

Income

This self-study course discusses various types of income and will explain which income is and is not taxed. Though this basic tax course does not require any prerequisites, its recommended target audience is for existing Enrolled Agents, however anyone may take this course. This course provides 5 CE credits in the IRS Federal Tax Law category.

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NOTICE

This course is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional advice and assumes no liability whatsoever in connection with its use. Since laws are constantly changing, and are subject to differing interpretations, we urge you to do additional research and consult appropriate experts before relying on the information contained in this course to render professional advice

Chapter 1: Wages, Salaries, And Other Earnings

Chapter Objective

After completing this chapter, you should be able to:

- Recall what types of compensation are included as income for tax purposes.

I. What's New

For 2023, the tax rate on the employee portion of social security is 6.2% on wages up to \$160,200. Social security tax withholdings should not exceed \$9,932.40. Medicare tax of 1.45% is withheld from all wages regardless of amount.

Self-employment tax of 15.3% applies to earnings of up to \$160,200 after the earnings are reduced by 7.65%. The 15.3% rate equals 12.4% for social security (6.2% employee share and 6.2% employer share) plus 2.9% for Medicare. If net earnings exceed \$160,200, the 2.9% Medicare rate applies to the entire amount. For 2024, the wage base will rise to \$168,600.

Net self-employment earnings will be subject to the 0.9% Additional Medicare Tax if earnings exceed \$200,000 if single, head of household, or qualifying widow(er), \$250,000 if married filing jointly, and \$125,000 if married filing separately.

II. Introduction

This chapter discusses compensation received for services as an employee, such as wages, salaries, and fringe benefits. The following topics are included:

- Bonuses and awards,
- Special rules for certain employees, and
- Sickness and injury benefits.

The chapter explains what income is included in the employee's gross income and what is not included.

III. Employee Compensation

This section discusses various types of employee compensation followed by a detailed explanation of fringe benefits.

MISCELLANEOUS COMPENSATION

Bonuses and awards. If you receive a bonus or award (cash, goods, services) from your employer, you must include its value in your income. However, if your employer merely promises to pay you a bonus or award at some future time, it is not taxable until you receive it or it is made available to you.

Sick pay. Pay you receive from your employer while you are sick or injured is part of your salary or wages. In addition, you must include in your income sick pay benefits received from any of the following payers.

1. A welfare fund.
2. A state sickness or disability fund.
3. An association of employers or employees.
4. An insurance company, if your employer paid for the plan.

However, if you paid the premiums on an accident or health insurance policy yourself, the benefits you receive under the policy are not taxable.

FRINGE BENEFITS

Fringe benefits received in connection with the performance of your services are included in your income as compensation unless you pay fair market value for them or they are specifically excluded by law. Refraining from the performance of services (for example, under a covenant not to compete) is treated as the performance of services for purposes of these rules.

Accident or Health Plan

In most cases, the value of accident or health plan coverage provided to you by your employer is not included in your income. Benefits you receive from the plan may be taxable, as explained later under Sickness and Injury Benefits.

Long-term care coverage. Contributions by your employer to provide coverage for long-term care services are generally not included in income. However, contributions made through a flexible spending or similar arrangement offered by your employer must be included in your income. This amount will be reported as wages in box 1 of your Form W-2.

Archer MSA contributions. Contributions by your employer to your Archer MSA are not included in your income. Their total will be reported in box 12 of Form W-2 with code R. You must report this amount on Form 8853, Archer MSAs and Long-Term Care Insurance Contracts. File the form with your return.

De Minimis (Minimal) Benefits

If your employer provides you with a product or service and the cost of it is so small that it would be unreasonable for the employer to account for it, you generally do not include the value in your income. In most cases, the value of discounts at company cafeterias, cab fares home when working overtime, and company picnics are not included in your income.

Holiday gifts. If your employer gives you a turkey, ham, or other item of nominal value at Christmas or other holidays, do not include the value of the gift in your income. However, if your employer gives you cash or cash equivalent, you must include it in your income.

Educational Assistance

You can exclude from your income up to \$5,250 of qualified employer-provided educational assistance.

Group-Term Life Insurance

In most cases, the cost of up to \$50,000 of group-term life insurance coverage provided to you by your employer (or former employer) is not included in your income. However, you must include in income the cost of employer-provided insurance that is more than the cost of \$50,000 of coverage reduced by any amount you pay toward the purchase of the insurance.

Transportation

If your employer provides you with a qualified transportation fringe benefit, it can be excluded from your income, up to certain limits. A qualified transportation fringe benefit is:

- Transportation in a commuter highway vehicle (such as a van) between your home and work place,
- A transit pass, or
- Qualified parking.

Cash reimbursement by your employer for these expenses under a bona fide reimbursement arrangement is also excludable. However, cash reimbursement for a transit pass is excludable only if a voucher or similar item that can be exchanged only for a transit pass is not readily available for direct distribution to you.

Exclusion limit. The exclusion for commuter highway vehicle transportation and transit pass fringe benefits cannot be more than \$300 a month.

The exclusion for the qualified parking fringe benefit cannot be more than \$300 per month.

If the benefits have a value that is more than these limits, the excess must be included in your income.

Commuter highway vehicle. This is a highway vehicle that seats at least six adults (not including the driver). At least 80% of the vehicle's mileage must reasonably be expected to be:

- For transporting employees between their homes and work place, and
- On trips during which employees occupy at least half of the vehicle's adult seating capacity (not including the driver).

Transit pass. This is any pass, token, farecard, voucher, or similar item entitling a person to ride mass transit (whether public or private) free or at a reduced rate or to ride in a commuter highway vehicle operated by a person in the business of transporting persons for compensation.

Qualifying parking. This is parking provided to an employee at or near the employer's place of business. It also includes parking provided on or near a location from which the employee commutes to work by mass transit, in a commuter highway vehicle, or by carpool. It does not include parking at or near the employee's home.

IV. Special Rules For Certain Employees

FOREIGN EMPLOYER

Special rules apply if you work for a foreign employer.

U.S. citizen. If you are a U.S. citizen who works in the United States for a foreign government, an international organization, a foreign embassy, or any foreign employer, you must include your salary in your income.

Social security and Medicare taxes. You are exempt from social security and Medicare taxes if you are employed in the United States by an international organization or a foreign government. However, you must pay self-employment tax on your earnings from services performed in the United States, even though you are not self-employed. This rule also applies if you are an employee of a qualifying whollyowned instrumentality of a foreign government.

Employees of international organizations or foreign governments. Your compensation for official services to an international organization is exempt from federal income tax if you are not a citizen of the United States or you are a citizen of the Philippines (whether or not you are a citizen of the United States).

Your compensation for official services to a foreign government is exempt from federal income tax if all of the following are true:

- You are not a citizen of the United States or you are a citizen of the Philippines (whether or not you are a citizen of the United States).
- Your work is like the work done by employees of the United States in foreign countries.
- The foreign government gives an equal exemption to employees of the United States in its country.

Waiver of alien status. If you are an alien who works for a foreign government or international organization and you file a waiver under section 247(b) of the Immigration and Nationality Act to keep your immigrant status, different rules may apply.

MILITARY

Payments you receive as a member of a military service generally are taxed as wages except for retirement pay, which is taxed as a pension. Allowances generally are not taxed.

Military retirement pay. If your retirement pay is based on age or length of service, it is taxable and must be included in your income as a pension on lines 5a and 5b of Form 1040 or 1040-SR. Do not include in your income the amount of any reduction in retirement or retainer pay to provide a survivor annuity for your spouse or children under the Retired Serviceman's Family Protection Plan or the Survivor Benefit Plan.

Veterans' benefits. Do not include in your income any veterans' benefits paid under any law, regulation, or administrative practice administered by the Department of Veterans Affairs (VA). The following amounts paid to veterans or their families are not taxable.

- Education, training, and subsistence allowances.
- Disability compensation and pension payments for disabilities paid either to veterans or their families.
- Grants for homes designed for wheelchair living.
- Grants for motor vehicles for veterans who lost their sight or the use of their limbs.
- Veterans' insurance proceeds and dividends paid either to veterans or their beneficiaries, including the proceeds of a veteran's endowment policy paid before death.
- Interest on insurance dividends you leave on deposit with the VA.
- Benefits under a dependent-care assistance program.
- The death gratuity paid to a survivor of a member of the Armed Forces who dies after September 10, 2001.
- Payments made under the compensated work therapy program.
- Any bonus payment by a state or political subdivision because of service in a combat zone.

VOLUNTEERS

Peace Corps. Living allowances you receive as a Peace Corps volunteer or volunteer leader for housing, utilities, household supplies, food, and clothing are exempt from tax.

Taxable allowances. The following allowances must be included in your income and reported as wages.

