each contribution you make that is $250 or more, you must obtain a contemporaneous written acknowledgment from the charitable organization containing specific information specified in IRS regulations.

If you make a contribution of property, then the records you must keep depend upon the amount of your deduction for the contribution. For all contributions of property, you must also keep additional written records that include, but are not limited to, a description of the property, the FMV of the property on the date of the contribution and how that value was determined, the basis of the property, and any terms or conditions attached to the contribution of the property. Additionally, a qualified appraisal and a Form 8283, *Noncash Charitable Contributions*, may be required for certain property contributions.

These requirements are summarized in the chart below.

Planning tip

- In determining whether you made a contribution of $250 or more for purposes of determining whether or not you need a contemporaneous written acknowledgment, you need not aggregate separate contributions made to an organization. For example, if you donated $100 per month to a charity, then your monthly contributions do not have to be combined for purposes of the contemporaneous written acknowledgment requirement.
- To determine whether your deduction is more than $500 (or more than $5,000), combine your claimed deductions for all similar items of property donated to any charitable organization during the year.

General summary of recordkeeping requirements for cash contributions

$0–$249	Bank record or receipt from the donee organization showing: • The name of the organization • The date of the contribution • The amount of the contribution
$250 or more	Written acknowledgment from the donee organization that: • Includes the name of the organization • States the date of the contribution • Includes the amount of the contribution • States whether goods or services were received in exchange for the contribution • Provides a description and good-faith estimate of the value of any goods or services received • Is obtained on or before the earlier of the due date of your return (including extensions) or the date you file your return

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General summary of recordkeeping requirements for property contributions

$0–$249	Receipt from the donee organization showing: • The name and address of the organization • The date of the contribution • A reasonably detailed description of the property
$250–$500	Written acknowledgment from the donee organization that: • Includes the name and address of the organization • States the date of the contribution • Provides a reasonably detailed description of the property • States whether goods or services were received in exchange for the contribution • Provides a description and good-faith estimate of the value of any goods or services received • Is obtained on or before the earlier of the due date of your return (including extensions) or the date you file your return
$501–$5,000	A written acknowledgment that contains the information described above, and a completed Form 8283 (Section A), filed with the return on which the deduction is claimed
More than $5,000	A written acknowledgment that contains the information described above, a completed Form 8283 (Section B) filed with the return on which the deduction is claimed, and a qualified appraisal. An exception applies (and only Form 8283 [Section A] is required) for publicly traded securities, inventory, certain qualified vehicles, and certain intellectual property.
More than $500,000	A written acknowledgment that contains the information described above, a completed Form 8283 (Section B) filed with the return on which the deduction is claimed, and a qualified appraisal attached to the return on which the deduction is claimed. An exception applies (and only Form 8283 [Section A] is required) for publicly traded securities, inventory, certain qualified vehicles, and certain intellectual property.

If you provide services to a charitable organization and have unreimbursed out-of-pocket expenses related to these services, then the contemporaneous written acknowledgment you receive should describe the services you provide (rather than the cash paid or property transferred) and otherwise meet the requirements for this acknowledgment. You should also have adequate records to substantiate the amount of your expenditures. Consult your tax adviser for more information.

For purposes of the above requirements (as well as the deduction limitations and other rules governing charitable contributions), contributions of cryptocurrency are treated as contributions of property.

The OB3 changes to charitable giving rules

Refer to the "Provisions related to charitable giving" section in the KPMG report "Exempt organization provisions in the One Big Beautiful Bill Act" for more information on recent legislative changes affecting individual charitable contribution deductions.

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Chapter 4
Family matters



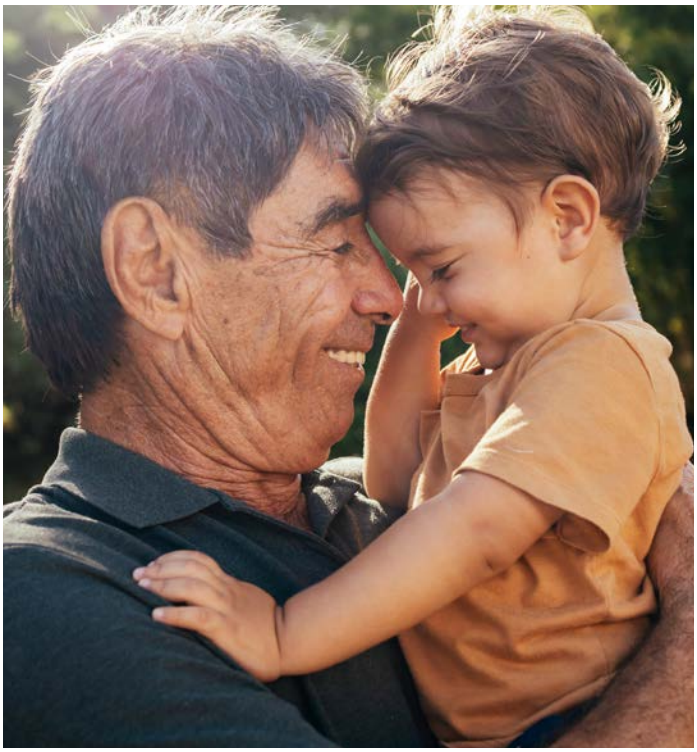
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Determining your family tax benefits

Supporting children in college while also providing financial support for elderly relatives is commonplace today. If you are a source of support for others, then be sure to review and understand all family deductions and credits that you may claim this year.

To qualify as your dependent, a person must be either your qualifying child or a qualifying relative. To be a qualifying child, the child:

- Must be your son, daughter, adopted child, stepchild, foster child, brother, sister, half-brother, half-sister, stepbrother, stepsister, or a descendant of any of these individuals (e.g., your grandchild, niece, or nephew)
- Must be under age 19 at the end of the year and younger than you (or your spouse, if filing jointly); under age 24 at the end of the year, a full-time student, and younger than you (or your spouse if filing jointly); or any age if permanently and totally disabled
- Must live with you for more than half the year (some exceptions apply) and must not have provided more than half of his or her own support
- Must not file a joint tax return (unless this is done solely for the purpose of obtaining a refund of taxes withheld or estimated taxes paid).



To be a qualifying relative, the person:

- Must not be your (or anyone else's) qualifying child
- Must be related to you in one of the ways specified in the following paragraph or, if not related, must live with you as a member of your household
- Must have gross income of less than $5,300 (for 2026)
- Must receive more than half of his or her total support for the year from you.

The specified relationships for purposes of the qualifying relative test are child (including adopted child); stepchild; foster child; a descendant of any child, stepchild, or foster child; siblings, half-siblings and stepsiblings; parents and their ancestors (but not foster parents); stepparents; nieces and nephews (including the children of half-siblings); uncles and aunts; sons- and daughters-in-law; fathers- and mothers-in-law; and brothers- and sisters-in-law.

Claiming tax credits for dependent family members

You are allowed a credit for each dependent child who is under the age of 17 on the last day of the tax year. For 2026, the amount of the credit is $2,200 per child, although that amount begins to phase out if your modified AGI is over $200,000 ($400,000 in the case of a married couple filing jointly). Beginning in 2026, the child tax credit will be adjusted for inflation so the maximum amount of the credit may increase in future tax years. If your credits exceed your tax liability, then up to $1,700 of the credit may be refunded to you, increasing your tax refund, but you must have earned income of at least $2,500 to be eligible for any refund. There is also an important caveat: The credit is allowed only if the taxpayer claiming the credit and the child both have a Social Security Number (SSN). A child who has an Individual Tax Identification Number (issued by the IRS) because he or she does not qualify for an SSN is not eligible for the $2,200 credit.

A special credit of $500 is allowed for each dependent who doesn't qualify for the $2,200 child tax credit. This includes children age 17 or over, children with no SSN, and qualified dependents who aren't children, such as parents or siblings. An individual must be a US citizen, US national, or US resident alien to qualify for this credit for other dependents. Similar to the child tax credit, the credit for other dependents begins to phase out at $200,000 of modified AGI ($400,000 in the case of a married couple filing jointly).

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Claiming the child and dependent care credit

If you pay someone to provide household services or care for a qualifying member of your householdwhile you work, then you may be entitled to a tax credit for child and dependent care. You can claim the credit for employment-related expenses incurred for the care of a member of your household who is your dependent under age 13 and any other dependent or your spouse incapable of caring for himself or herself.

Employment-related expenses include household services and expenses for care of the qualifying individual. The cost of a daytime summer camp should qualify if all other requirements are met. However, if the child or dependent stays overnight at the camp, then the expenses would not qualify for the credit. Expenses for nursery school, preschool, or other similar programs may be employment-related expenses. While the expense of an elementary school does not qualify, the expense for before- or after-school care may qualify. For 2026, credits are allowed for $3,000 of expenses for one dependent's care and $6,000 for two or more.

Beginning in 2026, the credit is 50 percent (increased by OB3 from 35 percent for years prior to 2026) of the employment-related expenses if AGI is $15,000 or less. For taxpayers with AGI over $15,000, the 50 percent is reduced by one percentage point for each $2,000 of AGI (or fraction thereof) over $15,000 but not below 20 percent.

The minimum percentage of 20 percent applies to taxpayers with AGI greater than $103,000 ($206,000 for married filing jointly). Eligible expenses are reduced for amounts excluded from income under an employer's dependent care assistance program. Special rules apply if your spouse is a student or is incapable of caring for himself or herself.

Most dependent care expenses paid to relatives qualify, unless the relative is your spouse, the parent of the qualifying individual if the qualifying individual is your child and is under age 13, your child who is under age 19, or a person who qualifies as a dependent of you or your spouse. The name, address, and taxpayer identification number of the care provider must be reported on your return in order to claim the credit. If the care provider is a tax-exempt organization, then only its name and address must be furnished.

Paying tax on your children's income

Special "kiddie tax" rules can apply to the net unearned income of children under the age of 18 and full-time college students under the age of 24. These rules are meant to discourage the transfer of property to dependents in order to have the income from such property taxed at lower income tax rates.

The kiddie tax rules apply when the child is required to file a tax return (but not a joint return) and at least one parent of the child is living. If a child is subject to the kiddie tax and their unearned income exceeds $2,700 (for 2026), then it will be taxed at the parent's marginal tax rate. In addition, the 3.8 percent NIIT (discussed in Chapter 2) may apply.

Planning tips

- In some cases, you may be able to pay a relative to care for your children. This approach allows you to provide income to a person who may be in a lower tax bracket while you use the credit.
- If your employer offers a dependent care assistance program, then you should consider using this benefit. You may exclude from gross income up to $5,000 ($2,500 if you are married and filing separately) per year under an employer-provided program. While these amounts will reduce the expenses eligible for the childcare credit, the reimbursement plan usually provides better savings. The employer plan is free from Social Security and income taxes.



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Planning tips

- You may find it feasible to transfer income-producing property to your children under certain circumstances once they are old enough to no longer be subject to the kiddie tax rules. Income accruing to them will be taxed at their presumably lower rate. In many cases, you can successfully reduce your family's overall tax liability by giving income-producing assets to such older children.
- If you transfer the right types of income-producing property to younger children, you may still preserve some benefits. For example, your child could be given income-producing property that defers income recognition until the child is old enough to no longer be subject to the kiddie tax rules. In this regard, you should consider giving your child growth stocks; mutual funds; remainder interests in property, land, tax-exempt bonds, and bond funds; closely held stock; and market discount obligations (not original issue discount obligations).
- By including your child's investment income on your return, you may be able to deduct more investment interest expense (as discussed in Chapter 1).
- Evaluate the effect of reporting your child's income on your return. Your dependent child's unearned income could be taxed at a lower effective rate if it is included on your tax return than if your child files his or her own return.



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Hiring household employees

Individuals often hire people to do work in or around their house. The determination of whether these workers are employees or independent contractors depends on many different factors, but, generally, if you control the services that are provided and how the services are performed, then the individuals are considered to be your employees. As a household employer, you may have to file employment tax returns and pay various employment taxes, including Social Security and Medicare, when the cash wages paid to the employee exceed a threshold ($3,000 for 2026). Additionally, if household employees are paid cash wages of $1,000 (for 2026) or more in any quarter, then you may be liable for federal and/or state unemployment taxes.

With all of the obligations and considerations that come with hiring a household employee, we recommend you consult with the appropriate advisers to ensure you are aware of and comply with your responsibilities.

Alimony makes a difference for both parties

Alimony is essentially an amount paid by a person to a spouse or former spouse under a divorce or separation agreement. Usually, these payments provide support to a spouse or former spouse with whom you no longer live. Alimony does not include child support payments or property settlement amounts.

The 2017 law changed the treatment of alimony paid beginning with divorce settlements or decrees of separate maintenance concluded in 2019 and after. If you pay alimony under a post-2018 agreement, you will not be allowed a deduction, and your former spouse will not include the payment in taxable income. The 2017 law does not apply to alimony payments made under divorce settlements or separation agreements entered into prior to January 1, 2019. If you pay alimony under a pre-2019 agreement, then you generally can deduct it from your gross income in the year you pay it—even if you do not itemize—as long as you meet certain requirements. Your spouse or former spouse includes the alimony in his or her gross income in the year it is received.

In general, alimony is paid from the spouse with more income to the spouse who has less income, i.e., from the spouse in a higher tax bracket to the spouse in a lower tax bracket. The current rule could increase the overall tax burden on the total income of the two spouses and will mean that the manner in which an equitable amount of alimony to be paid is calculated may need to be reconsidered because the paying spouse will effectively have less income with which to pay the alimony. Conversely, the receiving spouse will not have to take tax into consideration when determining the spending power of the amount received. Not all states have adopted this provision, so alimony related to post-2018 settlements could be treated as deductible to the payer and taxable to the recipient at the state level.

Planning tip

If you are paying alimony, then carefully review your situation to ensure that you achieve the most desirable tax consequences. You may need to modify agreements to recharacterize payments or make certain elections. Consult your attorney and tax adviser.

Payment of alimony became more expensive for divorces and separations settled beginning in 2019 because the payment is now made from after-tax rather than pretax dollars.

Education: A top investment priority

With higher education costs climbing steadily upward (significantly above the general rate of inflation), many families are particularly concerned about accumulating sufficient funds to put their children through college.

Cost projections clarify the challenge. While actual costs and rates of inflation may vary, it has been estimated that a child who enters kindergarten in 2026 will face four-year costs of over $25,000 if he or she chooses an out-of-state public university in 2039 (assumptions include an annual 3 percent increase for tuition, fees, room, and board).

Various saving/investment alternatives exist. The major savings vehicles for college expenses are qualified tuition programs, also known as 529 plans, and Coverdell education savings accounts (Coverdell ESAs). 529 plan funds may be used for the payment of elementary, secondary or trade school tuition, curriculum materials and more. In addition, 529 prepaid tuition plans, while more restrictive than 529 savings plans, may allow you to prepay future tuition costs at the current rates, which could result in a significant savings over time. For tax years beginning in 2026, the OB3 increases the allowable annual withdrawals from $10,000 to $20,000 and also expands the definition of qualified higher education expenses.

If the 529 plan beneficiary does not need the 529 funds for education expenses, then the plan may be rolled over tax-free into an ABLE account or, if certain conditions are met, into a Roth Individual Retirement Account (IRA). This may provide families with more

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Planning tip

Tax-free distributions from 529 plans can also be used to pay for registered apprenticeship programs and to pay down student loans. There is a lifetime limit for student loan repayments of $10,000 for a beneficiary and each of the beneficiary's siblings. For example, a family with two children each with a student loan can take out a maximum of $20,000 to pay down the loans.

Additionally, no student loan interest deduction is permitted for payments made from the 529 plan.

flexibility to save for education and retirement expenses at the same time.

Contributions to a 529 plan are not subject to limits or phaseouts based on the donor's AGI but cannot exceed the necessary amount of qualified higher education expenses of the beneficiary. Contributions are treated as gifts for gift tax purposes; annual donations of $19,000 (2026 amount) can therefore be made without incurring gift tax liability. Additionally, an election can be made to treat a contribution upto $95,000 (or $190,000 for a married couple that is gift-splitting) as if it had been paid over a five-year period. The larger contribution is still sheltered by the annual exclusions and gets more dollars into the 529 plan sooner to maximize growth. Amounts in the plan grow tax-free, and distributions from the plan are not treated as income to the beneficiary to the extent they are used to pay for qualified higher education expenses.

Coverdell ESAs permit up to $2,000 to be contributed per year toward qualified education expenses of a beneficiary. As with 529 plans, contributions are treated as gifts by the donor to the beneficiary of the plan.

However, in contrast to 529 plans, the ability to make contributions to a Coverdell ESA is subject to phaseout for single filers with modified AGI between $95,000 and $110,000 and for joint filers with modified AGI between $190,000 and $220,000. The contribution deadline is April 15 of the following year. Amounts within the account can grow tax free and are not treated as income to the beneficiary if used for qualified education expenses.

If your child receives a scholarship

Students who receive scholarships may exclude from income the amount required for tuition, fees, books, and supplies. However, they must report as income any scholarship funds used for other expenses, such as room and board.