- Allowances paid to your spouse and minor children while you are a volunteer leader training in the United States.
- Living allowances designated by the Director of the Peace Corps as basic compensation. These are allowances for personal items such as domestic help, laundry and clothing maintenance, entertainment and recreation, transportation, and other miscellaneous expenses.
- Leave allowances.
- Readjustment allowances or termination payments. These are considered received by you when credited to your account.

Example

Gary Carpenter, a Peace Corps volunteer, gets \$175 a month as a readjustment allowance during his period of service, to be paid to him in a lump sum at the end of his tour of duty. Although the allowance is not available to him until the end of his service, Gary must include it in his income on a monthly basis as it is credited to his account.

Volunteers in Service to America (VISTA). If you are a VISTA volunteer, you must include meal and lodging allowances paid to you in your income as wages.

National Senior Services Corps programs. Do not include in your income amounts you receive for supportive services or reimbursements for out-of-pocket expenses from the following programs.

- Retired Senior Volunteer Program (RSVP).
- Foster Grandparent Program.
- Senior Companion Program.

Service Corps of Retired Executives (SCORE). If you receive amounts for supportive services or reimbursements for out-of-pocket expenses from SCORE, do not include these amounts in gross income.

V. Sickness And Injury Benefits

In most cases, you must report as income any amount you receive for personal injury or sickness through an accident or health plan that is paid for by your employer. If both you and your employer pay for the plan, only the amount you receive that is due to your employer's payments is reported as income. However, certain payments may not be taxable to you.

Tip

Do not report as income any amounts paid to reimburse you for medical expenses you incurred after the plan was established.

Cafeteria plans. In most cases, if you are covered by an accident or health insurance plan through a cafeteria plan, and the amount of the insurance premiums was not included in your income, you are not considered to have paid the premiums and you must include any benefits you receive in your income. If the amount of the premiums was included in your income, you are considered to have paid the premiums, and any benefits you receive are not taxable.

DISABILITY PENSIONS

If you retired on disability, you must include in income any disability pension you receive under a plan that is paid for by your employer. You must report your taxable disability payments as wages on line 1 of Form 1040 or 1040-SR until you reach minimum retirement age. Minimum retirement age generally is the age at which you can first receive a pension or annuity if you are not disabled. There is a tax credit for people who are permanently and totally disabled when they retired.

Beginning on the day after you reach minimum retirement age, payments you receive are taxable as a pension or annuity. Report the payments on lines 5a and 5b of Form 1040 or 1040-SR.

Retirement and profit-sharing plans. If you receive payments from a retirement or profit-sharing plan that does not provide for disability retirement, do not treat the payments as a disability pension. The payments must be reported as a pension or annuity.

Accrued leave payment. If you retire on disability, any lump-sum payment you receive for accrued annual leave is a salary payment. The payment is not a disability payment. Include it in your income in the tax year you receive it.

Military and Government Disability Pensions

Certain military and government disability pensions are not taxable.

Service-connected disability. You may be able to exclude from income amounts you receive as a pension, annuity, or similar allowance for personal injury or sickness resulting from active service in one of the following government services.

- The armed forces of any country.
- The National Oceanic and Atmospheric Administration.
- The Public Health Service.
- The Foreign Service.

Pension based on years of service. If you receive a disability pension based on years of service, you generally must include it in your income. However, if the pension qualifies for the exclusion for a service-connected disability, do not include in income the part of your pension that you would have received if the pension had been based on a percentage of disability. You must include the rest of your pension in your income.

Terrorist attack or military action. Do not include in your income disability payments you receive for injuries resulting directly from a terrorist attack directed against the United States (or its allies), whether outside or within the United States or from military action.

WORKERS' COMPENSATION

Amounts you receive as workers' compensation for an occupational sickness or injury are fully exempt from tax if they are paid under a workers' compensation act or a statute in the nature of a workers' compensation act. The exemption also applies to your survivors. The exemption, however, does not apply to retirement plan benefits you receive based on your age, length of service, or prior contributions to the plan, even if you retired because of an occupational sickness or injury.

OTHER SICKNESS AND INJURY BENEFITS

Railroad sick pay. Payments you receive as sick pay under the Railroad Unemployment Insurance Act are taxable and you must include them in your income. However, do not include them in your income if they are for an on-the-job injury.

Federal Employees' Compensation Act (FECA). Payments received under this Act for personal injury or sickness, including payments to beneficiaries in case of death, are not taxable. However, you are taxed on amounts you receive under this Act as continuation of pay for up to 45 days while a claim is being decided. Report this income as wages. Also, pay for sick leave while a claim is being processed is taxable and must be included in your income as wages.

Caution!

If part of the payments you receive under FECA reduces your social security or equivalent railroad retirement benefits received, that part is considered social security (or equivalent railroad retirement) benefits and may be taxable.

Other compensation. Many other amounts you receive as compensation for sickness or injury are not taxable. These include the following amounts.

- Compensatory damages you receive for physical injury or physical sickness, whether paid in a lump sum or in periodic payments.
- Benefits you receive under an accident or health insurance policy on which either you paid the premiums or your employer paid the premiums but you had to include them in your income.
- Disability benefits you receive for loss of income or earning capacity as a result of injuries under a no-fault car insurance policy.
- Compensation you receive for permanent loss or loss of use of a part or function of your body, or for your permanent disfigurement. This compensation must be based only on the injury and not on the period of your absence from work. These benefits are not taxable even if your employer pays for the accident and health plan that provides these benefits.

Reimbursement for medical care. A reimbursement for medical care is generally not taxable. However, it may reduce your medical expense deduction.

CHAPTER 1: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. In 2023, how much can you exclude from your income for qualified employer provided educational assistance:

- A. \$1,000
- B. \$2,000
- C. \$4,000
- D. \$5,250

2. What is the exclusion limit for a qualified parking fringe benefit for 2023:

- A. \$150 per month
- B. \$300 per month
- C. \$350 per month
- D. \$500 per month

CHAPTER 1: SOLUTION AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.

- A. Incorrect. The amount is higher than \$1,000.
- B. Incorrect. The amount is higher than \$2,000.
- C. Incorrect. The amount is higher than \$4,000.
- D. **CORRECT**. Employer-provided educational assistance is among the list of employer fringe benefits that can be excluded from income.

2.

- A. Incorrect. One hundred fifty dollars per month is significantly lower than the allowed fringe benefit exclusion.
- B. **CORRECT**. The exclusion limit for a qualified parking fringe benefit is \$300 per month. If the benefit has a value greater than this limit, the excess must be included in the taxpayers' income.
- C. Incorrect. Three hundred fifty dollars per month is not related to any fringe benefit exclusion limit.
- D. Incorrect. Five hundred dollars per month is not related to any fringe benefit exclusion limit discussed.

Chapter 2: Tip Income

Chapter Objective

After completing this chapter, you should be able to:

- Recognize what tips should be included in income for tax purposes.

I. Reporting Tip Income

This chapter is for employees who receive tips.

All tips you receive are income and are subject to federal income tax. You must include in gross income all tips you receive directly, charged tips paid to you by your employer, and your share of any tips you receive under a tip-splitting or tip-pooling arrangement.

The value of noncash tips, such as tickets, passes, or other items of value, is also income and subject to tax.

Reporting your tip income correctly is not difficult. You must do three things.

1. Keep a daily tip record.
2. Report tips to your employer.
3. Report all your tips on your income tax return.

CHAPTER 2: TEST YOUR KNOWLEDGE

The following question is designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). It is included as an additional tool to enhance your learning experience and does not need to be submitted in order to receive CE credit.

We recommend that you answer the question and then compare your response to the suggested solution on the following page before answering the final exam question(s) related to this chapter (assignment).

1. Tip income must be correctly reported. Which of the following tasks is not required of employees receiving tips:

- A. keep a daily tip record
- B. separate and report only currency tips to your employer
- C. report all tips to your employer
- D. report all your tips on your income tax return

CHAPTER 2: SOLUTION AND SUGGESTED RESPONSES

Below is the solution and suggested responses for the question on the previous page. If you choose an incorrect answer, you should review the page(s) as indicated for the question to ensure comprehension of the material.

1.

- A. Incorrect. Keeping a daily tip record in some form is required of all employees who regularly receive tip income.
- B. **CORRECT**. This task statement is incomplete for any employee receiving tip income. All cash (currency + coins), checks, and credit card tips received must be reported to your employer. These will be subject to social security taxes.
- C. Incorrect. Reporting all tips (except non-cash items such as tickets, passes etc.) to your employer is required.

- D. Incorrect. Reporting all of your tip income (including non-cash items of value such as tickets and passes) must be reported on your income tax return.

Chapter 3: Interest Income

Chapter Objective

After completing this chapter, you should be able to:

- Recall the proper tax treatment for various types of interest.

I. Important Reminder

Foreign-source income. If you are a U.S. citizen with interest income from sources outside the United States (foreign income), you must report that income on your tax return unless it is exempt by U.S. law. This is true whether you reside inside or outside the United States and whether or not you receive a Form 1099 from the foreign payer.

II. Introduction

This chapter discusses:

- Different types of interest income, and
- What interest is taxable and what interest is nontaxable.

III. Taxable Interest

Taxable interest includes interest you receive from bank accounts, loans you make to others, and other sources. The following are some other sources of taxable interest.

Dividends that are actually interest. Certain distributions commonly called dividends are actually interest. You must report as interest so-called “dividends” on deposits or on share accounts in:

- Cooperative banks,
- Credit unions,
- Domestic building and loan associations,
- Domestic savings and loan associations,
- Federal savings and loan associations, and
- Mutual savings banks.

The “dividends” will be shown as interest on Form 1099-INT.

Money market funds. Generally, amounts you receive from money market funds should be reported as dividends, not as interest.

Certificates of deposit and other deferred interest accounts. If you open any of these accounts, interest may be paid at fixed intervals of 1 year or less during the term of the account. You generally must include this interest in your income when you actually receive it or are entitled to receive it without paying a substantial penalty. The same is true for accounts that mature in 1 year or less and pay interest in a single payment at maturity. If interest is deferred for more than 1 year, see Original Issue Discount (OID), later.

Interest subject to penalty for early withdrawal. If you withdraw funds from a deferred interest account before maturity, you may have to pay a penalty. You must report the total amount of interest paid or credited to your account during the year, without subtracting the penalty.

Interest on insurance dividends. Interest on insurance dividends left on deposit with an insurance company that can be withdrawn annually is taxable to you in the year it is credited to your account. However, if you can withdraw it only on the anniversary date of the policy (or other specified date), the interest is taxable in the year that date occurs.

Prepaid insurance premiums. Any increase in the value of prepaid insurance premiums, advance premiums, or premium deposit funds is interest if it is applied to the payment of premiums due on insurance policies or made available for you to withdraw.

U.S. obligations. Interest on U.S. obligations, such as U.S. Treasury bills, notes, and bonds, issued by any agency or instrumentality of the United States is taxable for federal income tax purposes.

Interest on tax refunds. Interest you receive on tax refunds is taxable income.

Interest on condemnation award. If the condemning authority pays you interest to compensate you for a delay in paying an award, the interest is taxable.

Installment sale payments. If a contract for the sale or exchange of property provides for deferred payments, it also usually provides for interest payable with the deferred payments. Generally, that interest is taxable when you receive it. If little or no interest is provided for in a deferred payment contract, part of each payment may be treated as interest.

Interest on annuity contract. Accumulated interest on an annuity contract you sell before its maturity date is taxable.

Usurious interest. Usurious interest is interest charged at an illegal rate. This is taxable as interest unless state law automatically changes it to a payment on the principal.

Interest income on frozen deposits. Exclude from your gross income interest on frozen deposits. A deposit is frozen if, at the end of the year, you cannot withdraw any part of the deposit because:

1. The financial institution is bankrupt or insolvent, or
2. The state where the institution is located has placed limits on withdrawals because other financial institutions in the state are bankrupt or insolvent.

The amount of interest you must exclude is the interest that was credited on the frozen deposits minus the sum of:

1. The net amount you withdrew from these deposits during the year, and
2. The amount you could have withdrawn as of the end of the year (not reduced by any penalty for premature withdrawals of a time deposit).

The interest you exclude is treated as credited to your account in the following year. You must include it in income in the year you can withdraw it.

Example

\$100 of interest was credited on your frozen deposit during the year. You withdrew \$80 but could not withdraw any more as of the end of the year. You must include \$80 in your income for the year and exclude \$20 from your income for the year. You must include the \$20 in your income for the year you can withdraw it.

Bonds traded flat. If you buy a bond when interest has been defaulted or when the interest has accrued but has not been paid, the transaction is described as trading a bond flat. The defaulted or unpaid interest is not income and is not taxable as interest if paid later. When you receive a payment of that interest, it is a return of capital that reduces the remaining cost basis of your bond. Interest that accrues after the date of purchase, however, is taxable interest income for the year it is received or accrued. See *Bonds Sold Between Interest Dates*, later, for more information.

Below-market loans. A below-market loan is a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate.

U.S. SAVINGS BONDS

Accrual method taxpayers. If you use an accrual method of accounting, you must report interest on U.S. savings bonds each year as it accrues. You cannot postpone reporting interest until you receive it or the bonds mature.

Cash method taxpayers. If you use the cash method of accounting, as most individual taxpayers do, you generally report the interest on U.S. savings bonds when you receive it.

U.S. TREASURY BILLS, NOTES, AND BONDS

Treasury bills, notes, and bonds are direct debts (obligations) of the U.S. Government.

Taxation of interest. Interest income from Treasury bills, notes, and bonds is subject to federal income tax, but is exempt from all state and local income taxes. You should receive a Form 1099-INT showing the amount of interest (in box 3) that was paid to you for the year.

Treasury bills. These bills generally have a 4-week, 13-week, 26-week, or 52-week maturity period. They are issued at a discount in the amount of \$100 and multiples of \$100. The difference between the discounted price you pay for the bills and the face value you receive at maturity is interest income. Generally, you report this interest income when the bill is paid at maturity. If you paid a premium for a bill (more than face value), you generally report the premium as a section 171 deduction when the bill is paid at maturity.

Treasury notes and bonds. Treasury notes have maturity periods of more than one year, ranging up to ten years. Maturity periods for Treasury bonds are longer than ten years. Both of these Treasury issues generally are issued in denominations of \$100 to \$1 million. Both notes and bonds generally pay interest every six months. Generally, you report this interest for the year paid.

BONDS SOLD BETWEEN INTEREST DATES

If you sell a bond between interest payment dates, part of the sales price represents interest accrued to the date of sale. You must report that part of the sales price as interest income for the year of sale.

If you buy a bond between interest payment dates, part of the purchase price represents interest accrued before the date of purchase. When that interest is paid to you, treat it as a return of your capital investment, rather than interest income.

INSURANCE

Life insurance proceeds paid to you as beneficiary of the insured person are usually not taxable. But if you receive the proceeds in installments, you must usually report a part of each installment payment as interest income.

Annuity. If you buy an annuity with life insurance proceeds, the annuity payments you receive are taxed as pension and annuity income from a nonqualified plan, not as interest income.

ORIGINAL ISSUE DISCOUNT (OID)

Original issue discount (OID) is a form of interest. You generally include OID in your income as it accrues over the term of the debt instrument, whether or not you receive any payments from the issuer.

A debt instrument generally has OID when the instrument is issued for a price that is less than its stated redemption price at maturity. OID is the difference between the stated redemption price at maturity and the issue price.

All debt instruments that pay no interest before maturity are presumed to be issued at a discount. Zero coupon bonds are one example of these instruments.

The OID accrual rules generally do not apply to short-term obligations (those with a fixed maturity date of 1 year or less from date of issue).

Example 1

You bought a 10-year bond with a stated redemption price at maturity of \$1,000, issued at \$980 with OID of \$20. One-fourth of 1% of \$1,000 (stated redemption price) times 10 (the number of full years from the

date of original issue to maturity) equals \$25. Because the \$20 discount is less than \$25, the OID is treated as zero. (If you hold the bond at maturity, you will recognize \$20 (\$1,000 - \$980) of capital gain.)

Example 2

The facts are the same as in Example 1, except that the bond was issued at \$950. The OID is \$50. Because the \$50 discount is more than the \$25 figured in Example 1, you must include the OID in income as it accrues over the term of the bond.

Debt instrument bought after original issue. If you buy a debt instrument with de minimis OID at a premium, the discount is not includible in income. If you buy a debt instrument with de minimis OID at a discount, the discount is reported under the market discount rules.

Certificates of deposit (CDs). If you buy a CD with a maturity of more than 1 year, you must include in income each year a part of the total interest due and report it in the same manner as other OID.

This also applies to similar deposit arrangements with banks, building and loan associations, etc., including:

- Time deposits
- Bonus plans,
- Savings certificates,
- Deferred income certificates,
- Bonus savings certificates, and
- Growth savings certificates.

Bearer CDs. CDs issued after 1982 generally must be in registered form. Bearer CDs are CDs that are not in registered form. They are not issued in the depositor's name and are transferable from one individual to another.

Banks must provide the IRS and the person redeeming a bearer CD with a Form 1099-INT.

STATE OR LOCAL GOVERNMENT OBLIGATIONS

Interest on a bond used to finance government operations generally is not taxable if the bond is issued by a state, the District of Columbia, a possession of the United States, or any of their political subdivisions.