Planning tip

Monitor estimated tax payments for children who receive taxable scholarships, as the institutions granting the scholarships are not required to withhold tax.

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Chapter 5

Retirement planning



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Where do you start?

Providing for a comfortable retirement requires comprehensive planning, taking into account cash flow, income taxes, available assets, retirement plan distributions, and preferred lifestyle. The goal is to match expected expenditures to projected retirement income cash flow and provide for contingencies (such as extended illness, rapid inflation, and investment losses).

Most individuals share similar concerns when they consider their retirement years. These concerns include having enough income to live comfortably, providing security for a spouse or children, minimizing income and transfer taxes, accounting for inflation, and outliving assets.

Take a serious look ahead to determine how much income you will need to maintain your current lifestyle when you retire. When you estimate how much income you will need, take into account inflation, future tax rates (e.g., income taxes in the state you anticipate residing), and the investment returns on your retirement savings. Most retirement planning advisers say that you will need 60 percent to 80 percent of your preretirement income to maintain your current standard of living.

Determining your retirement income needs

By completing the "Calculating future income needs" worksheet below, you can assess your financial position in terms of future retirement income. This assessment will help you determine a realistic investment goal.

To evaluate future income sources, start with Social Security. The Social Security Administration (SSA) website has a retirement benefit estimator that can determine your maximum benefit at your normal retirement age (generally, age 65–67) and your maximum benefit at age 70.

Calculating future income needs		
1	How much annual income (net of taxes) will you need after you retire? Adjust estimate for inflation using Chart A (below)	$
2	How much annual income (net of taxes) will come from: A. Social Security? • Adjust for inflation using Chart A B. Employer-provided benefits?	$
3	What is the current value of your personal retirement assets?	$
4	What will be the value of your personal assets at retirement? *Multiply line 3 by the factor in Chart B*	$
5	How much annual income (net of taxes) will your personal assets provide during retirement? *Multiply line 4 by the annual return you expect*	$
6	What is your total annual income (net of taxes) from these sources? *Add lines 2A, 2B, and 5*	$
7	What is your annual income (net of taxes) shortfall? *Subtract line 6 from line 1*	$

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Chart A: Figuring inflation	
Years to retirement	Inflation multiplier*
1	1.03
3	1.09
5	1.16
10	1.34
15	1.56
20	1.81
25	2.09

* Assumes inflation rate of 3 percent.

Chart B: Figuring inflation	
Years to retirement	Inflation multiplier**
1	1.06
3	1.19
5	1.34
10	1.79
15	2.40
20	3.21
25	4.29

**Assumes an annual rate of return of 6 percent (3 percent higher than inflation). Actual returns will depend on market conditions and the investments you select.

Next, consider retirement distributions you can expect from your company's qualified retirement plan (see "Retirement savings through an employer's plan"). Talk to your Human Resources person or plan administrator to get an estimate of future distributions at different retirement ages.

In addition to amounts deferred under a qualified retirement plan, you may be able to negotiate deferred compensation in a nonqualified plan to increase your retirement savings (see "Nonqualified deferred compensation").

If you are a self-employed individual who is not a partner in a partnership, then you can set up your own simplified employee pension (SEP), SIMPLE, or qualified retirement plan (as discussed in Chapter 7, "Planning for your business").

Beyond these types of retirement income, you will have to develop resources on your own through other savings and investment strategies. Most people have to provide for at least 40 percent of their retirement income from other sources.

Other retirement instruments, such as annuities, enable tax-deferred accumulation of earnings but without the contribution restrictions of an IRA. An annuity allows you to choose guaranteed life income payments or payments for a predetermined period of time, usually beginning at retirement.

A comprehensive investment program is an integral part of retirement planning, with periodic adjustment of strategies to fit your objectives as you progress toward retirement (see Chapter 2, "Investment-related tax issues"). Your tax adviser can help you determine your retirement needs and develop a feasible retirement savings plan.

Should you have an IRA account?

Traditional IRAs were first introduced to encourage taxpayers to save for retirement even if their employers did not offer retirement savings plans.

Many working Americans qualify for at least a partial income tax deduction for contributions to retirement savings through an IRA. You may make a deductible IRA contribution of up to the lesser of $7,500 or 100 percent of earned income (or $8,600 for individuals age 50 or older), provided neither you nor your spouse is an active participant in an employer-sponsored retirement plan. In addition, there is no age limit to make contributions to a traditional IRA, so if you are not yet ready to retire, you can continue to supplement your retirement savings.

Contributions to traditional IRAs may be deductible for taxpayers who are eligible for employer retirement plans but only up to certain limits based on income and filing status. For example, a taxpayer who is covered by an employer plan and is married and filing

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jointly is subject to a deduction phaseout for his or her IRA contributions if the couple's income is between $129,000 and $149,000 (although a spouse who is not eligible for an employer plan but who is married to someone covered by an employer plan can deduct the whole contribution if the family income is not more than $242,000 in 2026). However, nondeductible contributions to a traditional IRA still provide tax-deferred accumulation of investment earnings that may be beneficial, especially if you expect to have a lower tax rate once you are retired, and also provide a first step for a Roth IRA conversion.

As of 2026, an individual can contribute $7,500 (or $8,600 at or above age 50) per year as a nondeductible contribution to a traditional IRA. A taxpayer can also contribute to his or her spouse's traditional IRA.

Contributions to traditional IRAs over many years can substantially enhance family savings. Even at a 3 percent interest rate, a contribution of $7,000 per year for 10 years may result in just under $83,000 of savings or over $94,000 for individuals age 50 and over contributing $8,000 per year for 10 years.

Traditional IRA contributions are generally taxable as ordinary income on distribution; if the contributions were nondeductible, then only a part of the distribution may be taxable. Distributions before age 59½ may be subject to an early withdrawal penalty.



At age 73, you would generally have to start receiving required minimum distributions (RMDs) from the IRA (see "Minimum annual distributions").

The SECURE 2.0 Act of 2022 (SECURE 2.0 Act) has raised the age at which RMDs must begin to age 73 for individuals who reach age 72 after December 31, 2022. The beginning age for RMDs will be raised again in 2033 to age 75.

Planning tip

- If you are at least age 70½ and have a traditional IRA, you may be able to make a qualified charitable distribution (QCD) from your IRA to an eligible charity (up to $111,000 for 2026) without having to pay tax on the amount transferred to the charity. If you file a joint return, then your spouse may also make a QCD up to $111,000.
- The QCD counts toward your RMD but is not included in taxable income. It also cannot be used as a deductible charitable contribution. The QCDs exclusion from AGI may have a favorable impact in cases where limitations or phaseouts are based on AGI. In addition, the QCD is not subject to the AGI floor or 2/37 reduction imposed on charitable contributions reported as itemized deductions, which can produce an enhanced tax benefit.
- This rule applies to traditional IRAs. While it is possible to make a QCD from a Roth IRA, there is generally no advantage in doing so since Roth IRAs are not subject to the RMD rules (during the owner's lifetime) and distributions from Roth IRAs are not taxable.

Roth IRAs

A Roth IRA is an IRA with a special tax structure. Contributions to a Roth IRA are not deductible, but the eventual distributions are not included in income (and thus earnings are distributed tax-free). In addition, a Roth IRA is not subject to the RMD requirements that apply to an IRA, so the amounts can be left in the Roth IRA until needed. Special penalties apply to distributions from a Roth IRA before the Roth IRA has been in existence for five years and before you reach age 59½.

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For 2026, married individuals filing jointly with modified AGI between $242,000 and $252,000 can contribute reduced amounts to a Roth IRA. Married individuals with modified AGI above $252,000 and single taxpayers with modified AGI above $168,000 cannot directly contribute to a Roth IRA but are allowed to convert a traditional IRA into a Roth IRA. On conversion, all taxable amounts in all of the individual's aggregate IRAs are used to determine the taxable and nontaxable portions of the conversion amount. Maximum QCD for 2025 is $111,000.

Example A

Sarah has a nondeductible traditional IRA with $10,000 of contributions and $2,000 of earnings (and has no other IRAs). She converts the IRA to a Roth IRA. The $10,000 of after-tax contributions is treated as basis and is not taxed again on conversion, but the $2,000 of earnings is taxable as ordinary income when it is contributed to the Roth IRA.

Example B

Michael has two IRAs, one a nondeductible traditional IRA with $10,000 of contributions and $2,000 of earnings and one an old rollover IRA with $20,000 that has never been taxed (such as from a 401(k) rollover).

Michael wants to convert the $12,000 traditional IRA to a Roth IRA. On conversion, he has an aggregate IRA balance of $32,000 ($12,000 plus $20,000) and a total nondeductible contribution balance of $10,000.

Michael calculates the nontaxable part of the conversion as ($10,000/$32,000) × $12,000, or $3,750. The remaining $8,250 is taxable income on conversion.

If Michael instead rolls his old rollover IRA into his current employer's 401(k) plan and later converts the remaining IRA to a Roth IRA, he would include in income only the $2,000 of earnings above the after-tax contributions.

Roth(k) contributions

A 401(k) plan can be designed to allow plan participants to elect to defer amounts as pretax contributions (normal 401(k) elective contributions) or as after-tax Roth contributions. After-tax Roth contributions (sometimes called Roth(k) contributions) are generally treated the same way as the pretax contributions except with respect to income tax (both are subject to Social Security and Medicare taxes on contributions and subject to the same dollar restrictions). An employee can choose to contribute partly pretax and partly through Roth(k) contributions.

Between the pretax contributions and the after-tax Roth(k) contributions, the employee cannot contribute more than $24,500 (or $32,500 if the participant is at least age 50 or $35,750 for ages 60–63) in 2026. Your employer can match your elective contributions, whether they are 401(k) elective contributions or Roth(k) contributions.

Like Roth IRA contributions, Roth(k) contributions are taxable as made, and the contribution amount and accrued earnings on the contributions are not taxable on distribution so long as the Roth rules are satisfied at the time of distribution. Thus, the first Roth(k) contribution starts the five-year Roth holding period. The amounts in a Roth(k) account can be rolled over to a Roth IRA if all of the requirements are satisfied.

The SECURE 2.0 Act changed the RMD rules for Roth(k) contributions. The rules are now similar to Roth IRAs, and participants are not required to take a RMD from the Roth(k) contributions until death.

Note: Roth IRA contributions may not be recharacterized as a contribution to a traditional IRA. If you convert a traditional IRA to a Roth IRA and later find that the conversion was not a good strategy (e.g., the investments had declined in value or you did not have the cash to pay the taxes resulting from the conversion), then you cannot recharacterize the Roth IRA contribution as a contribution to a traditional IRA. Therefore, you should be very careful when you convert a traditional IRA to a Roth IRA.

Note: If you contribute to an IRA and decide after the due date (including extensions) of your tax return that you do not want to make a contribution, then you are treated as taking a distribution from your account on which you will be taxed currently. If you are younger than 59½, then you most likely will incur a nondeductible penalty tax of 10 percent of the taxable amount of the distribution.

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Planning tips

- Some individuals make the maximum nondeductible contributions to a traditional IRA and convert the IRA to a Roth IRA the next day. In this case, there is generally no income to include (assuming the individual has no other IRAs with deductible contributions). This makes the conversion tax-free; all additional interest or other earnings will fall under the Roth IRA rules and not be subject to tax on distribution.
- If you have money in an IRA, are under age 59½, and need cash, then consider using the substantially equal payment exception. By using this "life annuity" option, you can arrange for equal, periodic withdrawals to be made at least annually and avoid penalties for early withdrawal. The withdrawal amount is based on life expectancy and actual or projected IRA earnings. Withdrawals will be subject to income tax but not the 10 percent early withdrawal penalty. However, the same rules do not apply to a Roth IRA.
- Penalty-free distributions may also be made for certain "hardships," such as paying for health insurance premiums if you've been unemployed for at least 12 consecutive weeks, covering unreimbursed medical expenses in excess of 7.5 percent of AGI, paying qualified higher education expenses, and purchasing your first home (but limited to $10,000). The distribution will still be subject to tax, but you won't be subject to the 10 percent penalty tax as long as you qualify under one of the hardship exceptions.
- If you need a short-term loan, then under the rollover rules, you may withdraw money from an IRA temporarily and redeposit the full amount within 60 days in the same or a different IRA without tax consequences. Only one rollover of this type, however, is generally permitted in any 12-month period.
- If you are divorced and receive alimony, then you can make an IRA contribution even if all your income is from taxable alimony.
- To maximize the accumulation of tax-deferred income, consider making your contribution as early as possible. You can make an IRA contribution in the first week of the new year. If you cannot deduct the amount, then you can leave it in as a nondeductible contribution, or you can withdraw the contribution (and the attributable earnings) without penalty before the due date (including extensions) of your tax return. The income attributable to the withdrawn contribution will be taxable income for the year in which the contribution was made.



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In-plan Roth conversions

Some plans allow for "conversion" of pretax contributions (such as 401(k) elective contributions) into Roth accounts within the same plan. On conversion, the pretax amounts are not distributed to the individual and remain in the same plan, but the amounts converted are subject to ordinary tax in the year of the conversion. Once in the Roth account, the earnings accrue under the Roth rules and can eventually be rolled over to a Roth IRA if all of the Roth rules are satisfied at the time of distribution. As with other Roth accounts, there is a five-year holding period on converted amounts. There is no withholding within the plan on these conversions, so you would have to be prepared to pay the tax on the amount converted from other sources of cash.

Other IRA and Roth IRA issues

Contributions to an IRA in excess of the limits are subject to an annual 6 percent penalty until withdrawn. Also, money generally cannot be withdrawn from an IRA without a 10 percent penalty tax—except in substantially equal payments over your life expectancy (or the joint life expectancy of you and a designated beneficiary)—until after you are at least age 59½, disabled, or deceased.



Planning tip

Consider the gift of an IRA or a Roth IRA contribution on behalf of a working child or grandchild. By taking advantage of the annual gift tax exclusion, you can make a contribution for another person up to the lesser of his or her earned income for the year or the IRA limit for the year, generally $7,000. If you contribute $7,000 a year for four years while a child attends college (ages 18–22) and works part-time, then those contributions will grow to over $80,000 by the time he or she reaches age 62 (assuming 3 percent annual return). Those same four $7,000 contributions beginning at age 30 would accumulate to around $57,000 by the time the child reached age 62. The contribution is treated as a gift to the account holder, so be sure to also take into consideration other gifts that you may have made during the year when determining the amount of your contribution.

Retirement savings through an employer's plan

Many employers have established 401(k) plans (or 403(b) plans for certain tax-exempt organizations—because 401(k) and 403(b) plans have similar rules, they will be discussed together). If you are enrolled in a 401(k) or 403(b) plan, then you can reduce your salary by making pretax plan contributions (which are still subject to Social Security and Medicare taxes).

Some 401(k)/403(b) plans permit Roth(k) contributions as well as pretax contributions. Roth(k) contributions are includable in taxable income, but distributions are not.

Your employer may match a portion of your pretax or Roth(k) contributions (see "Roth(k) contributions" above).

The amount you can contribute to a 401(k) or 403(b) plan in 2026 is limited to $24,500 (or $32,500 with a catch-up contribution for employees at least age 50 or $35,750 for ages 60–63) but may be less depending on participation in the plan by other employees. Catch-up contributions for high earners were expected to be required as Roth contributions starting in 2024. However, enforcement of this Roth catch-up provision is delayed until 2026. Beginning in 2025, participants aged 60–63 will be allowed an increased catch-up contribution of the greater of $10,000 or 150 percent of the aged 50 catch-up amount.

If you inadvertently elect to defer more than a total of $23,500 in 2025 to all 401(k) and 403(b) plans in which you participate, then you must notify your employer and have excess amounts (and allocable earnings) returned to you by April 15, 2026. You will owe income tax on any excess deferrals and on income earned on the funds.

No penalty will apply to this amount. However, if excess deferrals are not repaid to you by April 15, 2026, then you must include the excess deferral as income both in the year of contribution and in the year of distribution. In addition, if a corrective distribution is not timely made, then the excess deferrals generally may not be distributed to you until a distribution is otherwise permitted under the plan.

Some plans allow additional after-tax contributions. These funds accumulate tax deferred, and you pay tax only on the earnings when you receive distributions at retirement or later.

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Employee stock ownership plans

Another type of qualified retirement plan, which encourages employee ownership of the company, is an employee stock ownership plan (ESOP). ESOPs are defined contribution plans designed to invest primarily in qualifying employer securities. An ESOP can be a portion of another qualified plan (e.g., a 401(k) plan) or a stand-alone plan and may or may not permit participants to make elective deferrals. Similar to pretax contributions to a 401(k) plan, contributions are generally made on a pretax basis, and income tax is deferred until distribution. Distributions from an ESOP may be made in cash or employer securities; participants generally have the right to demand stock (unless ownership is restricted by the corporate charter or bylaws) or require the employer to repurchase any distributed stock if it is not readily tradable.