Bonds issued after 1982 (including tribal economic development bonds issued after February 17, 2009) by an Indian tribal government are treated as issued by a state. Interest on these bonds is generally tax exempt if the bonds are part of an issue of which substantially all proceeds are to be used in the exercise of any essential government function.

CHAPTER 3: TEST YOUR KNOWLEDGE

The following question is designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). It is included as an additional tool to enhance your learning experience and does not need to be submitted in order to receive CE credit.

We recommend that you answer the question and then compare your response to the suggested solution on the following page before answering the final exam question(s) related to this chapter (assignment).

1. A U.S. citizen with interest income from sources outside of the United States must report the income on his or her tax return in all cases listed below except:

- A. when he or she resides outside of the U.S. year round
- B. when he or she resides inside the U.S. for a portion of the tax year
- C. when the foreign payer does not provide Form 1099
- D. when the specific interest income is exempt by U.S. law

CHAPTER 3: SOLUTION AND SUGGESTED RESPONSES

Below is the solution and suggested responses for the question on the previous page. If you choose an incorrect answer, you should review the page(s) as indicated for the question to ensure comprehension of the material.

1.

- A. Incorrect. Unless specifically excluded by law, U.S. citizens must report interest income regardless of the duration and location of residency.
- B. Incorrect. Unless specifically excluded by law, U.S. citizens must report interest income regardless of the duration and location of residency.
- C. Incorrect. The non-delivery of a Form 1099 to a U.S. taxpayer by a foreign payer has no effect on a U.S. taxpayer's legal reporting obligations.
- D. **CORRECT**. Only foreign payer interest income exempted by U.S. law can be excluded from a U.S. taxpayer's tax return.

Chapter 4: Dividends And Other Distributions

Chapter Objective

After completing this chapter, you should be able to:

- Identify the proper treatment of various types of dividends.

I. What's New

CAPITAL GAINS AND DIVIDENDS

Qualified dividends and long-term capital gains may escape tax entirely under the 0% rate, or be subject to capital gain rates of 15% or 20% depending on filing status, taxable income, and how much of the taxable income consists of qualified dividends and eligible long-term gains. The 20% capital gain rate taxable income thresholds for 2023 are either \$553,850, \$523,050, \$492,300, or \$276,900, depending on the filing status. The 0%, 15%, and 20% rates do not apply to long-term gains from collectibles, which are subject to a 28% rate, or the 25% rate for unrecaptured real estate depreciation.

II. Introduction

This chapter discusses the tax treatment of:

- Ordinary dividends,
- Capital gain distributions,
- Nontaxable distributions, and
- Other distributions you may receive from a corporation or a mutual fund.

III. Ordinary Dividends

Ordinary (taxable) dividends are the most common type of distribution from a corporation or a mutual fund. They are paid out of the earnings and profits of a corporation and are ordinary income to you. This means they are not capital gains. You can assume that any dividend you receive on common or preferred stock is an ordinary dividend unless the paying corporation tells you otherwise. Ordinary dividends will be shown in box 1a of the Form 1099-DIV you receive.

QUALIFIED DIVIDENDS

Qualified dividends are the ordinary dividends subject to the same 0%, 15%, or 20% maximum tax rate that applies to net capital gain. They should be shown in box 1b of Form 1099-DIV you receive.

The maximum rate of tax on qualified dividends is the following.

- The 0% rate applies to -
 - Single filers with income up to \$44,625,
 - Married filers filing separately with income up to \$44,625,
 - Head of household filers with income up to \$59,750,
 - Joint filers with income up to \$89,250,
 - Trusts and estates with income up to \$3,000;
- The 15% rate applies to -
 - Single filers with income between \$44,625 and \$492,300,
 - Married filers filing separately with income between \$44,625 and \$276,900,
 - Head of household filers with income between \$59,750 and \$523,050,
 - Joint filers with income between \$89,250 and \$553,850,

- Trusts and estates with income between \$3,000 and \$14,650; and
- The 20% rate applies to -
 - Single filers with income exceeding \$492,300,
 - Married filers filing separately with income exceeding \$276,900,
 - Head of household filers with income exceeding \$523,050,
 - Joint filers with income exceeding \$553,850,
 - Trusts and estates with income exceeding \$14,650.

To qualify for the maximum rate, all of the following requirements must be met.

- The dividends must have been paid by a U.S. corporation or a qualified foreign corporation.
- The dividends are not of the type listed later under Dividends that are not qualified dividends, later.
- You meet the holding period (discussed next).

Holding period. You must have held the stock for more than 60 days during the 121-day period that begins 60 days before the ex-dividend date. The ex-dividend date is the first date following the declaration of a dividend on which the buyer of a stock will not receive the next dividend payment. Instead, the seller will get the dividend.

When counting the number of days you held the stock, include the day you disposed of the stock, but not the day you acquired it.

Exception for preferred stock. In the case of preferred stock, you must have held the stock more than 90 days during the 181-day period that begins 90 days before the ex-dividend date if the dividends are attributable to periods totaling more than 366 days. If the preferred dividends are attributable to periods totaling less than 367 days, the holding period in the previous paragraph applies.

Dividends that are not qualified dividends. The following dividends are not qualified dividends. They are not qualified dividends even if they are shown in box 1b of Form 1099-DIV.

- Capital gain distributions.
- Dividends paid on deposits with mutual savings banks, cooperative banks, credit unions, U.S. building and loan associations, U.S. savings and loan associations, federal savings and loan associations, and similar financial institutions. (Report these amounts as interest income.)
- Dividends from a corporation that is a tax-exempt organization or farmer's cooperative during the corporation's tax year in which the dividends were paid or during the corporation's previous tax year.
- Dividends paid by a corporation on employer securities which are held on the date of record by an employee stock ownership plan (ESOP) maintained by that corporation.
- Dividends on any share of stock to the extent that you are obligated (whether under a short sale or otherwise) to make related payments for positions in substantially similar or related property.
- Payments in lieu of dividends, but only if you know or have reason to know that the payments are not qualified dividends.
- Payments shown in Form 1099-DIV, box 1b, from a foreign corporation to the extent you know or have reason to know the payments are not qualified dividends.

IV. Capital Gain Distributions

Capital gain distributions (also called capital gain dividends) are paid to you or credited to your account by mutual funds (or other regulated investment companies) and real estate investment trusts (REITs). They will be shown in box 2a of the Form 1099-DIV you receive from the mutual fund or REIT.

Report capital gain distributions as long-term capital gains, regardless of how long you owned your shares in the mutual fund or REIT.

Qualified Opportunity Fund. Effective December 22, 2017, IRC 1400Z-2 provides a temporary deferral of inclusion in gross income for capital gains invested in Qualified Opportunity Funds, and permanent exclusion of capital gains from the sale or exchange of an investment in the Qualified Opportunity Fund if the investment is held for at least 10 years. See Form 8949 instructions on how to report your election to defer eligible gains invested in a Qualified Opportunity Fund.

Qualified opportunity investment. If you held a qualified investment in a qualified opportunity fund (QOF) at any time during the year, you must file your return with Form 8997, Initial and Annual Statement of Qualified Opportunity Fund Investments, attached. See Form 8997 instructions.

Undistributed capital gains of mutual funds and REITs. Some mutual funds and REITs keep their long-term capital gains and pay tax on them. You must treat your share of these gains as distributions, even though you did not actually receive them. However, they are not included on Form 1099-DIV. Instead, they are reported to you in box 1a of Form 2439, Notice to Shareholder of Undistributed Long-Term Capital Gains. Form 2439 also will show how much, if any, of the undistributed capital gains is unrecaptured Section 1250 gain (box 1b), gain from qualified small business stock (Section 1202 gain, box 1c), or collectibles (28%) gain (box 1d). The tax paid on these gains by the mutual fund or REIT is shown in box 2 of Form 2439.

Basis adjustment. Increase your basis in your mutual fund, or your interest in a REIT, by the difference between the gain you report and the credit you claim for the tax paid.

V. Nondividend Distributions

Basis adjustment. A nondividend distribution reduces the basis of your stock. It is not taxed until your basis in the stock is fully recovered. This nontaxable portion is also called a return of capital; it is a return of your investment in the stock of the company. If you buy stock in a corporation in different lots at different times, and you cannot definitely identify the shares subject to the nondividend distribution, reduce the basis of your earliest purchases first.

When the basis of your stock has been reduced to zero, report any additional nondividend distribution that you receive as a capital gain. Whether you report it as a long-term or short-term capital gain depends on how long you have held the stock.

Example

You bought stock in 2010 for \$100. In 2013, you received a nondividend distribution of \$80. You did not include this amount in your income, but you reduced the basis of your stock to \$20. You received a return of capital of \$30 in 2023. The first \$20 of this amount reduced your basis to zero. You report the other \$10 as a long-term capital gain for 2023. You must report as a long-term capital gain any nondividend distribution you receive on this stock in later years.