Some ESOPs are structured as a "leveraged" ESOP; whether the ESOP has a loan may affect the available distribution timing options. Special rules apply to ESOPs maintained by S corporations.

Nonqualified deferred compensation

Your employer may provide additional opportunities to defer your income by establishing a nonqualified deferred compensation plan. Such plans have no mandatory contribution limits, and employers generally may use their discretion as to who will participate.

You generally get the benefit of deferring income tax on these amounts until they are distributed. As with all deferred compensation (other than Roth IRAs and Roth 401(k) accounts), you receive compensation (taxed at ordinary income rates) on amounts deferred once distributions are made under the plan. You may, however, be subject to Social Security and Medicare taxes in the year of vesting if the amounts are vested prior to the year of distribution. Unlike qualified retirement plans, your employer cannot deduct the promised compensation until the year in which the distribution is made.

Remember, however, that you are a general creditor of the business with regard to this deferred compensation; therefore, in bankruptcy, the business's secured creditors will be paid before you. In many cases, there is nothing left with which to pay the nonqualified deferred compensation. Another consideration with respect to a nonqualified deferred compensation plan is that distributions will be taxed as ordinary income and may be subject to Social Security and Medicare withholding.



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Planning tip

- In negotiating a compensation package with your employer, evaluate the risk of forfeiture, distribution schedule, and type of benefit and weigh the after-tax advantages of each choice available to you.
- Carefully compare the overall benefit of deferred compensation plans to the advantage of receiving cash today. Depending on your company's situation and your personal financial goals, up-front cash payments might be better suited, especially if you prefer investing in savings vehicles with lower tax rates, such as municipal bonds.
- Taking some nontaxable compensation (such as additional pretax fringe benefits or health coverage) may be worth more than taxable compensation. Likewise, if your employer will pay for something for you and include the payment in your taxable compensation, then you have only "paid" the tax rather than the full cost of the benefit.

  As an example, if your employer agrees to pay for life insurance premiums equal to $20,000 and includes the value of the premiums in your income, then you pay only tax on the premium amounts at your tax rate plus Medicare (and additional Medicare if applicable), assuming you have already exceeded your Social Security wage base.
- For some companies and their executives, up-front cash makes good business sense. Payments now can be put into savings vehicles with lower tax rates (such as municipal bonds). Also, if tax rates are low, then individuals generally include amounts in income while the tax rates are low rather than deferring until the tax rates are possibly higher. Employees defer more when tax rates are high, assuming that postretirement income may be lower and, thus, subject to lower tax rates.
- Nonqualified deferred compensation plans must comply with the rules of Section 409A, or the compensation deferred will be subject to immediate taxation at vesting as well as an additional 20 percent tax and other penalties. State taxes and penalties may also apply (e.g., California imposes a 5 percent additional state income tax on Section 409A noncompliant amounts).



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Planning for retirement distributions

Retirement planning involves determining future needs and how your resources will satisfy those needs. Penalty taxes apply to early distributions, late distributions, excess distributions, and distributions of less than the required minimums with respect to tax-qualified plans. You also must consider the effect penalties will have on undistributed retirement plan balances that are part of your estate. To avoid incurring these penalties, you should review your retirement plans and applicable rules to determine the optimum method of taking distributions.

Planning tips

- IRA distributions must begin by April 1 of the year after you turn age 73. If you keep money in your employer's plan (if permitted), then you can avoid RMDs while you are still working as an employee of that employer (provided you are not a 5 percent owner of the company).
- Roth IRAs and Roth(k) contributions to a 401(k) plan do not have RMD requirements.
- For individuals other than at least 5 percent owners, as long as you are working at least part-time as an employee, amounts held in your employer's 401(k)/403(b) plan do not have to be distributed as RMDs starting at age 73, as applicable. Some companies allow you to roll over IRA amounts so you can prevent RMDs until you are ready to stop working.
- Consider designating a younger beneficiary in order to minimize the required minimum annual distributions and delay them as long as possible. If the beneficiary is your spouse, then you can recalculate your and your spouse's life expectancies. However, this is not a decision to be made lightly. If you elect to recalculate life expectancy, then the distribution is treated as a single-life annuity when one of you dies. If either of you is not in good health, recalculation may not defer distributions.

The most advantageous way to receive retirement distributions from an employer's plan or an IRA depends not only on penalty taxes and your need for income but also the extent to which the amounts are taxable on distribution.

Minimum annual distributions

You generally are required to take minimum annual distributions from most qualified retirement plans no later than April 1 of the year following the year in which you reach age 73 or once you retire, if you are not at least a 5 percent owner. Distributions for subsequent years must be made by December 31 of each year.

For example, if you reach age 73 in 2026, you must begin receiving distributions by April 1, 2027. However, delaying the required 2026 distribution until 2027 will force you to include in your 2027 taxable income required distributions for both 2026 and 2027.

The minimum annual distribution amounts are determined by calculating the amount necessary to distribute the retirement plan interest over your life, or over your life and that of a designated beneficiary. The minimum annual distribution rules allow you to avoid depletion of your retirement savings through annual recalculation of your life expectancy (and the life expectancy of your designated beneficiary if that person is your spouse).

If minimum distributions are required, the amounts must be taken out timely. Otherwise, you will be subject to a penalty totaling half the amount you should have withdrawn.

For defined contribution plan participants or IRA owners who die after December 31, 2019, the SECURE 2.0 Act requires the entire balance of the participant's account be distributed within 10 years. There is an exception for "eligible designated beneficiaries" (i.e., surviving spouse, a child who has not reached the age of majority, a disabled or chronically ill person, or a person not more than 10 years younger than the employee or IRA account owner), in which case distributions can be made over the life expectancy of such beneficiary. The 10-year rule applies regardless of whether the participant dies before, on, or after the required beginning date (now age 73).

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Taxation of distributions

A 10 percent penalty tax generally applies if you receive tax-deferred retirement savings from your 401(k) or qualified pension plan or from your IRA before you reach age 59½, die, or become disabled. The penalty does not apply to the extent you roll over amounts to an IRA or another qualified plan. Distributions that are made in substantially equal payments over your life expectancy (or the joint lives of you and your beneficiary) are also exempt from the penalty. If the payment schedule is modified for reasons other than death or disability, then the taxable amount will be calculated by applying the 10 percent early withdrawal penalty retroactively if you are not age 59½ and have not been receiving payments for at least five years.

Several techniques are available to defer or reduce tax on distributions:

- You can defer taxes on a lump-sum distribution and certain partial distributions by rolling the distribution amounts into an IRA or, when permitted, to another qualified plan. The plan administrator can usually do a "direct rollover" or trustee-to-trustee transfer to another plan or IRA. Otherwise, you need to move the money within 60 days.
- If you receive your distributions in the form of a life annuity, then you will pay tax in the year in which you receive each payment.

Beneficiary designations

Consider reviewing your beneficiary designations and elections each year or as warranted by other significant life events. Restrictive rules generally require that IRA and retirement plan accounts be fully distributed within 10 years of the account owner's death, with a few exceptions (eligible designated beneficiaries) including for a surviving spouse and minor children. This change limits the ability to spread withdrawals over the life expectancy of the beneficiary through a so-called "stretch IRA." For further discussion related to distributions to beneficiaries through a trust, please see Chapter 6, "Transfer tax planning." In addition, keep in mind that spousal consent may be required in some cases when changing the beneficiary designation on certain plans or accounts.

Withholding requirement

If you do not elect to have your qualified plan (e.g., 401(k), 403(b), or defined benefit plan) distribution transferred or rolled over directly to an IRA or another qualified plan, then you will receive only 80 percent of your distribution. The remaining 20 percent will be withheld to pay income taxes. This is the case even if you plan to roll the funds into an IRA within 60 days of receiving the distribution. Of course, you will not owe tax on the amount you roll over. But if you only receive 80 percent of your distribution and only roll over that 80 percent, then you will be taxed on the 20 percent withheld.

Also, remember that any portion of the distribution not rolled over may be subject to the 10 percent penalty on early distributions in addition to ordinary income taxes if you are under age 59½ and do not meet certain other exceptions.



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Planning tips

- In certain instances, you may find it advantageous to receive a lump sum from your employer's plan and purchase a commercial annuity. Whether or not this is beneficial depends on the assumptions the plan makes in computing your lump-sum distribution and the investment opportunities available to you and also on the amount of the annuity surrender costs, commissions, and other fees.
- If your plan permits annuity payments, then it is sometimes more beneficial to elect a single-life annuity and use the excess amounts received to purchase life insurance or a commercial annuity that will pay your beneficiary at your death. The benefits of this approach will depend on the assumptions a plan uses to calculate a single-life annuity that is equivalent to a joint life with last survivor annuity and the investment opportunities available to you, including commercial annuities. Compare the single-life to joint-type payments from your plan.
- If the individual or family is covered by a "high-deductible health plan" arrangement (see IRS Publication 969 or ask your healthcare provider whether your plan is a high-deductible health plan), then an individual with self-only coverage can contribute up to $4,400 (for 2026) and $4,300 (for 2025), and an individual with family coverage can contribute up to $8,750 (for 2026) and $8,550 (for 2025) to a health savings account (HSA), with an additional $1,000 catch-up contribution if an eligible individual is at least age 55. This contribution is fully deductible, and the account grows tax free.
- If amounts in the account are used for approved healthcare expenses, the payments from the HSA are also tax-free. The HSA is the property of the family and can be used for qualified healthcare expenses in the current year, or it can be saved to use for qualified healthcare expenses, including Medicare premiums, in a later year. Some families choose to pay healthcare expenses currently and save the HSA for later expenses when they are covered by a less generous plan or have higher expenses as older individuals. HSAs often have investment provisions allowing a portion of the account to be invested for longer-term growth.



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Planning tip

- Elect a direct transfer from your plan to an IRA or another qualified plan to avoid the withholding rule. You can withdraw the funds from the IRA with no withholding.
- If you do not do a direct rollover, then contribute the 80 percent distribution plus out-of-pocket cash equal to the 20 percent withheld within 60 days of distribution. You will receive a refund for the withheld amount (adjusted for your other ordinary income taxes due, if any) after you file your income tax return for the year. However, these funds will not be working for you during the interim period before you receive the refund.
- There may be other ways to bypass the withholding requirement, depending on whether your employer offers these alternatives. Some employers will let employees keep the funds in the company plan. Also, some plans may include an option of taking the money in substantially equal payments made over a period of 10 years or more or for life.
- To determine the optimum method of taking distributions and the timing of those distributions, evaluate your retirement plans in conjunction with such factors as your age, health, beneficiaries, and cash flow requirements. Work closely with your tax adviser to consider the complex rules that govern distributions.

Social Security benefits

If you are under your normal retirement age (between age 65 and age 67, depending on your birth year) and are still employed but are taking Social Security benefits, then your Social Security benefits will be reduced if your current earnings exceed a prescribed limit.

You should review the SSA report on earnings and confirm that it is a correct record of your earnings. To correct an error, you must notify the SSA within three years, three months, and 15 days after the year in which your wages were paid or your self-employment income was derived. In some circumstances, your earnings record may be corrected even after this time limit has expired. You can check the SSA website (Review record of earnings | SSA) to obtain this information and model payments at various ages.

Planning tip

If you are newly eligible for Social Security benefits and would be subject to tax on the Social Security payments, then you may want to delay applying for those benefits. Doing so will increase the monthly benefits you are eligible to receive. However, you should sign up for Medicare at your normal retirement age, as medical insurance may cost more if you delay application.

Cross-border benefits considerations

If you have performed services outside the United States during the course of your career, then your retirement and other benefits may be subject to taxation in more than one country. All of the relevant facts should be considered along with relevant sourcing rules and applicable treaty provisions in analyzing the proper tax treatment of the benefits or any distributions you may receive in retirement. Careful consideration of the tax treatment may be necessary prior to any decision to take a distribution or transfer amounts.

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Chapter 6

Transfer tax planning



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While income tax planning focuses on the short term, transfer tax planning takes a long-term view of preserving your family wealth for generations to come. Whatever your age, health, or net worth, you should look to the future, keeping an up-to-date will and planning the disposition of your estate. If you plan properly, then you can provide security for your family and potentially reduce the gift and estate taxes you or your estate must pay.

Enhanced lifetime exemption amount

Federal law provides a lifetime exemption that allows you to gift or bequeath a certain amount of wealth without having to pay transfer tax. Under the TCJA, the exemption amount was only temporarily increased and was scheduled to be reduced at the end of 2025. However, the OB3 increased the exemption and made it permanent—the increase is no longer scheduled to sunset. The exemption amount is currently $13,990,000 (for 2025 transfers), and under the OB3, the exemption will increase to $15,000,000 in 2026 and will then be adjusted for inflation annually going forward. This means that as of 2026, you may give up to $15,000,000 ($30,000,000 collectively with your spouse) of assets over the course of your life or at your death without incurring a gift or estate tax. The generation-skipping transfer (GST) tax exemption is also $15,000,000 for 2026.

Overview of federal transfer tax system

Broadly speaking, when you transfer an asset to someone and get back less than the FMV of what you transferred (often referred to as "full and adequate consideration"), you have made a gift that may be subject to transfer tax. Such transfers can be made during life or at death. Transfers made during life may be subject to gift tax. Transfers made at death may be subject to estate tax. Transfers made to much younger individuals ("skip persons," such as grandchildren) may be subject to GST tax. Each of these taxes is reviewed in more detail below.

Various exclusions and deductions are available, in addition to the $15 million lifetime exemption discussed above, to reduce your transfer tax liability. For example, each year, you can make a gift of up to $19,000 (for 2026—this amount is adjusted for inflation annually) to as many people as you choose without making a taxable gift. This benefit is called the "annual exclusion." If you are married, then it is possible with your spouse's consent to double that amount to $38,000 per recipient. You are also allowed to pay for someone's tuition or medical expenses without those payments being subject to gift tax—but those amounts have to be paid directly to the service provider to qualify for that exclusion. In addition, assuming you are both US citizens, you can gift an unlimited amount to your spouse without those transfers being subject to gift tax (these are discussed in more detail below). Transfers to charities will generally qualify for the unlimited gift tax charitable deduction. (Note that these rules are different than those for income tax purposes, which are discussed in Chapter 3, "Charitable tax planning"). Certain requirements must be met in connection with each of these exclusions and deductions.

For example, annual exclusion gifts must be present interest gifts or, stated differently, enjoyable by the individual currently rather than only at some future time. Thus, speaking with your tax adviser prior to embarking on a gifting program is advised to help you avoid any pitfalls. If your gifts exceed these excludable and deductible amounts (as well as the lifetime exemption),then the excess will be subject to tax at a rate of 40 percent. If you are the one making the gift, then you are responsible for filing Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return*, and paying any required gift tax.

The gift and estate tax systems are unified; this means that if you fully utilized your lifetime exemption by making gifts during life, then you will not have any exemption remaining at your death and any assets included in your estate will be subject to estate tax at a rate of 40 percent. At your death, Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*, must be filed if your gross estate (plus any taxable gifts made during life) exceeds the lifetime exemption available at that point in time. Even if your estate is under that amount, it may be beneficial to file Form 706 as discussed in the section on Portability below. Deductions for spousal transfers and charitable transfers are also available for estate tax purposes.

Note: Estates that exceed the decedent's remaining exemption amount and have to file an estate tax return are required to report to both the IRS and the appropriate heirs the value of bequeathed property as of the owner's death, thereby allowing the IRS to track the basis of the inherited property more easily.

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Although the gift and estate tax regimes form a unified system, transfers may still have different tax consequences depending on when they occur. For instance, if you make a gift of appreciated property, then the recipient will generally have "carryover" basis—the same basis as you did in the asset. Alternatively, if the transfer is made from your estate, then the tax basis in the asset will generally be "stepped up" to the FMV of the asset at your date of death. This is true whether or not your estate has to pay estate tax.

Planning tip

Given today's higher exemption amount and historically low transfer tax rate compared to the combined federal and state income tax rate, you may want to consider postponing the transfer of high-value, low-basis assets (especially when they are not appreciating rapidly) until your death. That way, your heir would be able to sell the asset and incur a lower capital gains tax due to the resulting step-up in basis at your death.

In addition to any potential gift or estate tax, if a transfer is made to a "skip" person (such as a grandchild or an unrelated person more than 37½ years younger than you), then the transfer may also be subject to GST tax. As mentioned above, there is a similar exemption of $15 million (for 2026 transfers) from this tax that can be used during your life or at death. Any GST tax due is generally reported on Form 709 or Form 706 (depending on whether the GST tax is incurred during life or at death) and paid along with any gift or estate tax due.

Unlimited marital deduction

As mentioned earlier, transfers to your US citizen spouse will not be subject to the gift or estate tax because of the unlimited marital deduction. The marital deduction is available for outright transfers to your spouse and transfers to certain types of trusts.

A common trust established for a spouse's benefit that qualifies for the marital deduction is a qualified terminable interest property (QTIP) trust. Among other requirements, a QTIP trust must pay all net income to the spouse at least annually, cannot be used to benefit anyone other than the spouse during the spouse's lifetime, and will be included in the spouse's estate at the spouse's death. A QTIP trust can be set up during your lifetime (as an inter vivos trust) or set up at your death (as a testamentary trust). The reasons for using a QTIP trust instead of transferring assets outright to your spouse are generally not tax related; they include maintaining financial control for a spouse who may need assistance in managing money and making sure the assets pass to your descendants when your spouse dies. This may be particularly important to you if this is not your first marriage and you have children from another marriage whom you wish to benefit while still making the assets available for your surviving spouse should they be needed.

Portability

The traditional approach to estate planning involved the creation of a bypass (or credit shelter) trust to hold the amount of the decedent's unused lifetime exemption for the benefit of the children and the spouse and a QTIP trust to hold the balance of the decedent's assets for the benefit of the surviving spouse. This approach created a nontaxable estate at the death of the first spouse to die by virtue of the lifetime exemption and marital deduction and also enabled the couple to transfer assets equal in value to both spouses' exemption amounts to their heirs without paying gift or estate tax. In contrast, if the assets of the first spouse to die were transferred outright to the survivor, then although no tax would be due at that time by virtue of the marital deduction, only the surviving spouse's lifetime exemption would be available to protect the remaining assets from estate tax when the second spouse died.



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Legislation allowing for the portability (or transferability) of the lifetime exemption to the surviving spouse has made this planning less critical in some cases. Now, a decedent leaving everything to the surviving spouse (either outright or in trust) can pass on his or her unused exemption amount to the surviving spouse so that both spouses' exemption amounts can be utilized at the second spouse's death without using the two-trust structure described above. In order to transfer the unused exemption amount, the executor of the first deceased spouse's estate must make an election by filing Form 706 (even if it is not otherwise required).

Planning tip

If an estate establishes both a QTIP and a trust funded with the taxpayer's lifetime exemption amount (also known as a bypass trust), then to the extent possible, the surviving spouse should generally use the assets in the QTIP trust rather than the bypass trust. This is because the QTIP trust assets will be included in the surviving spouse's estate, while the bypass trust assets, including any appreciation since the date of death of the first spouse to die, will pass tax free at the death of the surviving spouse.



Although portability was meant to simplify estate planning (particularly for those with estates with a total value between one and two times the lifetime exemption amount), it adds another variable in determining the most appropriate estate plan. Creating a bypass trust instead of relying on portability has the added advantage of shielding the additional appreciation on those assets that takes place between the first and second deaths from the estate tax; however, for income tax purposes, assets in a bypass trust would be inherited with only a carryover basis at the death of the second spouse instead of a step-up (assuming appreciation) to their FMV at that later date. In addition, to the extent that you want to utilize both spouses' GST exemptions, the GST exemption is not portable. Finally, there may be nontax benefits to creating one or more trusts—protecting assets from creditors, protecting someone who is not financially savvy, and making sure assets are preserved for later generations, to name a few. You must carefully consider the benefits and burdens of relying on portability versus employing a more traditional estate plan and determine which approach would best meet your personal objectives.

Planning tip

Depending on the desired goals, an alternative to creating a bypass trust would be to rely on portability and then have the surviving spouse create a trust with the deceased spouse's unused exemption amount. This type of planning would shield additional appreciation on those assets similar to a bypass trust and, as an added benefit, would allow the surviving spouse to pay income tax on the trust assets, passing even more estate-tax-free assets to the heirs. Disadvantages of this type of planning as compared to the bypass trust are that the surviving spouse may not be able to be a potential beneficiary of the trust without risking estate tax inclusion and that the deceased spouse's unused GST exemption cannot be utilized.

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Planning tip

Some property owned by a decedent, such as IRAs and bonuses paid after death, may be subject to both estate tax and income tax. Such assets are referred to as income in respect of a decedent (IRD) property. A beneficiary who inherits such an asset is entitled to an income tax deduction for the amount of estate tax paid on the asset.

While the income tax deduction is beneficial, if you are planning to make charitable contributions at death, then it is more tax advantageous to give IRD assets to a charity that will not have to pay taxes on the amount in any event. In other words, if you have two items, one that involves IRD and another one that does not have a built-in income tax liability, then it would be advisable to give the item without the income tax liability to a noncharitable beneficiary and the IRD item to a charity, which will not have to pay income tax on it. To do this, specify in your will that the charity is to receive the IRD.

Importance of your will

One basic building block of a proper estate plan is your last will and testament. In drafting your will with legal counsel, you should provide for the disposition of your property, name an executor, and designate guardians for your minor children. If you fail to take care of these items in your will, then the state will do it for you, distributing property in accordance with state law and appointing an executor and guardians for your children. Although the court acts in good faith, the outcome may not match your intentions. You may also want to have other basic but often essential documents, such as a medical directive and a financial power of attorney, drafted at the same time.

Estate planning requires a comprehensive approach, including succession planning for your business and determining the appropriate beneficiaries for life insurance and compensation plans. At the heart of the process, however, is your will. Not only is it the primary instrument for determining the distribution and management of your property but it may also help you manage estate and GST taxes.



Some people may prefer to use what is typically called a "revocable living trust" (RLT), along with a shorter "pour-over" will, to dispose of assets. The advantages of an RLT include avoidance of probate, confidentiality, and an easier transition in the case of disability. RLTs and other types of trusts are discussed further below.

Once your documents are properly drafted, it is important to keep them up to date. Certain events should trigger a reexamination of your documents to ensure that they still fulfill your intentions. For example, you should revisit your documents when there is a marriage, divorce, birth of a child or grandchild, death of someone named in your documents, purchase or sale of major assets, change in state of domicile, or change in the tax law such as the OB3 discussed above.

Planning tip

While the enhanced lifetime exemption provided by the OB3 is helpful from a tax perspective, some estate plans may not work as planned with such a large exemption amount. If the estate is to divide into a credit shelter trust and the remainder to a marital trust (the traditional estate plan discussed above in the "Portability" section), then the large exemption might not leave any assets for the marital trust. It may be wise to revisit your basic estate planning documents in light of the OB3.

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Planning tips

- Examine your will to make certain that it reflects your current intentions and that all appropriate provisions have been included. Significant changes to the tax law have occurred in the past several years, so make sure that your document's provisions are still appropriate and effective under current law. The manner in which you hold property and whether you reside in a common law or a community property state are important factors in your estate plan. Generally, joint ownership provides the benefits of survivorship, avoidance of probate, and immediate access to the asset. However, joint ownership may result in increased estate taxes and loss of control over the ultimate disposition of the property.
- Analyze your will to ensure that there is alignment between your will and the type of property you own. Generally, your will controls only probate property (that which comes into the hands of the executor). Property held jointly with someone else and property that has a designated beneficiary (e.g., life insurance or a pension/profit-sharing plan) will not be controlled by your will. For example, if you and your spouse structure your wills to take advantage of the marital deduction and your lifetime exemptions but retain all your property in joint names, then the wills will have no effect. While the ability to transfer your exemption amount (as a result of portability) mitigates this problem to some extent, you will potentially lose planned tax benefits and the ability to control the disposition of the property because all property passes outright to the surviving spouse by operation of law. In short, no matter how good the will is, it will fail to achieve its intended purpose if the ownership of your property does not correlate with the provisions of the document.
- Consider reviewing your retirement plan and IRA beneficiary designations each year or as warranted by other significant life events. The SECURE Act and SECURE Act 2.0 changed some of the rules around timing of distributions to beneficiaries. For example, more restrictive rules now generally require that IRA and retirement plan accounts be fully distributed within 10 years of the account owner's death, with a few exceptions including for a surviving spouse and minor children. This change limits the ability to spread withdrawals over the life expectancy of the beneficiary through a so-called "stretch IRA." Some individuals designate a trust established under their will as the beneficiary of their retirement assets. The SECURE Acts may make some of the features of these trusts less necessary and/or effective. If you have named a trust as the beneficiary of a retirement account, then you should review your current plan to determine if it is still appropriate under these relatively new laws or if changes should be made to better carry out your wishes. In addition, keep in mind that spousal consent may be required in some cases when changing the beneficiary designation on certain plans or accounts.

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Choosing the right executor

One of the important issues you should address in your will is the identity of your executor (or personal representative)—the person responsible for managing your estate and distributing assets as directed in your will. This individual will have various responsibilities, including conserving the assets, preparing them for distribution to beneficiaries, and making required government filings.

Planning tip

Choose your executor carefully. You may designate a family member, trusted friend, or associate. If your estate is particularly complex, then you may prefer to name a professional adviser or an organization such as a financial institution as executor or coexecutor. As you contemplate the choices, consider the responsibilities, the required time commitment, and the capabilities of the individual. Also, remember that your executor will be working with your family during a time of stress and grief. An ability to navigate family personalities and issues may be an important factor in your decision. Also, consider indicating a second choice, in case the person you name is not in a position to serve when it becomes necessary.

Shifting assets to heirs

Shifting assets to your heirs (or trusts for their benefit) during your life offers both long-term and short-term financial benefits. First, by transferring income-producing assets, you can possibly reduce total family income tax liability associated with the property (although this advantage may be diminished by the kiddie tax). Second, you can help your children build wealth of their own. Finally, you can reduce the size of your estate and therefore, ultimately, the tax on your estate. If properly planned, then shifting assets can accomplish your objectives and ensure that the rewards of a lifetime of work pass to your heirs.

Planning tip

Consideration should be given to gifting assets with the most appreciation potential. This allows you to maximize the benefits associated with using your lifetime exemption and the payment of any gift tax. Gifting such assets today allows the anticipated future increase in value to escape transfer tax.

Current tax law allows you to make individual present interest gifts of $19,000 annually to any number of persons without being liable for gift tax. If your spouse agrees to split gifts, then you can give $38,000 free of gift tax to each person (however, your spouse would not be able to make additional annual exclusion gifts to that same person).



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Planning tips

- Consider the impact of a planned giving program that takes advantage of the annual gift tax exclusion. For example, you and your spouse can give $38,000 per year to each child free of gift tax. Over a 10-year period that would add up to $380,000 in total to each child, reducing your taxable estate and building wealth for the next generation. Your children will not be subject to income or gift tax on the receipt of the gifts, and any subsequent appreciation in value will avoid transfer tax at your level as well. If this same $380,000 passes to your child under your will, then it could be subject to as much as $152,000 in federal estate tax and potentially much more when taking into account appreciation that might occur before death. For example, assuming a relatively modest 5 percent growth rate per year, the assets would be worth over $500,000 at the end of 10 years, and the planned giving program would have potentially saved you over $200,000 per child in tax. In some situations, you could even use this technique to pass on shares of the family business. Note, however, that if you have typical restrictions on the transfer of interests in your business operating agreement such that economic benefits are not presently accessible, then a gift of these interests may not qualify for the annual exclusion.
- If you pay certain tuition or medical expenses on behalf of another person, then those amounts will not be subject to gift tax if you make payments directly to the service provider. Please note that this exclusion does not apply to contributions to a qualified tuition program (i.e., a 529 plan).
- However, contributions to a 529 plan do qualify for the annual exclusion ($19,000 per year). In addition, a special election for 529 plans allows you to make one large lump-sum contribution, up to five years' worth of annual exclusion gifts (currently $95,000), to a 529 plan without incurring a gift tax. In other words, you could make use of future year's annual exclusion gifts by making a larger up-front payment without incurring gift tax. However, you would not be able to make any additional tax-free annual exclusion gifts to the plan beneficiary or 529 plan until the end of the five-year period (unless the annual exclusion amount increases as it did for 2025 and may in 2026, in which case you could gift that additional incremental amount).
- To ensure that your year-end gifts qualify for the annual gift tax exclusion, make certain that the transfers are completed in time. A gift by check is not considered a completed gift until it is cashed. If you think the donee might not cash the check by year-end, then consider electronic transfers or using a cashier's or certified check, since those funds will be irrevocably removed from your account when the transfer is initiated or the check is issued.
- If your children are minors, then consider setting up custodial accounts for them. Under the Uniform Gifts to Minors Act, you can give a child gifts of cash, securities, bank and money market accounts, and (in some states) insurance policies. Certain states have adopted the more flexible Uniform Transfers to Minors Act (UTMA). Under UTMA, you can also transfer other types of property, including partnership interests. With a custodial account, you transfer the assets and the income they produce to your child. Contributions you make to these accounts may also qualify for the annual gift tax exclusion. Although the assets belong to your child, your designated custodian controls and manages these assets for the minor's benefit until the child is 18, 21, or 25 years old, depending on state law. At that time, all the assets in the account are required to be passed out to the child. As already noted, if you and your spouse have been making annual exclusion gifts to the account each year for the prior 10 years (assuming a 5 percent rate of return on the assets in the account), then that would mean that your 18-, 21-, or 25-year-old child would receive over $500,000. Some parents might feel that such a significant sum is too much for their

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child to handle at a relatively young age; in that case, a trust may make more sense. Also, note that if you are the donor and also control the assets as custodian, then the assets will be taxed as part of your estate if you die before the assets pass to your child. This result can be avoided if you appoint your spouse as custodian of assets you transfer to your minor children.

- Another way to preserve your family wealth is to decrease the number of times assets are subject to transfer tax. Skipping a generation (or two) by transferring property to your grandchildren or great-grandchildren is a way to avoid estate tax liability at the intervening generation or generations. However, you could be subject to the GST tax described above. The GST tax is designed to eliminate the tax advantages of transmitting wealth through succeeding generations without each generation paying a transfer tax. However, there is a GST lifetime exemption ($13.99 million for 2025 and $15 million for 2026) and a GST tax annual exclusion ($19,000 for 2025) that may mitigate GST tax exposure. Without the exemption and exclusion, the GST tax would be very substantial. To make an outright gift of $500,000 to a skip person without the benefit of the annual exclusions or lifetime exemptions would generate $480,000 in taxes—a 96 percent tax rate.



Establishing trusts

A trust is a legal entity that is established for a given period. It separates legal title (the powers of ownership) from equitable title (the benefits of ownership). The trustee has legal title to the trust property but holds it for the benefit of the beneficiaries who have equitable title to the trust property.

Federal income tax rates on trust income parallel individual tax rates but with more compressed brackets. While an unmarried individual will not reach the top tax rate of 37 percent for 2026 until he or she has over $640,600 of income, a trust will reach that rate with just $16,000 of income. In addition, the 3.8 percent Medicare tax (NIIT, as discussed in Chapter 2) and capital gains and qualified dividend rates, now 20 percent for those in the 37 percent bracket, may also apply. The combined effect could be severe for those trusts and estates that do not distribute all of their income each year.

Trusts can be utilized to achieve both tax and nontax goals of the creator of the trust. For example, a trust might be established to:

- Avoid the cost and administrative effort associated with probate
- Minimize gift, estate, and GST tax on the transfer of wealth to your descendants
- Arrange for proper management of assets until children or grandchildren reach a certain age
- Provide income and ease of management for your surviving spouse
- Maintain income for your surviving spouse while naming children as ultimate beneficiaries
- Prevent creditors or former spouses of your children and grandchildren from reaching assets held for your descendants' future benefit
- Contribute current income to a charity with yourself or others named as beneficiaries after a given period
- Provide current income for yourself or others with the remainder going to a charity when the trust terminates
- Retain income from assets for a period of years and then pass on remainder interest to others
- Ensure professional management of assets.

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Revocable living trust

One of the most popular trusts is the RLT (as discussed above), which can be established to manage assets and avoid the difficulties and costs associated with the probate process for the assets transferred to the trust before death. Because it is revocable, you can change the terms and beneficiaries as needed. You can be as involved or uninvolved as desired in managing the assets, serving as trustee personally or naming another trustee. Upon your death, the assets that have been titled in the name of the RLT pass to your beneficiaries outright (or remain in trust for their benefit) as designated in the trust agreement without going through probate. An RLT thus allows you to retain control of the trust assets during your life and allows your trustee to access funds immediately at your death instead of being tied up in probate. However, keep in mind that the assets held in the RLT are still included as part of your estate for estate tax purposes.

Other trusts are irrevocable and involve a permanent transfer of assets. Although you relinquish all control and may have to pay gift tax on the transfer, the trust assets, as well as the income and appreciation attributable to the transferred assets, are owned by the trust and are not subject to estate tax upon your death, unless you retain a beneficial interest in the trust.



Planning tip

It may be wise—especially when the recipient beneficiaries are in a lower tax bracket than the nongrantor trust or are living in a low-tax state—to minimize trust taxable income by increasing distributions to beneficiaries to the extent allowed in the trust instrument and consistent with the grantor's intent. The beneficiaries will then pick up the income on their individual returns and potentially pay less total tax than the trust would have paid on the same income.

As a taxpayer separate from the individual who created it, a nongrantor trust is entitled to its own tax deductions and exclusions. As a result, it may also be possible to minimize income taxes by virtue of a nongrantor trust's ability to utilize the $40,000 SALT deduction (in addition to the potential $40,000 deduction available to the grantor individually), the trust's deduction for amounts of gross income paid to charity pursuant to the governing instrument, and the QSBS exclusion for capital gains (see Chapter 2 for details).