LIQUIDATING DISTRIBUTIONS

Liquidating distributions, sometimes called liquidating dividends, are distributions you receive during a partial or complete liquidation of a corporation. These distributions are, at least in part, one form of a return of capital. They may be paid in one or more installments. You will receive a Form 1099-DIV from the corporation showing you the amount of the liquidating distribution in box 9 or 10.

VI. Other Distributions

You may receive any of the following distributions during the year.

Exempt-interest dividends. Exempt-interest dividends you receive from a mutual fund or other regulated investment company are not included in your taxable income. Exempt-interest dividends should be shown in box 12 of Form 1099-DIV.

Information reporting requirement. Although exempt-interest dividends are not taxable, you must show them on your tax return if you have to file a return. This is an information reporting requirement and does not change the exempt-interest dividends to taxable income.

Alternative minimum tax treatment. Exempt-interest dividends paid from specified private activity bonds may be subject to the alternative minimum tax.

Dividends on insurance policies. Insurance policy dividends that the insurer keeps and uses to pay your premiums are not taxable. However, you must report as taxable interest income the interest that is paid or credited on dividends left with the insurance company.

If dividends on an insurance contract (other than a modified endowment contract) are distributed to you, they are a partial return of the premiums you paid. Do not include them in your gross income until they are more than the total of all net premiums you paid for the contract. Report any taxable distributions on insurance policies on Schedule 1 (Form 1040), line 8.

Dividends on veterans' insurance. Dividends you receive on veterans' insurance policies are not taxable. In addition, interest on dividends left with the Department of Veterans Affairs is not taxable.

Patronage dividends. Generally, patronage dividends you receive in money from a cooperative organization are included in your income.

Do not include in your income patronage dividends you receive on:

1. Property bought for your personal use, or
2. Capital assets or depreciable property bought for use in your business. But you must reduce the basis (cost) of the items bought. If the dividend is more than the adjusted basis of the assets, you must report the excess as income.

These rules are the same whether the cooperative paying the dividend is a taxable or tax-exempt cooperative.

Alaska Permanent Fund dividends. Do not report these amounts as dividends. Instead, include these amounts on Schedule 1 (Form 1040), line 8f.

CHAPTER 4: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. Ordinary dividends are the most common type of distribution from a corporation, and are considered capital gain income.

- A. true
- B. false

2. Qualified dividends are taxable as ordinary income, but are subject to a lower tax rate. Which of the following is not one of the tests that must be met to be treated as a qualified dividend:

- A. the dividend is paid by a U.S. corporation or qualified foreign corporation
- B. the dividend is paid on deposits held by a U.S. savings bank or credit union
- C. the dividend is not a capital gain distribution
- D. the taxpayer meets the appropriate stock holding period

3. All dividends distributed to an individual on insurance contracts should be included in gross income.

- A. true
- B. false

CHAPTER 4: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.
 - A. Incorrect. Ordinary (taxable) dividends are paid out of the earnings and profits of a corporation and are ordinary income to the taxpayer.
 - B. **CORRECT**. They are ordinary income rather than capital gain to the taxpayer.
2.
 - A. Incorrect. Payment of a dividend by a U.S. corporation, or a qualified foreign corporation, is one of three necessary tests to determine whether a dividend payment qualifies for the favorable tax rates of a qualified dividend.
 - B. **CORRECT**. Dividends paid on deposits with mutual savings banks, cooperative banks, credit unions, U.S. building and loan associations, and similar financial institutions do not qualify as qualified dividends. They therefore are not included in any three-factor test.
 - C. Incorrect. To meet one of the three tests to qualify as a qualified dividend, the dividend cannot be a capital gain distribution.
 - D. Incorrect. Meeting the holding period of the dividend's underlying stock is one of three necessary tests needed to establish a qualifying dividend from other payments.
3.
 - A. Incorrect. If dividends on an insurance contract (other than a modified endowment contract) are distributed to the individual, they are a partial return of the premiums the individual paid. As such, they are not included in gross income until they are more than the total of all net premiums paid for the contract.
 - B. **CORRECT**. Only distributions greater than the total of all net premiums paid for the contract are taxable.

Chapter 5: Rental Income And Expenses

Chapter Objective

After completing this chapter, you should be able to:

- Recognize the proper treatment of rental property income and expenses for tax purposes.

I. Introduction

This chapter discusses rental income and expenses. It covers the following topics.

- Personal use of dwelling unit (including vacation home).
- Depreciation.
- Limits on rental losses.

II. Rental Income

In most cases, you must include in your gross income all amounts you receive as rent. Rental income is any payment you receive for the use or occupation of property. It is not limited to amounts you receive as normal rent payments.

When to report. If you are a cash basis taxpayer, report rental income on your return for the year you actually or constructively receive it, regardless of when it was earned. You constructively receive income when it is made available to you, for example, by being credited to your bank account. If you are an accrual basis taxpayer, you generally report income when you earn it, rather than when you receive it.

Advance rent. Advance rent is any amount you receive before the period that it covers. Include advance rent in your rental income in the year you receive it regardless of the period covered or the method of accounting you use.

Example

You sign a 10-year lease to rent your property. In the first year, you receive \$9,600 for the first year's rent and \$9,600 as rent for the last year of the lease. You must include \$19,200 in your income in the first year.

Security deposits. Do not include a security deposit in your income when you receive it if you plan to return it to your tenant at the end of the lease. But if you keep part or all of the security deposit during any year because your tenant does not live up to the terms of the lease, include the amount you keep in your income in that year.

If an amount called a security deposit is to be used as a final payment of rent, it is advance rent. Include it in your income when you receive it.

Payment for canceling a lease. If your tenant pays you to cancel a lease, the amount you receive is rent. Include the payment in your income in the year you receive it regardless of your method of accounting.

Expenses paid by tenant. If your tenant pays any of your expenses, those payments are rental income. You must include them in your income. You can deduct the expenses if they are deductible rental expenses. See Rental Expenses, later, for more information.

Property or services. If you receive property or services, instead of money, as rent, include the fair market value of the property or services in your rental income.

If the services are provided at an agreed upon or specified price, that price is the fair market value unless there is evidence to the contrary.

Rental of property also used as a home. If you rent property that you also use as your home and you rent it fewer than 15 days during the tax year, do not include the rent you receive in your income and do not

deduct rental expenses. However, you can deduct on Schedule A (Form 1040) the interest, taxes, and casualty and theft losses that are allowed for nonrental property. See Personal Use of Dwelling Unit (Including Vacation Home), later.

Part interest. If you own a part interest in rental property, you must report your part of the rental income from the property.

III. Rental Expenses

This part discusses repairs and certain other expenses of renting property that you ordinarily can deduct from your rental income. It includes information on the expenses you can deduct if you rent part of your property, or if you change your property to rental use. Depreciation, which you can also deduct from your rental income, is discussed later.

When to deduct. If you are a cash basis taxpayer, you generally deduct your rental expenses in the year you pay them. If you are an accrual basis taxpayer, you generally deduct your expenses when you incur them, rather than when you pay them.

Vacant rental property. If you hold property for rental purposes, you may be able to deduct your ordinary and necessary expenses (including depreciation) for managing, conserving, or maintaining the property while the property is vacant. However, you cannot deduct any loss of rental income for the period the property is vacant.

Vacant while listed for sale. If you sell property you held for rental purposes, you can deduct the ordinary and necessary expenses for managing, conserving, or maintaining the property until it is sold. If the property is not held out and available for rent while listed for sale, the expenses are not deductible rental expenses.

Pre-rental expenses. You can deduct your ordinary and necessary expenses for managing, conserving, or maintaining rental property from the time you make it available for rent.

Personal use of rental property. If you sometimes use your rental property for personal purposes, you must divide your expenses between rental and personal use. Also, your rental expense deductions may be limited. See Personal Use of Dwelling Unit (Including Vacation Home), later.

Part interest. If you own a part interest in rental property, you can deduct expenses that you paid according to your percentage of ownership.

Uncollected rent. If you are a cash basis taxpayer, you do not deduct uncollected rent. Because you do not include it in your income, it is not deductible.

Depreciation. You can begin to depreciate rental property when it is ready and available for rent. See Placed-in-Service Date under Depreciation, later.

REPAIRS AND IMPROVEMENTS

Generally, an expense for repairing or maintaining your rental property may be deducted if you are not required to capitalize the expense.

Improvements. You must capitalize any expense you pay to improve your rental property. An expense is for an improvement if it results in a betterment to your property, restores your property, or adapts your property to a new or different use.

Betterments. Expenses that may result in a betterment to your property include expenses for fixing a pre-existing defect or condition, enlarging or expanding your property, or increasing the capacity, strength, or quality of your property.