Individuals living in high-tax states may also want to consider creating a nonresident nongrantor trust if income on the assets would otherwise be subject to tax in the high-tax state. Creating trusts that are only subject to tax in low-tax nonresident states has become more viable in some states as a result of recent court decisions. Most significantly, in *North Carolina v. The Kimberly Rice Kaestner 1992 Family Trust*, the US Supreme Court determined that the state of North Carolina could not tax a trust as a resident where the sole connection to the state was in-state contingent beneficiaries; more than that was required before a trust would have sufficient contact with the state to justify the imposition of tax. As a result of this case and others decided by various state courts, individuals should consider structuring new or existing trusts to avoid state income tax where possible.

In 2023, California enacted a new law that prevents California resident individuals from avoiding state income tax through use of incomplete gift nongrantor trusts (commonly known as INGs generally, DINGs when established in Delaware, or NINGs when in Nevada). This new treatment applied retroactively to tax years beginning on or after January 1, 2023. California is the second high-tax state to take aim at INGs. In 2014, New York enacted a similar law (although it allowed a brief grace period during which taxpayers could liquidate existing INGs in order to avoid being taxed on their income). Since it is possible that other states may follow New York and California in taking this step, individuals should carefully consider any pending legislation (or the potential for legislation in the near term) in their jurisdiction before putting an ING in place.

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Some common irrevocable trusts are described below.

Irrevocable life insurance trusts

Life insurance proceeds can be used to pay estate taxes or otherwise enhance your wealth. You should determine the amount of insurance you need and then decide on the type of policy that is best for you. Although the death benefit from a life insurance policy is not taxable to the beneficiary for income tax purposes, the value of the death benefit will be subject to estate tax in the estate of the insured if the insured owns the policy at death or has given it away within the three years preceding death. This will occur unless you relinquish, more than three years before death, all incidents of ownership, including the right to:

- Name or change the beneficiary
- Surrender or cancel the policy
- Assign the policy
- Revoke an assignment
- Pledge the policy for a loan
- Obtain a policy loan
- Elect the time or manner of the payment of proceeds.

In some instances, the inclusion of a life insurance policy could cause the value of the estate to exceed the exemption amount. If this were to occur, then the beneficiary of the policy could be forced to use life insurance proceeds to pay an estate tax caused by the presence of that very policy. As a result, it generally is more beneficial to have someone else (such as an irrevocable life insurance trust [ILIT]) own the policy.

As noted above, an effective way to keep life insurance proceeds out of your estate is to establish an ILIT. You can either transfer a current policy—individual, split-dollar, or group term—to the ILIT or empower the ILIT trustee to purchase a new policy on your life. You can gift to the ILIT the amount needed each year to pay the premiums. By using a trust, you will have greater flexibility in handling distributions of life insurance proceeds and income than would be possible under insurance settlement options. If you assign a current policy to the ILIT (as opposed to having the ILIT purchase a new policy), then you must live for at least three years after the transfer is complete or the proceeds will still be included in your estate. Assignment of a policy will be considered a gift at FMV and will be subject to gift tax. In most cases, term insurance has a negligible value.

Planning tip

- You, as the covered individual, can pay the premiums on the policy in the life insurance trust without jeopardizing its estate-tax-free status. Granting trust beneficiaries a temporary withdrawal right with respect to contributions to the trust (known as a "Crummey power") may even allow you to use your annual exclusion to avoid gift tax on the premium payment.
- With a second-to-die—or survivorship—life insurance policy, the death benefits are not paid until the second spouse dies (regardless of the order of death). They pass to your heirs free of income tax and can be used to pay the estate taxes on the remainder of the inheritance.

Intentionally defective grantor trusts

The tax rules regarding what qualifies as a completed transfer for income tax purposes and for estate tax purposes are not identical. Because of these differences, an irrevocable trust can be structured so its assets are excluded from the grantor's estate (and considered completed gifts), but its income is taxed to the grantor (as if the gift had not been made). An intentionally defective grantor trust (IDGT) takes advantage of these differences, allowing the trust assets to grow undiminished by income tax (because the tax liability associated with such growth is paid by the grantor of the trust rather than the trust itself) for the benefit of future generations while also removing growth on assets gifted or sold to the trust from your estate for estate tax purposes.

A trust that is treated as not separate from the grantor for income tax purposes has another advantage: Sales of appreciated assets by the grantor to the trust are ignored for income tax purposes and generate no capital gain. Nor does a sale to the trust result in gift tax liability, as the transfer of additional assets to the trust is for full and adequate consideration.

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Planning tips

- An IDGT will generally purchase assets using a promissory note as consideration. Typically, "seed" money should be gifted to the IDGT before the sale to give it some equity (generally at least 10 percent of the total asset value to be placed in the trust). Although the promissory note (or the proceeds) would be includable in the grantor's estate at death, any appreciation on the assets after the sale would be excluded. Thus, this technique works best with assets expected to appreciate significantly and those that can generate an income stream to pay off the note.
- An IDGT can also be structured as a "dynasty trust" that may benefit children, grandchildren, great-grandchildren, etc., without inclusion of the trust assets in the estate of the grantor or any of the trust's beneficiaries. Structuring the IDGT as a dynasty trust may allow the trust to continue for multiple generations without being subject to transfer tax, thereby increasing the value passing to your future heirs.

Grantor retained annuity trusts

For those who have already utilized or wish to minimize use of their lifetime exemption amount, a grantor retained annuity trust (GRAT) may be a way to shift additional assets to children without generating a gift tax. The GRAT pays you back an annuity amount each year, and any remaining assets in the trust at the end of the annuity term pass to the remainder beneficiaries (typically, the creator's children).

If the grantor retains a sufficiently large annuity payment during the term—equal in value to the assets originally transferred to the GRAT plus an assumed rate of return— the value of the remainder gift can be "zeroed out," such that no taxable gift is made.

If the assets in the trust outperform the assumed rate of return (which has ranged from 4.4 percent to 5.6 percent over the last couple years), then the excess passes to the beneficiaries free of gift tax.



Planning tip

A popular way to do GRAT planning is to set up rolling GRATs. These are short-term GRATs (e.g., two-year terms) that are staggered (e.g., one setup per year). The distributions from earlier GRATs fund the later GRATs. Setting up rolling GRATs instead of one longer-term GRAT may minimize the impact of a reduction in the value of the assets during any given term.

Qualified personal residence trusts

A qualified personal residence trust (QPRT) involves the transfer of ownership of your residence or vacation home to a trust with the retention of the right to live in that home for a term of years. The remainder interest generally passes to your children.

The benefit of this type of trust is that the gift amount is reduced by the value of your retained income interest. Therefore, you are able to leverage your gift tax exemption and exclude a valuable asset from your estate. The longer the term of years, the greater the reduction in the value of the gift. However, if you do not survive the term of years, then the entire value of the property is still includable in your estate. The term you choose must therefore strike the right balance between these competing goals.

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Planning tip

- When the house is transferred to the children at the end of the QPRT term, your cost basis carries over. If instead you passed away with the house still in your estate,then the house would receive an FMV basis. Although this difference in income tax may be more than offset by the savings in estate tax, it is something to consider, especially if it is likely that your children will sell the house after your death.
- Many people still want to live in the house after the QPRT term expires, particularly if they have transferred their primary residence to the trust. Although you are prohibited from purchasing the house back from your children, as long as your children agree, you can live in the house if you pay them FMV rent. Paying rent is actually beneficial for getting additional assets out of your estate, but you do have to be comfortable with your children as your landlords.

Charitable remainder trusts

By using a properly structured CRT to transfer highly appreciated, long-term gain property, you can improve your own financial situation in addition to benefiting a charity.

A CRT allows you to transfer assets to a trust with the stipulation that you receive distributions for a specified period. Property remaining in the trust is transferred to the charity at the end of the trust term. You can choose generally one of two options (although there are variations on both of these types):

- A charitable remainder annuity trust that provides a fixed amount of annual income irrespective of fluctuations in value within the trust from year to year or
- A charitable remainder unitrust that remits an amount based on a fixed percentage of trust assets valued annually.

With either option, the trust term can last for your lifetime, for beneficiaries' lifetimes, or for a designated period not to exceed 20 years. You also can name more than one income beneficiary in either type of trust.



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Charitable lead trusts

A charitable lead trust (CLT) is an arrangement whereby the donor gives an annuity or unitrust interest to a charity for a term of years (or for the donor's lifetime), after which the remaining value is paid to the donor's children or some other remainder beneficiary. This type of trust is the reverse of a CRT since the charity is the first party to enjoy an interest in the trust. It is generally preferable that the assets transferred to a CLT produce sufficient income to pay the annuity due to the charity.

A CLT can be either a nongrantor or a grantor trust.

A grantor trust allows you to receive an immediate income tax deduction; however, you will then be taxed on all income generated by the trust each year without any offsetting charitable income tax deduction for the amounts going to charity. A nongrantor CLT does not provide an up-front charitable deduction, but the trust will receive an income tax deduction each year for amounts transferred to the charity out of the trust's gross income.

While a CRT can help accomplish current financial objectives, it may not be as beneficial to your heirs. If you want to support your heirs as well as a charity, then a CLT might be an option. A CLT can pass assets to your heirs while minimizing the estate taxes due on a large estate. This is done by setting up a testamentary CLT and "zeroing out" the trust. This means that the percentage payout to the charity and term of the trust are set so that the charitable estate tax deduction equals the amount going into the trust. Assuming the trust outperforms the assumed appreciation rates, the remaining amount passes to your heirs free of estate tax.

Business succession planning

Passing on the family business to your successors involves many issues: transferring responsibility for running the business to the next generation, guaranteeing future income and financial resources, and minimizing income and estate taxes. A few planning ideas that may assist you in meeting your objectives are set forth below.

Planning during lifetime

With a family-owned business, it is important to address potential succession issues in your estate planning documents. Some family members may be interested in continuing the business, while others may not. Appropriate planning might avoid potential disputes among family members that could be disruptive to the family business and family relationships. How you would like the succession of the business to be handled should be discussed with your family members during your lifetime and be incorporated into your overall estate planning.

To the extent you are comfortable transferring interests in the closely held business during your lifetime, several estate tax planning techniques can be useful. While you would be relinquishing some control, if you anticipate that the business will appreciate in value, then the appreciation subsequent to the gift being made would not be subject to gift or estate tax. Interests in the business could be transferred in various ways, including directly to family members or to trusts for the benefit of family members. The planning tips discussed earlier in this chapter may be helpful in minimizing the estate taxes attributable to the family business.

Liquidity planning

For many closely held business owners, the bulk of their assets are illiquid because they are tied up in the business. At death, the family may face a liquidity crisis trying to gather sufficient liquid assets to pay the estate tax and other expenses. There are various ways to help mitigate the problem if proper planning has taken place prior to death; some are appropriate when you intend your heirs to continue to operate the business and others make sense where you simply wish to be bought out. A few of these options are discussed below.

Life insurance

Life insurance can be an effective way to generate the liquidity needed for taxes and expenses at your death. An ILIT (as discussed above) can be used to help make this method more tax efficient.

Section 6166 deferral

If an estate contains a closely held business interest that comprises more than 35 percent of the value of the adjusted gross estate, then the estate may qualify for deferral of the estate tax if an election under Section 6166 is made. The law allows the estate taxes attributable to the closely held business interest (along with interest) to be paid over a time period of up to 14 years rather than being due nine months after date of death. The election is a statutory tax deferral mechanism; if you meet the requirements as laid out in the statute, then the IRS must grant the deferral. If an estate is planning to use this option, then it is important to confirm that the business interest will qualify prior to your death.

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Commercial or noncommercial loan

To enable an illiquid estate to pay its estate tax liability (and other expenses), the executor could consider borrowing the funds. The lender could be a bank or other commercial lender. In the alternative, the lender could be a family member or other related party, including in some scenarios a business owned by the family. If the loan has a fixed rate of interest and does not allow prepayment of the loan (an arrangement that is more likely with a related, noncommercial lender), then it may be possible to deduct up front for estate tax purposes the full amount of the interest to be paid over the term of the loan. In June 2022, the IRS and Treasury released proposed regulations that may limit an estate's ability to take such a full deduction unless the loan is bona fide, is comparable to an arm's-length transaction, involves a lender that is not a beneficiary or entity controlled by a beneficiary, and is essential to the settlement of an estate.

Section 303 redemption

The law provides a means for an estate to treat a redemption of stock in a closely held business as an exchange for value rather than a dividend. Such treatment, assuming the stock basis is stepped up to FMV at death, will often mean that the redemption will have little or no income tax impact. If there has been postdeath appreciation, then it will be subject to capital gains rather than ordinary or dividend income rates.

As with Section 6166 deferral, the stock's value must exceed 35 percent of the adjusted gross estate to qualify. The proceeds cannot exceed the estate and GST taxes and any funeral and administrative expenses allowed as estate tax deductions. Section 303 redemptions can provide needed liquidity under beneficial income tax provisions and without having to find a third-party buyer. The company will need to have liquidity to redeem or have access to a third-party lender.

Buy-sell agreements

A buy-sell agreement is an agreement entered into by the owners of a business that governs what will happen to an owner's share of the business upon certain triggering events, such as the owner's death. The agreement creates a market for the decedent's business interest at a time when liquidity may be an issue. If the agreement meets certain requirements, then it may also be a useful tool in helping to determine the estate tax value of the business interest. A buy-sell agreement can be a good option when the family members have no interest in running the closely held business.

Two types of buy-sell agreements are popular. With a redemption-style agreement, the corporation buys out the owner. If properly structured, then the funds used to purchase shares are not considered a taxable dividend to the selling owner or the owner's estate. Alternatively, in a cross-purchase type of agreement, the owners themselves agree to buy out each other.

In either case, the buy-sell agreement places a value on the company, typically using a formula based on capitalization of earnings. The formula arrangement may be respected for estate and gift tax purposes provided it is a bona fide business arrangement, comparable to similar arrangements entered into by persons in an arm's-length transaction and not a device to transfer assets to family members at less than FMV. The buy-sell is often funded through the purchase of life insurance.

Note: If you had an agreement in place on October 8, 1990, then you should consult your tax adviser before you make any modifications. Some modifications may make you subject to more stringent statutory rules.



Planning tip

In 2024, the Supreme Court held (in *Connelly v. United States*) that a company's obligation to purchase stock from a deceased shareholder's estate does not reduce the value of the company but a life insurance policy held by the entity to fund the redemption does increase the value of the entity. In light of the *Connelly* decision, it may make sense to revisit existing redemption-style buy-sell arrangements. In addition, the *Connelly* decision will need to be carefully considered in structuring and funding such agreements going forward.

Employee stock ownership plans

An ESOP trust can also be a means to enhance the personal liquidity of closely held company stock. An ESOP is a tax-qualified employee retirement plan

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that can offer major advantages to you as a business owner by providing a market for closely held company stock. If structured appropriately, ESOPs can provide significant tax advantages where the intent is to buy out an owner or raise the value of the business. (For a detailed discussion, see Chapter 5, "Employee stock ownership plans.")

Installment sales

Consider an installment sale to transfer company stock to family members. Properly structured, an installment sale can "freeze" the value of closely held stock even though a family member pays for shares over a period of time. If assets are rapidly appreciating, then you can lock in the current value for estate tax purposes while transferring appreciation to the buyer. In addition, you can spread out receipt of gain on the sale, delaying payment of income tax until the year specific payments are received. However, certain installment sales may create an interest expense on a portion of the deferred gain. Similar benefits can be achieved through a sale to an IDGT (described previously).

Estate and charitable planning with closely held business interests

Many of the estate and charitable planning ideas discussed above can be used to transfer closely held business interests to the next generation while minimizing transfer tax. However, there are a few additional issues to keep in mind because of the unique nature of the gifted asset.

First, closely held businesses are typically hard to value; thus, there may be more expense and effort associated with obtaining appraisals and more uncertainty as to the value of the gift made. There are some ways to potentially limit this risk, such as use of a formula clause that limits the amount of the transferred property to the targeted value.

In addition, if you have typical restrictions on the transfer of interests in your business operating agreement such that economic benefits are not presently accessible, then a gift of these interests may not qualify for the annual exclusion.

If the business is an S corporation, then you need to be sure the trust vehicle or transferee is a qualified shareholder. Permitted trust shareholders include wholly owned grantor trusts (which provide maximum flexibility in the dispositive scheme as well as additional transfer tax benefits by virtue of the fact that the grantor pays tax on the trust's income), qualified Subchapter S trusts (which benefit only one person at a time who is then liable for tax on the income from the S corporation), and electing small business trusts (which permit multiple beneficiaries but subject the income from the S corporation to tax at the highest marginal rates at the trust level).

Some of the planning ideas (such as the GRAT and the sale to the IDGT) require periodic payments and the ideal source for those payments is generally distributions from the business entity rather than retransfer of interests in the business; as a result, consideration should be given as to whether the business can generate the required cash flow.

Finally, there are additional potential traps for the unwary when making gifts of closely held business interests to charitable entities or split-interest trusts (such as CLTs and CRTs). For example, the excise tax on excess business holdings or the unrelated business income tax could apply to the charitable recipient, a CRT is not a qualified S corporation shareholder, a charitable recipient might prohibit or be less content with a contribution of an interest in a business, and your income tax charitable deduction could be more limited for a contribution of this type of appreciated property.

As long as you navigate these issues up front, transferring closely held business interests in connection with your estate planning efforts may allow you to achieve a very beneficial transfer tax outcome due to the significant growth potential of many private businesses.

Planning tip

When gifting or selling hard-to-value assets (in particular, closely held business interests), taxpayers may be concerned about unanticipated gift tax exposure where the appraised value at the time of transfer ends up being lower than the value that is finally determined by the IRS and the courts. Various clauses have been included in gift and sale documentation in an effort to avoid the risk of undesirable gift tax exposure. While the IRS has not acquiesced to the use of such formulas, some courts have been more receptive.

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Chapter 7

Planning for your business



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Choosing an operating status for your business

After you have determined that you intend to open and operate a business, you have a number of choices in terms of how to organize that business. Both local law considerations and tax implications factor into the decision. Your alternatives include operating the business directly or using a business entity such as a limited liability company (LLC), a type of partnership (including general, limited, or limited liability partnership), or a corporation (either a C corporation or an S corporation).

The factors that may influence your decision include:

- The extent to which you want your personal assets to be protected from liabilities and obligations of the business
- Your anticipated sources of capital, including both investments and loans
- The number and types of expected owners and how they will share management, profits, and losses
- The types of assets the business will hold
- Your plans for hiring and compensating service providers
- Whether you expect to generate losses in the first few years
- The nature of the business and the jurisdictions in which it will operate
- Projections of when the business will likely generate net profit
- Your future plans for the business, including whether earnings will be retained or distributed, whether and when assets will be sold, and how you anticipate exiting the business
- How important administrative simplicity is to you.

Legal counsel can assist you in understanding the local law considerations when organizing your business, including how best to insulate your personal assets from liability for the business's debts and other liabilities.

The form of your business entity can affect federal and state tax consequences and must also be considered. In this connection, the following classifications of business entities are recognized for federal income tax purposes: the individual (sole proprietorship), a partnership, a C corporation, or an S corporation.

The following is a brief overview of the federal tax consequences associated with the various business alternative structures.

Sole proprietorship

A sole proprietorship is a business that an individual wholly owns either directly or through an entity that is disregarded for tax purposes. If the individual decides to own the business directly, then there is no need to set up a separate legal entity. If the individual prefers some liability protection, however, a sole proprietorship can be operated through a wholly owned business entity such as an LLC. Under federal tax law, a wholly owned domestic LLC is disregarded, and the owner is treated as owning and operating the business directly. Thus, the individual bears all of the income tax consequences directly and reports the business's income and losses on Schedule C of the individual's tax return. Many states follow this model and treat a wholly owned business entity such as an LLC as disregarded; however, you should consult local counsel on the SALT consequences of using a wholly owned limited liability entity.

Partnership

A domestic business entity that is not (and does not elect to be) a corporation, such as an LLC, general or limited partnership, or limited liability partnership, is classified as a partnership for federal tax purposes if it has two or more owners. Each of these entities (including a wholly owned LLC, as discussed above) can make an affirmative election to be treated as a corporation. If no election is made, then each of these entities is a flow-through entity, either treated as a partnership if it has two or more owners or as a disregarded entity if it has a single owner.

A flow-through entity means that the entity itself is not subject to income tax; the income, gain, loss, and deduction flow through to the owners, who are liable for the tax consequences. The partner's "basis" in the partnership measures the partner's remaining investment in the partnership, share of undistributed partnership income, and share of partnership liabilities; the rules relating to "basis" are designed to cause a partner to be taxed only once on the partnership's tax items.

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Subchapter K of the Internal Revenue Code provides the rules under which the partnership's income is allocated to the owners of the partnership and basis is maintained. Those rules are generally designed to provide a regime under which the partners who will receive the benefit of the income and gain or bear the cost of deductions and losses are taxed on the partnership's tax items, with the character of the partnership's tax items determined at the partnership level. For example, if a partnership sells a capital asset at a gain, then the partners will be allocated a share of the gain and will compute their individual taxes using the appropriate rate for capital gains. In addition, partnership losses pass through to (and reduce the basis of) the partners. Subject to certain other rules, such as the passive activity loss rules, at-risk rules, and excess business loss rules, the partner may be able to use those losses to offset other income. Finally, with some exceptions, a partner may receive a distribution of money or property without additional tax to the extent of the partner's basis in the partnership.

The federal tax rules relating to partnerships are flexible but can be complex. Among other things, the partnership federal tax rules generally:

- Permit partners to contribute money and property to the partnership in exchange for an interest in the partnership without immediate tax, regardless of the partner's lack of control of the partnership, and provide that the gain or loss existing in property that is contributed to a partnership must be allocated to the contributing partner.
- Permit distributions of property and money from the partnership to a partner without immediate tax consequences to the extent the partner has basis in the partnership and the distribution is not a "disguised sale".
- Provide rules that, in certain cases, will treat a contribution and a distribution to and from the partnership to be collapsed, treating the partner and partnership as engaging in a purchase and sale, rather than as making a tax-free contribution and distribution (commonly referred to as the "disguised sale" rules).
- Allow partnership liabilities to be shared by the partners to provide basis in the partnership.
- Allow an election to be made to adjust the basis of partnership assets when interests in the partnership are transferred and when certain distributions from the partnership are made.
- Allow for allocations of income, gain, loss, and deduction to be shared differently by partners as long as the "substantial economic effect" rules are satisfied.

The IRS takes the view that partners cannot be employees of partnerships. As a result, partners are subject to the self-employment tax, Self-Employed Contributions Act (SECA) rules, rather than the employment tax, Federal Insurance Contributions Act (FICA) rules. Under the SECA rules, a partner generally is subject to self-employment tax on his or her entire distributive share of the partnership's trade or business income, subject to the exceptions provided under SECA (for capital gains, rental income from real estate, interest, dividends, and so on). However, a "limited partner" is subject to the SECA tax only on the partner's guaranteed payments for services. The definition of a "limited partner" for this purpose is unclear, and individuals should consult their tax advisers. In addition, a partner who provides services is not eligible for some fringe benefits that are available for employees.

Corporations

Domestic corporations are legal entities formed under state law as well as certain entities that have elected to be treated as a corporation for federal tax purposes. For example, an LLC can elect to be treated as a corporation.

A corporation can be either a "C corporation" or an "S corporation." These two types of corporations are subject to different tax treatment.

C corporations

A corporation is a C corporation unless it qualifies and elects to be treated as an S corporation. C corporation income is subject to two levels of tax, once on the corporation's net earnings and again when those earnings are distributed as dividends. In addition, the capital gain on sale of C corporation stock and the dividend income from a C corporation may be subject to an additional 3.8 percent NIIT, as discussed in Chapter 2. Because C corporation status is the default tax status for corporations, no special federal income tax requirements must be met for an incorporated entity (or an entity that has made an election to be treated as a corporation) to be taxed as a C corporation.

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Planning tip

- A C corporation can, to some extent, control the distribution of dividends and, as a result, control when the second level of tax is triggered. For example, if a C corporation never distributes dividends to its shareholders, then it may pay tax on its income only at one level (the corporate level) until the shareholders sell their stock or the company liquidates; at that time, retained earnings can affect the stock's value and the amount of the shareholders' gain on the sale or liquidation. Note: Excessive accumulated earnings in a C corporation in some situations may be subject to a penalty tax.
- C corporation losses do not flow through to shareholders. Instead, C corporation losses may have little value from a federal income tax perspective until the corporation starts to generate income against which it can apply the losses. Some start-ups that expect to be unprofitable for some time may find S corporation or tax partnership status more attractive from a federal income tax perspective, so long as the owners' ability to use the losses is not limited (e.g., by basis limitations, at-risk rules, passive activity loss rules, or excess business loss rules).
- Determining whether C corporation status or flow-through status makes more sense in a particular situation often may require modeling the results of each status, based upon projections and assumptions regarding income, losses, deductions, distributions, credits, timing of stock sales or liquidations, future disposition transactions, and other facts. Negative tax consequences can be associated with a conversion from C corporation to flow-through status; thus, the initial choice of whether to be a C corporation or flow-through can be important.

S corporations

In contrast to a C corporation, an S corporation is generally a flow-through entity that is subject to only one level of tax, at the shareholder level, except to the extent the S corporation has assets acquired from a C corporation with a carryover basis within the last five years (the "recognition period"). Those assets are subject to tax at the S corporation level at the highest C corporation tax rate if sold during the recognition period. In addition, the conversion of a C corporation with earnings and profits (E&P) into an S corporation may generate an entity-level tax on certain "passive investment income." Otherwise, the S corporation shareholder takes into account separately his or her share of the S corporation's income, gain, loss, and deduction in computing the shareholder's individual tax liability, and stock basis rules are designed so that the shareholders are taxed only once on the S corporation's tax items. For example, to the extent of the shareholder's basis in the S corporation stock, the S corporation may make distributions of money without additional tax, and an S corporation may pass through losses to the shareholder to the extent of the shareholder's basis in the corporate stock. The passive activity rules, at-risk rules, and excess business loss rules may limit the shareholder's ability to use those losses, however.

Although S corporations are pass-through entities that are similar to partnerships, the rules applicable to S corporations are significantly different from those applicable to partnerships. Unlike partnerships generally, appreciated property distributions from an S corporation will trigger tax as though the property was sold by the corporation, and contributions of property to an S corporation for stock are tax free only if the transferors are in control of the S corporation. In addition, a shareholder of an S corporation does not generally receive basis in its S corporation stock for liabilities owed by the S corporation to third parties, and there is generally no ability to adjust the basis of assets held by an S corporation when the S corporation stock is sold. On the other hand, S corporations can engage in tax-free corporate reorganizations, and an S corporation election is the only way an existing C corporation can achieve pass-through status without triggering tax on the gain and loss in its assets. In this connection, a C corporation that is using the last-in, first-out (LIFO) inventory method will be required to recapture its

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LIFO reserve when it makes an S corporation election. There is also potential recapture of overall foreign losses when an S corporation election is made.

Moreover, unlike a partner, a shareholder in an S corporation can be an employee of the S corporation and is not subject to SECA on the shareholder's distributive share of the S corporation's income and gain. Finally, while a partnership may provide for different sharing of income and losses (subject to the substantial economic effect rules), an S corporation may have only one class of stock, and all allocations to shareholders must be proportionate.

As a threshold matter, there are limitations on what businesses are eligible to elect S corporation status. The S corporation must be a domestic corporation (including an entity that makes a valid election to be treated as a domestic corporation) and must satisfy the following requirements:

- The S corporation may have no more than 100 shareholders (counting members of a "family" as a single shareholder). All shareholders must be individuals who are US citizens or resident aliens, qualified trusts, estates, or certain kinds of tax-exempt organizations.
- The corporation must elect to be treated as an S corporation.
- The S corporation election must not terminate because it is revoked or because the S corporation has E&P and excess passive investment income or otherwise becomes ineligible because, for example, an ineligible shareholder acquires stock or the corporation has more than one class of stock.

As noted, S corporations that used to be C corporations, or that acquired assets from C corporations in "carryover basis" transactions, can be subject to certain corporate-level taxes at corporate tax rates. These corporate-level taxes do not apply to tax partnerships. For example, an S corporation with C corporation history can be subject to a corporate-level "built-in gains tax" during a "recognition period" on certain income and gain that is attributable to its C corporation period. Further, an S corporation with C corporation E&P can be subject to a corporate-level "sting" tax if a large part of its gross receipts is derived from passive investment income. (The S corporation election also can terminate if the corporation has "excess passive investment income" and E&P for three consecutive years.) Finally, a C corporation that uses the LIFO method of inventory accounting must recapture its LIFO reserve if it converts to S corporation status.

Some other differences between the tax partnership and S corporation rules are that, unlike the partnership rules, the S corporation rules:

- Do not allow for special allocations of gain or loss with respect to contributed property.
- Do not provide for the basis of the entity's assets to be adjusted when interests in the entity are transferred or when certain distributions are made.
- Do not allow for special allocations of different kinds of items.
- Do not allow corporate liabilities to be allocated to shareholders for basis purposes.
- Treat certain distributions of appreciated property as taxable transactions.

The employment tax rules applicable to S corporations also are different from those applicable to partnerships. Shareholders of S corporations can be employees of their corporations and therefore their compensation can be subject to the FICA and Federal Unemployment Tax Act (FUTA) rules. As a result, shareholder-employees generally are subject to employment tax on the amounts they are paid as compensation, and the amounts of such compensation must be "reasonable." Note, however, that shareholders who own more than 2 percent of the outstanding stock or voting power of all stock of the S corporation ("2 percent shareholders") are treated the same as partners in partnerships for purposes of the fringe benefit rules. Thus, there can be limitations on the availability of certain fringe benefits to these shareholders.

Simplified summary of federal tax differences among certain domestic business entities

The following chart summarizes at a high level some of the differences in the federal income tax rules applicable to domestic business entities that are not publicly traded and that are classified as partnerships, S corporations, or C corporations for federal income tax purposes. It is possible that other factors (and entity choices) not shown on this chart may be relevant in your particular situation. In addition, state and local tax, legal, and other considerations can be important to your choice of entity decision.

You should consult with your tax and legal advisers for assistance in determining which type of entity is most appropriate for your business.

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	Partnership (not publicly traded)	S corporation	C corporation
Limitations on capital structure			
Maximum number of owners	No	100 (with special counting No rules for "families")	No
Different economic rights for owners	Permissible as long as allocations have "substantial economic effect"	Not permissible; all shares must have same economic rights (different voting rights are permissible)	Permissible to have multiple classes of equity
Eligible owners			
Individuals	Permissible	Permissible, except for nonresident aliens	Permissible
Tax partnerships	Permissible	Not permissible	Permissible
Trusts	Permissible	Must meet certain requirements	Permissible
Corporations	Permissible	Not permissible	Permissible
Tax-exempt entities	Permissible	Must meet certain requirements	Permissible
Levels of tax			
Entity-level tax	No	Generally no, but some S corporations that used to be C corporations or that acquired assets from C corporations in carryover basis transactions can be subject to built-in gains tax or passive investment income tax; LIFO recapture tax can apply to converting corporations	Yes
Individual-level tax on flow-through income	Income flows through to partners as earned and is taxed at partner level; NIIT also may apply in certain cases.	Income flows through to shareholders as earned and is taxed at shareholder level; NIIT also may apply in certain cases.	Income does not flow through to owners as earned; however, shareholders pay tax when income is distributed as dividends (or when stock ultimately is sold for value that takes into account retained earnings); NIIT may apply to dividends and gain on sale of stock.
Flow-through of losses to owners	Yes, subject to certain limitations	Yes, subject to certain limitations	No

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	Partnership (not publicly traded)	S corporation	C corporation
Operational issues			
Adjustments to entity's basis	Can be adjusted in the case of certain transfers of interests and distributions to partners	Not adjusted for transfers of stock or distributions to shareholders	Not adjusted for transfers of stock or distributions to shareholders
Distributions of money (other than redemptions and liquidations)	Can be tax free to the extent partner already paid tax on the distributed income (and has sufficient basis), but some exceptions can apply	Can be tax-free to the extent shareholder already paid tax on the distributed income (and has sufficient basis); special rules apply if the S corporation has C corporation E&P	Taxable dividend to the extent of E&P (0, 15, or 20 percent qualified dividend rate depending on taxable income and filing status of the shareholder plus 3.8 percent NIIT)
Distributions of appreciated property to partners/ shareholders	Sometimes tax-free, but gain can be triggered in certain situations (for example, under "anti-mixing-bowl," "hot asset," or "disguised sale" rules	Treated as taxable disposition of property; can result in flow-through gain (and, sometimes, corporate-level built-in gains tax); value treated as distributed	Treated as taxable disposition of property; corporate-level tax on gain plus possible shareholder-level tax on distributions
Transfers of interests	Capital gain or ordinary income may result depending on the kind of assets held by the partnership.	Generally, capital gain; need to be sure stock transfers do not terminate S corporation status; see "Limitations on capital structure" and "Eligible owners" above	Generally, capital gain; transfer does not affect C corporation status
Allocations of gain on property distributions and sales	Precontribution gain generally allocated to contributing partner, other gain allocated in accordance with partnership agreement	Gain allocated pro rata to shareholders in accordance with stock ownership	Gain taxed at the corporate level; no gain allocated to shareholders
Ability to be acquired by corporation in tax-free reorganization	Corporate tax-free reorganization rules do not apply; acquisition may or may not be tax-free under partnership rules depending on facts	Yes	Yes

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	Partnership (not publicly traded)	S corporation	C corporation
Other			
Employment tax treatment	SECA rules apply; partners subject to self-employment tax on distributive shares, subject to special rule for "limited partners	FICA/FUTA rules apply; reasonable compensation standard for amount of compensation	FICA/FUTA rules apply; reasonable compensation standard for amount of compensation
Fringe benefits	Partners not eligible for tax-free treatment on some fringe benefits	"2 percent shareholders" not eligible for tax-free treatment on some fringe benefits	Regular rules apply
Election necessary	No	Yes	No, if incorporated; often yes, if not incorporated
Golden payments—change in control	Refer to the "C corporation" column for potential implications of a change in control of a lower-tier C corporation	Not applicable	Potential loss deduction and potential excise taxes related to parachute payments; private companies may mitigate through shareholder approval



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Qualified business income deduction

Section 199A provides for a 20 percent deduction with respect to "qualified business income" and certain other types of income. The deduction may be taken by individuals, estates, and trusts.