Restoration. Expenses that may be for restoration include expenses for replacing a substantial structural part of your property, repairing damage to your property after you properly adjusted the basis of your property as a result of a casualty loss, or rebuilding your property to a like-new condition.

Adaptation. Expenses that may be for adaptation include expenses for altering your property to a use that is not consistent with the intended ordinary use of your property when you began renting the property.

Safe harbor for routine maintenance. If you determine that your cost was for an improvement to a building or equipment, you still may be able to deduct your cost under the routine maintenance safe harbor.

Note

Separate the costs of repairs and improvements, and keep accurate records. You will need to know the cost of improvements when you sell or depreciate your property. The expenses you capitalize for improving your property generally can be depreciated as if the improvement were separate property.

Safe Harbors under the IRS Regulations

The final regulations provide for three safe harbors related to improvements. They are a de minimis safe harbor, a safe harbor for small taxpayers, and a safe harbor for routine maintenance. If a safe harbor applies, a current deduction is allowed. The de minimis and small taxpayer safe harbors are annual elections made on a statement to be attached to the return, and not a change in accounting method.

De minimis safe harbor. This safe harbor allows you to elect to apply a de minimis safe harbor to amounts paid to acquire or produce tangible property to the extent such amounts are deducted by you for financial accounting purposes or in keeping your books and records. If you have an applicable financial statement (AFS), you may use this safe harbor to deduct amounts paid for tangible property up to \$5,000 per invoice or item (as substantiated by invoice). If you do not have an AFS, you may use the safe harbor to deduct amounts up to \$2,500 per invoice or item (as substantiated by invoice). The de minimis safe harbor does not include amounts paid for inventory and land.

Small taxpayer safe harbor. This safe harbor allows small taxpayers to not capitalize an improvement, and therefore to deduct such costs of work performed on owned or leased buildings. In order to qualify, the requirements for small taxpayers are:

- Average annual gross receipts of \$10 million or less; and
- Owns or leases building property with an unadjusted basis of \$1 million or less; and
- The total amount paid during the taxable year for repairs, maintenance, improvements, or similar activities performed on such building property does not exceed the lesser of (1) two percent of the unadjusted basis of the eligible building property, or (2) \$10,000.

Routine maintenance safe harbor. This safe harbor allows you to deduct expenses if the amounts meet all of the following criteria:

- Amounts paid for recurring activities that you expect to perform;
- As a result of your use of the property in your trade or business;
- To keep the property in its ordinarily efficient operating condition; and
- You reasonably expect, at the time the property is placed in service, to perform the activities (1) for building structures and building systems, more than once during the 10-year period beginning when placed in service, or (2) for property other than buildings, more than once during the class life of the unit of property.

The routine maintenance safe harbor does not apply to amounts paid for betterments, but does apply to certain restorations that would otherwise be improvements, including when you pay amounts to replace a major component or substantial structural part of a unit of property.

OTHER EXPENSES

Other expenses you can deduct from your rental income include advertising, cleaning and maintenance, utilities, fire and liability insurance, taxes, interest, commissions for the collection of rent, ordinary and necessary travel and transportation, and other expenses, discussed next.

Rental of property. You can deduct the rent you pay for property that you use for rental purposes. If you buy a leasehold for rental purposes, you can deduct an equal part of the cost each year over the term of the lease.

Rental of equipment. You can deduct the rent you pay for equipment that you use for rental purposes. However, in some cases, lease contracts are actually purchase contracts. If so, you cannot deduct these payments. You can recover the cost of purchased equipment through depreciation.

Insurance premiums paid in advance. If you pay an insurance premium for more than one year in advance, you cannot deduct the total premium in the year you pay it. For each year of coverage, you deduct only the part of the premium payment that applies to that year.

Local benefits taxes. In most cases, you cannot deduct charges for local benefits that increase the value of your property, such as charges for putting in streets, sidewalks, or water and sewer systems. These charges are nondepreciable capital expenditures, and must be added to the basis of your property. However, you can deduct local benefit taxes if they are for maintaining, repairing, or paying interest charges for the benefits.

Travel expenses. You can deduct the ordinary and necessary expenses of traveling away from home if the primary purpose of the trip was to collect rental income or to manage, conserve, or maintain your rental property. You must properly allocate your expenses between rental and nonrental activities. You cannot deduct the cost of traveling away from home if the primary purpose of the trip was to improve your property.

Local transportation expenses. You may be able to deduct your ordinary and necessary local transportation expenses if you incur them to collect rental income or to manage, conserve, or maintain your rental property. However, transportation expenses incurred to travel between your home and a rental property generally constitute nondeductible commuting costs unless you use your home as your principal place of business.

Generally, if you use your personal car, pickup truck, or light van for rental activities, you can deduct the expenses using one of two methods: actual expenses or the standard mileage rate. For 2023, the standard mileage rate for all business travel is 65.5 cents per mile.

Records. To deduct car expenses under either method, you must keep record.

IV. Personal Use Of Dwelling Unit (Including Vacation Home)

If you have any personal use of a dwelling unit (including a vacation home) that you rent, you must divide your expenses between rental use and personal use. In general, your rental expenses will be no more than your total expenses multiplied by a fraction; the denominator of which is the total number of days the dwelling unit is used and the numerator of which is the total number of days actually rented at a fair rental price. Only your rental expenses may be deducted on Schedule E (Form 1040). Some of your personal expenses may be deductible if you itemize your deductions on Schedule A (Form 1040).

You must also determine if the dwelling unit is considered a home. The amount of rental expenses that you can deduct may be limited if the dwelling unit is considered a home. Whether a dwelling unit is considered a home depends on how many days during the year are considered to be days of personal use. There is a special rule if you used the dwelling unit as a home and you rented it for less than 15 days during the year.

Dwelling unit. A dwelling unit includes a house, apartment, condominium, mobile home, boat, vacation home, or similar property. A dwelling unit has basic living accommodations, such as sleeping space, a toilet, and cooking facilities.

A dwelling unit does not include property used solely as a hotel, motel, inn, or similar establishment. Property is used solely as a hotel, motel, inn, or similar establishment if it is regularly available for occupancy by paying customers and is not used by an owner as a home during the year.

Example

You rent a room in your home that is always available for short-term occupancy by paying customers. You do not use the room yourself, and you allow only paying customers to use the room. The room is used solely as a hotel, motel, inn, or similar establishment and is not a dwelling unit.

DWELLING UNIT USED AS HOME

The tax treatment of rental income and expenses for a dwelling unit that you use for both rental and personal purposes depends on whether you are considered to be using the dwelling unit as a home.

You use a dwelling unit as a home during the tax year if you use it for personal purposes more than the greater of:

1. 14 days, or
2. 10% of the total days it is rented to others at a fair rental price.

If a dwelling unit is used for personal purposes on a day it is rented at a fair rental price, do not count that day as a day of rental use in applying (2) above. Instead, count it as a day of personal use in applying both (1) and (2) above. This rule does not apply when dividing expenses between rental and personal use.

Fair rental price. A fair rental price for your property generally is the amount of rent that a person who is not related to you would be willing to pay. The rent you charge is not a fair rental price if it is substantially less than the rents charged for other properties that are similar to your property in your area.

WHAT IS A DAY OF PERSONAL USE?

A day of personal use of a dwelling unit is any day that it is used by any of the following persons.

1. You or any other person who has an interest in it, unless you rent it to another owner as his or her main home under a shared equity financing agreement (defined later).
2. A member of your family or a member of the family of any other person who has a financial interest in it, unless the family member uses the dwelling unit as his or her main home and pays a fair rental price. Family includes only brothers and sisters, half-brothers and half-sisters, spouses, ancestors (parents, grandparents, etc.) and lineal descendants (children, grandchildren, etc.).
3. Anyone under an arrangement that lets you use some other dwelling unit.
4. Anyone at less than a fair rental price.

Main home. If the other person or member of the family in (1) or (2) above has more than one home, his or her main home is ordinarily the one lived in most of the time.

Shared equity financing agreement. This is an agreement under which two or more persons acquire undivided interests for more than 50 years in an entire dwelling unit, including the land, and one or more of the co-owners is entitled to occupy the unit as his or her main home upon payment of rent to the other co-owner or owners.

Donation of use of property. You use a dwelling unit for personal purposes if:

- You donate the use of the unit to a charitable organization,
- The organization sells the use of the unit at a fund-raising event, and
- The “purchaser” uses the unit.

Examples

The following examples show how to determine days of personal use.

Example 1

You and your neighbor are co-owners of a condominium at the beach. Last year, you rented the unit to vacationers whenever possible. The unit was not used as a main home by anyone. Your neighbor used the unit for two weeks last year; you did not use it at all.

Because your neighbor has an interest in the unit, both of you are considered to have used the unit for personal purposes during those 2 weeks.