Unlike most deductions in the Internal Revenue Code, which provide for the recovery of costs incurred, this deduction is generated by the earning of income. In effect, the deduction indirectly reduces the taxpayer's marginal tax rate on their qualified business income. The amount of the reduction depends on which tax bracket the taxpayer is in. For instance, a taxpayer who is subject to the highest tax rate of 37 percent would receive an effective rate reduction of 7.4 percent (20 percent deduction times 37 percent tax rate), resulting in an effective tax rate on qualified business income of 29.6 percent.

Basic computational rules

Section 199A generally allows individuals to take a deduction equal to 20 percent of their combined qualified business income, subject to limitations, plus 20 percent of qualified REIT dividends and qualified publicly traded partnership income. A taxpayer's "combined qualified business income" is the net amount of "qualified items" of income, gain, deduction, and loss from all "qualified trades or businesses" (QTBs) carried on by the taxpayer during the tax year.

A variety of trades and businesses do not qualify for this deduction. These are known as "specified service trades or businesses" (SSTBs) and include (a) any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners and (b) any trade or business that involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.

The deduction is computed separately for each QTB, and limitations based on the amounts of qualified business income, W-2 wages, and property used by the trade or business apply in determining the allowable deduction. Taxpayers whose total taxable income is below a set threshold amount ($201,750 for individuals and $403,500 for joint filers for 2026) are not subject to these limitations or the exclusion of SSTBs as QTBs.

These threshold amounts are adjusted for inflation. For taxpayers whose taxable income exceeds the threshold amounts, the wage and property limitations are phased in gradually. For tax year 2026, the limitations are fully phased-in when taxable income exceeds the threshold amounts by $75,000 for individuals and $150,000 for joint filers.

Aggregation rules

Due to the separate QTB computations for each trade or business (as discussed above), in some cases, it may be beneficial for a taxpayer to combine, or aggregate, certain trades or businesses. An individual may aggregate trades or businesses only if they can demonstrate that certain requirements are satisfied. These requirements include factors such as common ownership, having the same taxable years, providing similar products or services, sharing of facilities or resources, and operating in coordination with or reliance upon each other. None of the aggregated trades or businesses can be an SSTB.

Recharacterization rules

While SSTBs generally are excluded from the definition of a QTB, there are rules that allow a small amount of SSTB activity to be included. For a trade or business with gross receipts of $25 million or less for the taxable year, the trade or business will not be considered an SSTB if less than 10 percent of the gross receipts of the trade or business are attributable to the performance of services in one of the fields listed above. For a trade or business with gross receipts of more than $25 million for the taxable year, less than 5 percent of gross receipts of the trade or business must be attributable to the performance of services in one of the fields listed above.

In addition, if a trade or business that is a QTB provides property or services to an SSTB with which it shares 50 percent or more common ownership, a portion of the business providing those services will be treated as an SSTB.

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Planning tip

- From the outset, it is important to assess whether the taxpayer is below the overall taxable income threshold, within the phaseout range, or above the overall taxable income threshold, as this determination may have a significant impact on the elements to include in the overall Section 199A computation.
- The 20 percent deduction is not allowed in computing AGI; instead, it is allowed as a deduction that reduces taxable income. Thus, the deduction does not affect limitations based on AGI. The deduction is available to taxpayers that itemize deductions as well as those that do not.
- Under aggregation rules, nonmajority owners may benefit from the common ownership of others and may be permitted to aggregate as a result.
- The common law employer rules may impact the analysis and calculation.

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Executive pay over $1 million

Publicly held corporations cannot deduct amounts in excess of $1 million paid to certain top executives as compensation. Prior to the TCJA, this limitation did not apply to certain performance-based compensation; this exception no longer applies unless the compensation is considered "grandfathered." Legislation expanded the category of individuals whose compensation is subject to the limitation. As a result, many corporate employers have reanalyzed the current structure of their executive compensation.

Tax-exempt organizations and related companies also need to consider whether the TCJA excise tax rules for compensation over $1 million apply and what compensation should be aggregated. For taxable organizations, any executives providing services to a related foundation could potentially trigger this excise tax, depending on the facts.

Enhancing executive compensation

Restricted stock and restricted stock units

An employer can transfer stock (or capital units of ownership in a partnership or LLC) to an employee. The employee has compensation income equal to the FMV of the stock (or unit in a partnership) less any amount the employee has to pay to receive the stock. Often, the price the employee pays is lower than the FMV on the date of grant. If the stock is subject to a vesting schedule (a substantial risk of forfeiture based on continuing service or a performance condition), then the employee is generally taxed on the FMV of the stock on the date of vesting absent an election to be taxed as of the grant date (a "Section 83(b) election").



Planning tip

If you receive restricted stock of a start-up company or other property with a relatively low value and an expectation of growth, then consider making a Section 83(b) election. This approach may be advantageous as it allows you to recognize ordinary compensation income on a relatively low value up front and plan for future appreciation to be taxed at more favorable capital gains rates. Keep in mind that a Section 83(b) election must generally be filed within 30 days of transfer of the stock (grant date).

Restricted stock units and phantom plans are a promise to transfer shares (or pay cash) at a future payment date rather than a transfer of shares at the grant date. The employee is taxed on the FMV of the share (or units) on the date the shares are transferred (or cash is paid) to the employee under the plan. Bear in mind that an employee cannot make a Section 83(b) election on a restricted stock unit or phantom plan because there is no actual transfer of property at grant in these arrangements.

Restricted stock units and phantom plans, like any deferred compensation plan, must comply with, or fit into an exemption to, the rules of Section 409A or the resulting compensation will be subject to immediate taxation at vesting as well as an additional 20 percent tax and other potential penalties. State taxes and penalties may also apply (e.g., California imposes a 5 percent additional state income tax on Section 409A noncompliant amounts).

Incentive stock options

With individual tax rates up to 37 percent, a 20 percent cap on capital gains rates, and the corporate tax rate at 21 percent, some companies believe ISOs are still more attractive for employees and employers. The major advantage of an ISO is that the increase in value from the time of grant to the time when the stock is eventually sold may be taxed at capital gains rates. When an ISO is exercised, the company generally receives no deduction, and the executive receives no taxable income. However, the ISO exercise can require an AMT adjustment for the executive in the year of exercise; as a result, highly compensated executives may not necessarily benefit from ISO status.

Certain holding periods are required for this treatment (two years from the grant date and one year from the exercise date). If the option shares are sold during the holding period (a "disqualifying disposition"), then the "spread" between the FMV of the stock on the date of exercise and the exercise price paid generally is compensation income reported on Form W-2. However, the compensation income spread is not subject to Social Security and Medicare taxes or federal income tax withholding. The employer is typically entitled to a corresponding deduction in the tax year during which the disposition occurs in this scenario.

Employee stock purchase plans

Similar to ISOs, stock that employees purchase through an employer's employee stock purchase plan (ESPP) is generally taxed at capital gains rates

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Planning tip

- Depending on when you sell ISO stock, you can control the type of income you realize. You will generate ordinary income generally equal to the difference between the option price and FMV at exercise, if you dispose of the stock before the required holding periods are met. If you sell the stock after the holding periods are met, then the appreciation will be taxable as capital gains.
- When you are holding ISO stock that you received within the past tax year, if you exercise the ISO and do not sell the shares within the tax year, you will be subject to AMT on the spread (FMV at exercise minus exercise price) in the year of exercise. Some employees sell before year-end to forestall AMT, though they then pay ordinary tax on the spread as of the date of exercise.



on a future disposition if certain holding periods are met. Under an ESPP, employees generally have the opportunity to use payroll deductions to purchase employer stock during each offering period at a discount up to 15 percent of FMV. The amount of the discount must be included in income as compensation, but the tax event can generally be deferred until a later disposition of the stock.

Nonqualified stock options

Nonqualified stock options (NQSOs) are generally granted with an exercise price equal to the FMV of the underlying stock. The employee can exercise the option by paying the exercise price for each option and receive shares that may be worth more than the exercise price paid. NQSOs are generally taxable on the date of exercise with the compensation equal to the excess of the FMV of the stock purchased over the amount paid (the exercise price).

NQSOs offer an advantage to the company because it can deduct the difference between the FMV of the stock and the option price when the option is exercised, assuming the stock transferred at exercise is not subject to a substantial risk of forfeiture.

Stock appreciation rights

A stock appreciation right is like an option in that it is typically granted at FMV of the underlying stock on the date of grant and can be exercised at a later date when the share value is higher. The employee generally receives cash equal to the FMV of the stock at exercise less the starting value at grant. This spread is taxable as ordinary compensation income on the date of exercise.

Planning tip

If you receive an NQSO, then you can defer the ordinary income recognition by not exercising the option, as the value increases in relation to the stock. This built-in appreciation eliminates the need to exercise options to increase wealth. However, if exercised, further increases in value after exercise are generally taxed at the capital gains rate when the shares are sold.

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Pros and cons of taxable fringe benefits

Many rules govern the taxability of employee fringe benefits and perquisites. Generally, you must include in taxable income the value of benefits you receive that are not specifically excluded from income.

Fringe benefits specifically excluded from income include certain employee discounts on employer goods and services; up to $340 a month (for 2026) of parking subsidies; no-additional-cost services; and benefits of extremely small value such as modest holiday gifts, personal use of office equipment such as a photocopying machine, occasional group meals, and company parties.

The value of other more substantial benefits—personal use of a company car or airplane or a country club membership, for example—must be included in your taxable income.

However, you do not have to include in income items considered working-condition fringe benefits. These include use of property and services while performing services as an employee, such as business use of a company car, for which you could take a business deduction if you had paid for them.

You should consult with your employer to determine if any benefits you receive are taxable. In most situations, you will know because your employer must report the value of taxable benefits as compensation and, in some cases, withhold income taxes as well as Social Security and Medicare taxes. These amounts should be reflected in your Form W-2. Unlike other fringe benefits, however, your employer may elect not to withhold income tax on your personal use of an employer-provided automobile. In that case, you may need to make estimated tax payments to avoid an underpayment penalty.

Your employer may make an election that will treat some benefits provided near the end of the year as provided in the following year. In this case, the value of those benefits would not be taxable to you until you file your return for the following year.

Qualified retirement plans for self-employed individuals

If you are self-employed, then you may establish a qualified retirement plan with contributions based on net earnings from self-employment. Either a defined-contribution or defined-benefit plan can be established.

Defined-contribution plans, such as profit-sharing plans, allow you a deductible contribution with an account-based plan. For a profit-sharing plan, the employer's deduction for the contribution is limited to 25 percent of employee compensation (approximately 20 percent of net earnings for partners). Only the first $360,000 of an individual's earnings (after being reduced by plan contributions and one-half of an individual's self-employment taxes) can be taken into account in 2026 in computing this deductible contribution. If you have employees in your business, then you are generally required to contribute amounts to the retirement plan on their behalf at roughly the same rate as the contributions for your own benefit.

Defined-benefit plans allow a self-employed individual to contribute an amount actuarially sufficient to produce a defined retirement benefit for each participant. This type of plan generally provides a larger tax deduction for older individuals. Generally, a self-employed person can contribute an amount to a defined-benefit plan for the year that will produce a benefit at age 65 of up to $290,000 (for 2026) per year for life. The limit is reduced if the person participates in the plan for less than 10 years. Because defined-benefit plans have required contributions, only companies with fairly large steady streams of income can establish and maintain defined-benefit plans. Most smaller businesses use defined-contribution plans with discretionary contributions.

If you are self-employed (and not an active partner in a partnership), then you can set up a SEP plan, which is effectively an employer-sponsored IRA. Individual accounts are established for each employee with contributions limited to 25 percent of compensation (about 20 percent for self-employed) as modified above or $72,000 (for 2026), whichever is less. Generally, all employees must be included in the SEP if they satisfy minimum age and service requirements and must receive contributions on the same basis.

For 401(k) plans, profit-sharing plans, defined-benefit plans, and SEPs, if the company, or any related company, has employees, then the employees must generally receive the same contribution or a contribution based on the same percentage of income.

A company or self-employed individual can also establish a SIMPLE 401(k) plan if certain requirements are met. This permits the employee to make elective contributions of up to $17,000 (for 2026). If permitted under the plan, then an employee who is age 50 or older can also make an additional catch-up contribution. The employer is required to make minimum contributions to each employee's account, and the employee's rights to all contributions are nonforfeitable.

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Planning tip

- If you are self-employed and will not have employees, then you can establish a "one-person" 401(k) plan. Under this plan, you can make elective contributions for 2025 of up to $24,500 ($32,500 including catch-up, or $35,750 enhanced catch-up if you are aged 60–63) and can make profit-sharing contributions up to a maximum of $72,000 counting both the employer and the elective contributions (for a partner, the deduction for the contribution may be lower based on your net earnings from self-employment). The $72,000 does not include the $8,000 catch-up elective deferrals for employees age 50 and older.
- Typically, you must establish your plan by the end of the year to claim a tax deduction for contributions for that year although you do not need to make contributions until the due date (with extensions) of your return. Depending on the facts, a qualified plan adopted after the close of a tax year but before the due date for filing its return for the tax year (including extensions) may be treated as having been adopted as of the last day of the tax year. Curative amendments to disqualifying provisions may be made retroactively within the period of time, including extensions for filing the return for the year that the amendment was adopted. The curative amendments implemented during the remedial amendment period must be made retroactive to the time when the plan was put into effect (in the case of a new plan) or to the earlier of the time when the amendment was adopted or put into effect (in the case of an amended plan). If you participate in a pension plan, then you must generally make your contributions within 8.5 months after the plan year ends (2.5 months if you do not extend your tax return date). In some cases, quarterly contributions must be made. A different rule may apply if you are the sole owner of an LLC.

Cash versus accrual method of accounting

Businesses must account consistently for income and deduction items. The major initial choice is between the cash and accrual methods of accounting:

- Under the cash method, income is taken into account when it is actually received or is otherwise made available without conditions or restrictions, and liabilities are taken into account upon actual payment.
- Under the accrual method, income is taken into account when the right to income is fixed and the amount can be determined with reasonable accuracy, but generally no later than recognized in the taxpayer's "applicable financial statements." Liabilities are taken into account when the underlying obligation is fixed, the amount is determinable with reasonable accuracy, and "economic performance" has occurred. Economic performance varies based on the type of liability, but goods and services meet the requirement when they are provided to or by the taxpayer.

While in many cases the cash method provides income deferral, its use is limited. For tax years beginning after December 31, 2017, C corporations or partnerships with C corporations as partners generally may not use the cash method unless their average annual gross receipts are $25 million or less, indexed for inflation for years beginning after 2018. For tax years beginning in 2026, the limit is $32 million. You should consult your tax adviser, as the rules concerning choice and application of methods of accounting can be complex.

Tax benefits of depreciation

The purchase of equipment or other property for use in your trade or business entitles you to depreciation over several years. By carefully analyzing these tax benefits, you may find it more advantageous to make a planned acquisition in one year rather than another.

Depreciation of nonbuilding property

Under the modified accelerated cost recovery system (MACRS), nonbuilding property is included in 3-year, 5-year, 7-year, 10-year, 15-year, or 20-year recovery classes, depending generally on the specific asset's class life. You may use a specified accelerated method to deduct the cost of this property over its recovery period.

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Under the TCJA, for certain property placed in service through 2026, a "bonus depreciation" deduction is allowed in the year the property is placed in service. In addition, the OB3 permanently reinstated 100-percent bonus depreciation for qualified property acquired after January 19, 2025. Bonus depreciation is generally available for assets used in the United States with a recovery period of 20 years or less for depreciable computer software and for certain creative property. The rate of bonus depreciation varies depending upon the year the property is acquired and placed in service. For assets acquired prior to September 28, 2017, bonus depreciation is only allowed on otherwise eligible property of which the taxpayer is the original user.

Non original-use assets acquired after September 27, 2017 may be eligible for bonus depreciation if they are acquired by purchase from an unrelated party, so long as the taxpayer did not have a prior depreciable interest in the acquired assets at any time in the year of acquisition or the five preceding years.

Any basis remaining after bonus depreciation is claimed is depreciated using the depreciation method that otherwise applies to the asset. The table below indicates the bonus depreciation percentages available by year.