Example 2

You and your neighbors are co-owners of a house under a shared equity financing agreement. Your neighbors live in the house and pay you a fair rental price.

Even though your neighbors have an interest in the house, the days your neighbors live there are not counted as days of personal use by you. This is because your neighbors rent the house as their main home under a shared equity financing agreement.

Example 3

You own a rental property that you rent to your son. Your son does not own any interest in this property. He uses it as his main home. He pays you a fair rental price for the property.

Your son's use of the property is not personal use by you because your son is using it as his main home, he owns no interest in the property, and he is paying you a fair rental price.

Example 4

You rent your beach house to Joshua. Joshua rents his house in the mountains to you. You each pay a fair rental price.

You are using your house for personal purposes on the days that Joshua uses it because your house is used by Joshua under an arrangement that allows you to use his house.

Days Used for Repairs and Maintenance

Any day that you spend working substantially full time repairing and maintaining your property is not counted as a day of personal use. Do not count such a day as a day of personal use even if family members use the property for recreational purposes on the same day.

Days Used as Main Home Before or After Renting

For purposes of determining whether a dwelling unit was used as a home, you may not have to count days you used the property as your main home before or after renting it or offering it for rent as days of personal use. Do not count them as days of personal use if:

1. You rented or tried to rent the property for 12 or more consecutive months.
2. You rented or tried to rent the property for a period of less than 12 consecutive months and the period ended because you sold or exchanged the property.

This special rule does not apply when dividing expenses between rental and personal use.

Examples

The following examples show how to determine whether you used your rental property as a home.

Example 1

You converted the basement of your home into an apartment with a bedroom, a bathroom, and a small kitchen. You rented the basement apartment at a fair rental price to college students during the regular school year. You rented to them on a 9-month lease (273 days). You figured 10% of the total days rented to others at a fair rental price is 27 days.

During June (30 days), your brothers stayed with you and lived in the basement apartment rent free. Your basement apartment was used as a home because you used it for personal purposes for 30 days. Rent-free use by your brother is considered personal use. Your personal use (30 days) is more than the greater of 14 days or 10% of the total days it was rented (27 days).

Example 2

You rented the guest room in your home at a fair rental price during the local college's homecoming, commencement, and football weekends (a total of 27 days). Your sister-in-law stayed in the room, rent free, for the last 3 weeks (21 days) in July. You figured 10% of the total days rented to others at a fair rental price is 3 days.

The room was used as a home because you used it for personal purposes for 21 days. That is more than the greater of 14 days or 10% of the 27 days it was rented (3 days).

Example 3

You own a condominium apartment in a resort area. You rented it at a fair rental price for a total of 170 days during the year. For 12 of those days, the tenant was not able to use the apartment and allowed you to use it even though you did not refund any of the rent. Your family actually used the apartment for 10 of those days. Therefore, the apartment is treated as having been rented for 160 (170 - 10) days. You figured 10% of the total days rented to others at a fair rental price is 16 days. Your family also used the apartment for 7 other days during the year.

You used the apartment as a home because you used it for personal purposes for 17 days. That is more than the greater of 14 days or 10% of the 160 days it was rented (16 days).

HOW TO DIVIDE EXPENSES

If you use a dwelling unit for both rental and personal purposes, divide your expenses between the rental use and the personal use based on the number of days used for each purpose.

When dividing your expenses follow these rules.

1. Any day that the unit is rented at a fair rental price is a day of rental use even if you used the unit for personal purposes that day. This rule does not apply when determining whether you used the unit as a home.
2. Any day that the unit is available for rent but not actually rented is not a day of rental use.

Example

Your beach cottage was available for rent from June 1 through August 31 (92 days). During that time, except for the first week in August (7 days) when you were unable to find a renter, you rented the cottage at a fair rental price. The person who rented the cottage for July allowed you to use it over a weekend (2 days) without any reduction in or refund of rent. Your family also used the cottage during the last 2 weeks of May (14 days). The cottage was not used at all before May 17 or after August 31.

You figure the part of the cottage expenses to treat as rental expenses as follows.

1. The cottage was used for rental a total of 85 days (92 - 7). The days it was available for rent but not rented (7 days) are not days of rental use. The July weekend (2 days) you used it is rental use because you received a fair rental price for the weekend.
2. You used the cottage for personal purposes for 14 days (the last 2 weeks in May).
3. The total use of the cottage was 99 days (14 days personal use + 85 days rental use).
4. Your rental expenses are 85/99 (86%) of the cottage expenses.

When determining whether you used the cottage as a home, the July weekend (2 days) you used it is personal use even though you received a fair rental price for the weekend. Therefore, you had 16 days

of personal use and 83 days of rental use for this purpose. Because you used the cottage for personal purposes more than 14 days and more than 10% of the days of rental use (8 days), you used it as a home. If you have a net loss, you may not be able to deduct all of the rental expenses.

V. Depreciation

You recover your cost in income producing property through yearly tax deductions. You do this by depreciating the property; that is, by deducting some of your cost on your tax return each year.

Three basic factors determine how much depreciation you can deduct. They are: (1) your basis in the property, (2) the recovery period for the property, and (3) the depreciation method used. You cannot simply deduct your mortgage or principal payments, or the cost of furniture, fixtures and equipment, as an expense.

You can deduct depreciation only on the part of your property used for rental purposes. Depreciation reduces your basis for figuring gain or loss on a later sale or exchange.

You may have to use Form 4562 to figure and report your depreciation.

Section 179 deduction. The section 179 deduction is a means of recovering part or all of the cost of certain qualifying property in the year you place the property in service. It is separate from your depreciation deduction.

Alternative minimum tax (AMT). If you use accelerated depreciation, you may be subject to the AMT. Accelerated depreciation allows you to deduct more depreciation earlier in the recovery period than you could deduct using a straight line method (same deduction each year).

Claiming the correct amount of depreciation. You should claim the correct amount of depreciation each tax year. If you did not claim all the depreciation that you were entitled to deduct, you must still reduce your basis in the property by the full amount of depreciation that you could have deducted.

If you deducted an incorrect amount of depreciation for property in any year, you may be able to make a correction for that year by filing Form 1040-X. If you are not allowed to make the correction on an amended return, you can change your accounting method to claim the correct amount of depreciation.

Changing your accounting method to deduct unclaimed depreciation. To change your accounting method, you must file Form 3115, Application for Change in Accounting Method, to get the consent of the IRS. In some instances, that consent is automatic.

Land. You can never depreciate the cost of land because land does not wear out, become obsolete, or get used up. The costs of clearing, grading, planting, and landscaping are usually all part of the cost of land and are not depreciable.

DEPRECIATION METHODS

There are three ways to figure depreciation. The depreciation method you use depends on the type of property and when the property was placed in service. For property used in rental activities you use one of the following.

- MACRS (Modified Accelerated Cost Recovery System) for property placed in service after 1986.
- ACRS (Accelerated Cost Recovery System) for property placed in service after 1980 but before 1987.
- Useful lives and either straight line or an accelerated method of depreciation, such as the declining balance method, if placed in service before 1981.

If you placed rental property in service before 2023, continue to use the same method of figuring depreciation that you used in the past.

Cooperative apartments. If you are a tenant-stockholder in a cooperative housing corporation and rent your cooperative apartment to others, you can deduct depreciation for the apartment even though it is owned by the corporation. Your depreciation deduction is your share of the corporation's depreciation.

MACRS

Most business and investment property placed in service after 1986 is depreciated using MACRS. MACRS consists of two systems that determine how you depreciate your property. The main system is called the **General Depreciation System (GDS)**. The second system is called the **Alternative Depreciation System (ADS)**. GDS is used to figure your depreciation deduction for property used in most rental activities, unless you elect to use ADS.

To figure your MACRS deduction, you need to know the following information about your property:

1. Its recovery class,
2. Its applicable recovery period,
3. Its convention,
4. Its placed-in-service date,
5. Its depreciable basis, and
6. Its depreciation method.

Section 179 election. You cannot claim the section 179 deduction for property held to produce rental income (unless renting property is your trade or business).

Qualified real property. Although most real property is not eligible for the section 179 deduction, qualified real property is eligible. Under prior law, qualified real property generally consisted of qualified leasehold improvements, qualified restaurant property, and qualified retail improvements.

The Tax Cuts and Jobs Act significantly expands the definition of qualified real property that taxpayers may elect to treat as section 179 property. Effective for tax years beginning after 2017, qualified real property is defined as:

1. Qualified improvement property; and
2. Any of the following improvements to nonresidential real property that are placed in service after the nonresidential real property was first placed in service:
 - Roofs;
 - Heating, ventilation, and air-conditioning property;
 - Fire protection and alarm systems; and
 - Security systems.