Acquired	Placed in service	Bonus percentage
9/11/2001–12/31/2004	9/11/2001–5/5/2003	30%
	5/6/2003–12/31/2004	50%
	1/1/2012–12/31/2017	50%
1/1/2008–9/27/2017	1/1/2008–9/8/2010	50%
	9/9/2010–12/31/2011	100%
	1/1/2012–12/31/2017	50%
	2018	40%
	2019	30%
9/28/2017–1/19/2025	9/28/2017–12/31/2022	100%
	2023	80%
	2024	60%
	2025	40%
	2026	20%
1/20/2025 and after		100%

Cost recovery deductions for most passenger automobiles used 100 percent for business purposes are subject to an annual limitation. For automobiles placed in service in 2026, the first-year depreciation deduction limit is $12,300; depreciation for subsequent years is limited to $19,800 in the second tax year, $11,900 in the third, and $7,160 in each year thereafter. If the automobile is eligible for bonus depreciation (acquired after September 27, 2017, and placed in service in 2026), then the first-year amount is $20,300. The limits are adjusted annually for inflation. Slightly higher limitations apply to passenger trucks and vans.

Depreciating real property

Accelerated methods of depreciation generally are not allowed for buildings. For the tax year the property is placed in service, cost recovery deductions are determined monthly. Residential rental property has a 27.5-year recovery period, while nonresidential real property is generally depreciated over 39 years. The recovery period for buildings under the alternative depreciation system is 30 years for residential rental property and 40 years for nonresidential real property.

Qualified improvement property (QIP) is depreciable over 15 years and is eligible for bonus depreciation. QIP is defined as improvements to the interior of nonresidential real property that are made by the taxpayer after the building's original placed-in-service date. QIP does not include elevators, escalators, improvements related to building enlargements, or improvements to the building's internal structural framework.

Prior to 2025, residential and nonresidential real property was not eligible for bonus depreciation. The OB3 created a new class of property, "qualified production property" (QPP), which is eligible for an elective 100 percent depreciation deduction, generally in the year the property is placed in service. QPP includes any portion of nonresidential real property used as an integral part of a "qualified production activity" for which construction begins after January 19, 2025, and before 2031, and which is placed in service in the United States before 2031. For this purpose, a qualified production activity is the manufacturing, production, or refining of a qualified product that is tangible personal property, where the activity results in a substantial transformation of the property.

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Limited expensing

In lieu of depreciation deductions, in 2026, you can elect to deduct up to $2,560,000 of personal property and certain building property placed in service in an active trade or business, provided the total cost of qualifying property you place in service during the tax year is no more than $4,090,000.

The $2,560,000 limitation is reduced by $1 for each dollar by which your aggregate cost of qualifying property placed in service exceeds $4,090,000. The amount eligible to be expensed is limited to the taxable income you derive from any active trade or business.

The annual dollar limitations on passenger automobile depreciation apply to the amount expensed under this election as well as to the depreciation (and bonus depreciation) deducted under the usual rules. For sports utility vehicles that weigh up to 14,000 pounds, in 2026, the first-year expensing amount is limited to $32,000 per vehicle.

Special limits

Depreciation deductions are limited for business property that is used for personal as well as business purposes.

Special rules apply to automobiles, airplanes, boats, and other property used for entertainment, recreation, or amusement. When the business use of such property does not exceed 50 percent of total use, depreciation deductions are allowed only under the alternative depreciation system—straight-line write-offs over the longer class life. You must be able to substantiate the property's business use to avoid application of this rule.

If your business use of property is originally greater than 50 percent but falls to 50 percent or less in a subsequent year, then you may have income from "recapture" of any prior benefit of accelerated depreciation and thus may need to use the slower depreciation going forward.

Tangible property costs

Final tangible property regulations—effective for tax years beginning on or after January 1, 2014—address a wide variety of issues concerning the lifecycle of assets, including:

- Costs to acquire or produce fixed assets or materials and supplies
- Costs to repair or maintain assets (deductible) versus costs to improve assets (capitalizable and recovered over the asset's life)
- Disposition of assets.

For tax years beginning after 2013, the tangible property regulations help taxpayers determine whether certain costs are currently deductible or must be capitalized, and they provide several simplifying provisions. The regulations are extensive and have a wide impact on taxpayers in various industries. Your business will need to assess how to comply with the regulations. This could include changing methods of accounting (normally necessitating a filing with the IRS) or in some cases electing to follow financial accounting treatment, depending on your facts. There are also streamlined procedures for businesses with less than $10 million or less in average annual gross receipts. You should consult your tax adviser, as the rules in this area can be complex.

Sales of depreciable property

If you sell property for which you have taken depreciation or cost recovery deductions, then you may have to report a portion of your gain as ordinary income to account for the benefit of those deductions. All gain on most personal property, on certain nonbuilding real property, and on QPP for which you claimed depreciation is ordinary income to the extent of prior deductions. Most buildings are depreciated using a straight-line method and would face no ordinary income recapture; some recapture might be required if an accelerated depreciation method was used or if bonus depreciation was claimed.

In addition, for an individual taxpayer, a portion of the capital gain on such real property would not be eligible for the 15 percent or 20 percent maximum capital gain tax rate and would be taxed at 25 percent. Gain recaptured as ordinary income cannot be offset by capital losses.



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Planning tips

- If you do not want the larger deductions allowed by the MACRS general depreciation system for personal property placed in service during the year or the bonus depreciation deduction, then you can elect not to use bonus depreciation and can also elect to apply the alternative depreciation system (ADS) rules, and deduct the cost of the property on a straight-line basis over the longer ADS recovery period. This spreads the annual deductions evenly over the life of the property (in the first and last years, however, the applicable convention is applied). This election applies to all personal property in a particular recovery class placed in service during the year. Thus, you can elect straight-line depreciation for all five-year personal property while still claiming accelerated cost recovery for all seven-year recovery property. The ADS election can also be made for nonresidential real property or residential rental property and is made separately with respect to each property.
- Another option is to elect to use the 150 percent declining balance method. This method generally is required for AMT purposes and offers the advantage of avoiding additional calculations for AMT purposes. However, although it may help with recordkeeping, this election will not reduce, and may increase, your total tax liability.
- Straight-line depreciation over the property's longer recovery period (under ADS) is generally required for certain property used outside the United States, property financed by tax-exempt bonds, and property used by or leased to a tax-exempt entity.
- If you have made or plan to make purchases of depreciable personal property, then you should carefully assess the effect of these different depreciation deductions and elections on your taxable income.

Taxation of net operating losses

Historically, if an individual taxpayer generated a net operating loss (NOL), the taxpayer was able to carry back such NOLs against 100 percent of the taxable income of the previous years, potentially creating a tax refund. If an NOL remained after considering the carryback above (or if such carryback was waived), then the individual taxpayer could carry the NOL forward to offset up to 100 percent of taxable income of the taxpayer for 20 years after the generation of the NOL.

Beginning in 2018, the NOL provisions have been modified, and losses generated in years ending after December 31, 2017 may no longer be carried back but may be carried forward indefinitely. In addition, NOLs carried forward are limited to 80 percent of taxable income for tax years ending after December 31, 2017. NOLs that arose in years beginning prior to January 1, 2018 are not subject to the 80 percent limitation.

Substantiating business expenses

Although you must be able to prove all deductions you take, more stringent substantiation rules apply to certain expenses (e.g., travel, meal and entertainment expenses, and business gifts) than to others. To deduct these expenses, you must document the amount of the expense; the date and place of the travel, entertainment, or meals; the business purpose of the expenditure; the nature of the business benefit derived; and the business relationship of the person for whom expenses were incurred. Safe harbors set by the IRS may alleviate the need to keep detailed records for various types of individual business expenses in certain situations. Many companies may have policies acceptable to the IRS that might require receipts only for expenses above a certain amount, for example, $75 or more.

For automobiles used for business, you can either deduct the actual expenses of using the automobile, or you can base your deduction on a standard mileage rate. Certain restrictions may apply to the method used. The standard mileage rate to be used for a given year is determined and published by the IRS (the rate for 2026 is 70 cents per mile). While you may not take a separate deduction for depreciation of the vehicle, fees and tolls incurred during business use may be deducted. Note that the amount of this deduction may be reduced if you work out of your home.

Historically, 50 percent of the cost of business meals and entertainment was deductible. The TCJA completely repealed deductions for entertainment, amusement, and recreation even when directly related

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to the conduct of a taxpayer's trade or business.

The TCJA provides that no deduction is allowed for (1) an activity considered entertainment, amusement, or recreation; (2) membership dues for any club organized for business, pleasure, recreation, or other social purposes; or (3) a facility or portion of a facility used in connection with entertainment, amusement, or recreation. The 50 percent deduction limitation for food and beverage expenses associated with a trade or business is generally retained. The Taxpayer Certainty and Disaster Relief Act of 2020 temporarily increased the deductibility of business meals provided at a restaurant to 100 percent for 2020 through 2022; however, the deductibility of those meals decreased to 50 percent again thereafter.

The TCJA expanded the 50 percent limitation to apply to certain meals provided by an employer that previously had been 100 percent deductible. The expanded 50 percent limit applies to food and beverages provided to employees as de minimis fringe benefits, to meals provided at an eating facility that meets the requirements for an on-premises dining facility, and to meals provided to employees for the convenience of the employer (Section 119 meals). The 50 percent deduction limit applies for tax years 2018 through 2025. On-premises meals, Section 119 meals expenses, and the expenses for the related on-premises facilities would be nondeductible after 2025.

Separately, the TCJA disallowed the ability for an individual taxpayer to deduct miscellaneous itemized deductions for tax years 2018 through 2025, including certain unreimbursed employee expenses. The OB3 makes the temporary suspension of miscellaneous itemized deductions permanent. See Chapter 1, "Miscellaneous itemized deductions," for more detail.

Calculating self-employment taxes

In 2025, the maximum wage base for Social Security taxes is $176,100. There is no maximum wage base for the Medicare tax. The rates used to calculate the correlating Social Security and Medicare portions of self-employment tax—known as SECA tax—are 15.3 percent on the first $176,100 and 2.9 percent on all amounts above (equal to both the employee and employer portion of Social Security and Medicare taxes). However, for compensation above $200,000, an additional Medicare contribution is required equal to an additional 0.9 percent, for a total of 3.8 percent Medicare tax on compensation above $200,000.

Other than the 0.9 percent additional Medicare contribution, half of a self-employed individual's Social Security and Medicare (i.e., SECA tax) contribution is deductible.

Planning tip

As a self-employed person, you may be entitled to deduct 100 percent of the premiums paid for health insurance for yourself, your spouse, and your dependents when calculating your AGI.

The deduction cannot exceed your net earnings from self-employment in the trade or business for which the insurance coverage was established. You cannot deduct this amount if you are eligible to participate in an employer-sponsored plan (yours or your spouse's). This deduction does not reduce the income base used for computing your SECA tax.

For monthly employment tax updates, including a payroll year-end guide and checklist, see Payroll Insights: Employment tax news to guide you now and for the future.

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Employee retention credit

The CARES Act allows eligible employers affected by COVID-19 to claim an employee retention credit (ERC)—a refundable payroll tax credit—with respect to qualified wages paid to employees after March 12, 2020 and before October 1, 2021 on Form 941-X, (*Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund*). For purposes of the ERC, however, qualified wages do not include amounts paid to individuals who are related to the employer or to certain direct and indirect owners of the employing entity.

Generally, the deadline for claiming the ERC for 2020 tax periods is April 15, 2024. For 2021 tax periods, the deadline is April 15, 2025.

Below-market-rate loans

You can provide financial assistance to family members without making outright gifts. For example, you may want to assist your child in purchasing a house or car or in funding undergraduate or postgraduate education. You can do this by making a loan to your child, either repayable with no interest or with an interest rate much lower than can be obtained from other lenders.

When loans are made to family members at less than a "market rate" of interest, the IRS requires the loan to be restructured, for tax purposes, as if the loan had been made at a market rate of interest. To accomplish this, you are treated as if you made a gift to your son, daughter, or other family member for the additional interest he or she would have paid if the loan had been made at a market rate. Further, you must recognize income for the additional interest—and your child or family member is entitled to a corresponding deduction subject to applicable limitations—as if the additional interest had been paid to you, a requirement known as imputed interest.

There are some important exceptions to the below-market-rate loan rules.

Under a de minimis exception, a gift loan of $10,000 or less is exempt from the below-market-rate loan provisions if the borrower does not use the money to purchase or to enable him or her to continue to hold income-producing assets, such as stocks or bonds. Gift loans you make to the same borrower are aggregated, and the de minimis exception applies only if the total of such loans is $10,000 or less.

Another exception limits the amount of additional interest income you have to report. If loans to your child or other family member do not exceed $100,000, then the additional income you must report will be no greater than the investment income your child receives. This exception does not apply if the principal purpose of making the loan was to avoid taxes.

Remember also that a below-market-rate loan may have gift tax consequences depending on whether the loan is payable on demand or is repayable over a stated period of time.

If you do not meet either of the above exceptions, then you can avoid the below-market-rate loan requirements by making a loan at a market rate of interest as defined by the tax law. This market rate is lower than the rate that normally could be obtained from lending institution.

Planning tip

To avoid the difficulty of computing and reporting imputed interest, charge a market rate of interest, then make a cash gift to your child that would allow him or her to pay you the interest.

Deducting home office expenses

In prior years, you could potentially deduct as a miscellaneous itemized deduction certain expenses incurred in maintaining the portion of your home that was utilized as a home office. However, the TCJA suspended miscellaneous itemized deductions that were previously subject to 2 percent of AGI limitation for tax years 2018 through 2025, and the OB3 made this suspension permanent.

If you are self-employed, then you may continue to deduct qualifying home office expenses.

Planning tip

The COVID-19-related changes in the workplace are beginning to reverse for some employers, but many individuals continue to work from home at least for a portion of their workweek. The potential benefit from the home office tax deduction that may be available to self-employed taxpayers (including certain partners in partnerships) should not be overlooked.

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Hobby losses

You may not deduct net losses from a hobby or any activity from which you do not expect to make a profit. However, if an activity results in a profit in at least three out of the last five consecutive tax years (two out of seven years for certain horse-related activities), then it will be presumed to be for profit and not a hobby.If you fail to make a profit within the testing period, then the burden of proof rests with you to prove to the IRS that you are engaged in the activity to make a profit. Even if your activity is not for profit, you must include income from the activity on your return. Hobby income is not subject to self-employment tax because a hobby is not considered a trade or business.

Historically, expenses have been allowed (not to exceed the amount of the hobby income) subject to an ordering system. For individuals, these expenses may only be deducted if you itemize and many of the expense items fall into the category of miscellaneous itemized deductions subject to 2 percent of AGI. Asnoted previously, theTCJA suspended the deductibility of miscellaneous itemized deductions for tax years 2018 through 2025, and the OB3 permanently eliminated the deduction for miscellaneous itemized deductions. As a result, deductions for hobby-related expenses are permanently disallowed.

Private aircraft

Travel expenses that are covered by the business and not limited to business purposes may result in taxable income to you. Generally, if you fly in an airplane owned or leased by the company and the trip has a personal component, then value attributable to that flight may need to be calculated and reported to you as compensation.The value of any flights for your friends or family members is generally taxable to you as well if not primarily for bona fide business purposes.

Details of each flight (including departure and arrival locations, miles flown, size, and weight of aircraft) as well as a standard industry fare level (SIFL) published semiannually are taken into account in determining the amount of taxable income.

The company's deduction may also be limited for expenses related to certain travel, e.g., entertainment trips, on the company aircraft (even when there is no taxable compensation to the individual). Special depreciation rules may apply, and the structure of any leasing arrangement should be considered.

Selling the business—golden parachute payments

If you are contemplating selling all or a part of the business, one item to consider is whether the sale is subject to the golden parachute rules.These rules apply when there is a change in control of a corporation.

The rules deny a deduction to the payer of any "excess parachute payments" and impose a 20 percent excise tax on the recipient of such payments.The deduction disallowance and excise tax only apply with respect to officers, highly compensated individuals, and stockholders holding more than 1 percent (held directly and indirectly).

Parachute payments generally include compensation contingent on the change in control, which can include items such as severance, transaction bonuses, and value attributable to the accelerated vesting or payment of any deferred compensation or equity awards. Parachute payments typically do not include any payments solely with respect to ownership of the company (i.e., payments that are not in the nature of compensation).Whether there are excess parachute payments is based on a comparison of total potential parachute payments to the individual's base amount or average annual taxable compensation.

For nonpublicly traded companies, the consequences of the golden parachute rules may be mitigated—or eliminated entirely—if certain shareholder disclosure and approval requirements are met.The consequences of these rules can also be mitigated with advanced planning.

Cross-border considerations

If you operate a multinational business or your business involves international travel, then there are cross-border considerations to keep in mind. Depending on the structure of the business, certain US tax rules regarding the deductibility of various compensation payments may need to be considered with respect to foreign branches or individuals. In addition to company tax considerations, compensation and other benefits may be subject to special sourcing rules, and taxation of those amounts may be affected by foreign tax rules and relevant tax treaties.

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