Exclusion for property used in connection with lodging. Effective for property placed in service in tax years beginning after December 31, 2017, property that is used predominantly to furnish lodging or in connection with the furnishing of lodging qualifies for section 179 expensing.

The primary impact of this provision is to allow expensing of section 1245 property purchased for use in connection with a residential rental building. Examples of property used in connection with the furnishing of lodging include lobby furniture, office equipment, and laundry and swimming pool equipment. Property used in furnishing electrical energy, water, sewage disposal services, gas, telephone service, or similar services are not used in connection with the furnishing of lodging.

No deduction greater than basis. The total of all your yearly depreciation deductions cannot be more than the cost or other basis of the property. For this purpose, your yearly depreciation deductions include any depreciation that you were allowed to claim, even if you did not claim it.

Personal home changed to rental use. You must use MACRS to figure the depreciation on property you used as your home and changed to rental property in 2023.

Excluded property. You cannot use MACRS for certain personal property placed in service in your rental property in 2023 if it had been previously placed in service before MACRS became effective in 1987 (before August 1, 1986, if election made).

Recovery Periods Under GDS

Each item of property that can be depreciated is assigned to a property class. The recovery period of the property depends on the class the property is in. Under GDS, the recovery period of an asset is generally the same as its property class. The property classes under GDS are:

- 3-year property,
- 5-year property,
- 7-year property,
- 10-year property,
- 15-year property,
- 20-year property,
- Nonresidential real property, and
- Residential rental property.

Recovery periods for property used in rental activities are shown in Table 5-1, next.

TABLE 5-1. MACRS RECOVERY PERIODS FOR PROPERTY USED IN RENTAL ACTIVITIES

MACRS Recovery Period		
Type of Property	General Depreciation System	Alternative Depreciation System
Computers and their peripheral equipment	5 years	5 years
Office machinery, such as: Typewriters Calculators Copiers	5 years	5 years
Automobiles	5 years	5 years
Light trucks	5 years	5 years
Appliances, such as: Stoves Refrigerators	5 years	9 years
Carpets	5 years	9 years
Furniture used in rental property	5 years	9 years
Office furniture and equipment, such as: Desks Files	7 years	10 years
Any property that does not have a class life and that has not been designated by law as being in any other class	7 years	12 years
Roads	15 years	20 years
Shrubbery	15 years	20 years
Fences	15 years	20 years
Residential rental property (buildings or structures) and structural components such as furnaces, water pipes, venting, etc.	27.5 years	30 years
Additions and improvements, such as a new roof	The same recovery period as that of the property to which the addition or improvement is made, determined as if the property were placed in service at the same time as the addition or improvement.	

Additions or improvements to property. Treat depreciable additions or improvements you make to any property as separate property items for depreciation purposes. The recovery period for an addition or improvement to property begins on the later of:

1. The date the addition or improvement is placed in service, or
2. The date the property to which the addition or improvement was made is placed in service.

The class and recovery period of the addition or improvement is the one that would apply to the original property if it were placed in service at the same time as the addition or improvement.

Example

You own a residential rental house that you have been renting since 1987 and depreciating under ACRS. You built an addition onto the house and placed it in service in 2023. You must use MACRS for the addition. Under GDS, the addition is depreciated as residential rental property over 27.5 years.

Placed-in-Service Date

You can begin to depreciate property when you place it in service in your trade or business or for the production of income. Property is considered placed in service in a rental activity when it is ready and available for a specific use in that activity.

Depreciable Basis

To deduct the proper amount of depreciation each year, you must first determine your basis in the property you intend to depreciate. The basis used for figuring depreciation is your original basis in the property increased by any additions or improvements made to the property. Your original basis is usually your cost. However, if you acquire the property in some other way, such as by inheriting it, getting it as a gift, or building it yourself, you may have to figure your original basis in another way. Other adjustments could also affect your basis.

Conventions

Under MACRS, conventions establish when the recovery period begins and ends. The convention you use determines the number of months for which you can claim depreciation in the year you place property in service and in the year you dispose of the property.

Mid-month convention. A mid-month convention is used for all residential rental property and nonresidential real property. Under this convention, you treat all property placed in service, or disposed of, during any month as placed in service, or disposed of, at the midpoint of that month.

Mid-quarter convention. A mid-quarter convention must be used if the mid-month convention does not apply and the total depreciable basis of MACRS property you placed in service in the last 3 months of a tax year (excluding nonresidential real property, residential rental property, and property placed in service and disposed of in the same year) is more than 40% of the total basis of all such property you place in service during the tax year.

Under this convention, you treat all property placed in service, or disposed of, during any quarter of a tax year as placed in service, or disposed of, at the midpoint of the quarter.

Half-year convention. The half-year convention is used if neither the mid-quarter convention nor the mid-month convention applies. Under this convention, you treat all property placed in service, or disposed of, during a tax year as placed in service, or disposed of, at the midpoint of that tax year.

If this convention applies, you deduct a half-year of depreciation for the first year and the last year that you depreciate the property. You deduct a full year of depreciation for any other year during the recovery period.

Example

During the tax year, Jordan purchased the following items to use in his rental property.

- A dishwasher for \$400 that he placed in service in January.
- Used furniture for \$100 that he placed in service in September.
- A refrigerator for \$800 that he placed in service in October.

Jordan uses the calendar year as his tax year. The total basis of all property placed in service in that year is \$1,300. The \$800 basis of the refrigerator placed in service during the last 3 months of his tax year exceeds \$520 ($40\% \times \$1,300$). Jordan must use the mid-quarter convention instead of the half-year convention for all three items.

MACRS DEPRECIATION UNDER GDS

You can figure your MACRS depreciation deduction under GDS in one of two ways. The deduction is substantially the same both ways. (The difference, if any, is slight.) You can either:

1. Use the percentage from the optional MACRS tables, see Table 5-2, or
2. Actually figure the deduction using the depreciation method and convention that apply over the recovery period of the property.

TABLE 5-2. OPTIONAL MACRS TABLES**TABLE 5-2A. MACRS 5-YEAR PROPERTY**

Year	Half-year convention	Mid-quarter convention			
		First quarter	Second quarter	Third quarter	Fourth quarter
1	20.00%	35.00%	25.00%	15.00%	5.00%
2	32.00	26.00	30.00	34.00	38.00
3	19.20	15.60	18.00	20.40	22.80
4	11.52	11.01	11.37	12.24	13.68
5	11.52	11.01	11.37	11.30	10.94
6	5.76	1.38	4.26	7.06	9.58

TABLE 5-2B. MACRS 7-YEAR PROPERTY

Year	Half-year convention	Mid-quarter convention			
		First quarter	Second quarter	Third quarter	Fourth quarter
1	14.29%	25.00%	17.85%	10.71%	3.57%
2	24.49	21.43	23.47	25.51	27.55
3	17.49	15.31	16.76	18.22	19.68
4	12.49	10.93	11.97	13.02	14.06
5	8.93	8.75	8.87	9.30	10.04
6	8.92	8.74	8.87	8.85	8.73

TABLE 5-2C. MACRS 15-YEAR PROPERTY

Year	Half-year convention	Mid-quarter convention			
		First quarter	Second quarter	Third quarter	Fourth quarter

Year		First quarter	Second quarter	Third quarter	Fourth quarter
1	5.00%	8.75%	6.25%	3.75%	1.25%
2	9.50	9.13	9.38	9.63	9.88
3	8.55	8.21	8.44	8.66	8.89
4	7.70	7.39	7.59	7.80	8.00
5	6.93	6.65	6.83	7.02	7.20
6	6.23	5.99	6.15	6.31	6.48

TABLE 5-2D. RESIDENTIAL RENTAL PROPERTY (27.5-YEAR)

	Use the row for the month of the taxable year placed in service					
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
January	3.485%	3.636%	3.636%	3.636%	3.636%	3.636%
February	3.182	3.636	3.636	3.636	3.636	3.636
March	2.879	3.636	3.636	3.636	3.636	3.636
April	2.576	3.636	3.636	3.636	3.636	3.636
May	2.273	3.636	3.636	3.636	3.636	3.636
June	1.970	3.636	3.636	3.636	3.636	3.636
July	1.667	3.636	3.636	3.636	3.636	3.636
August	1.364	3.636	3.636	3.636	3.636	3.636
September	1.061	3.636	3.636	3.636	3.636	3.636
October	0.758	3.636	3.636	3.636	3.636	3.636
November	0.455	3.636	3.636	3.636	3.636	3.636
December	0.152	3.636	3.636	3.636	3.636	3.636

USING THE OPTIONAL TABLES

You can use the tables in Table 5-2 to compute annual depreciation under MACRS. The tables show the percentages for the first 6 years. The percentages in Tables 9-2-A, 9-2-B, and 9-2-C make the change from declining balance to straight line in the year that straight line will yield an equal or larger deduction.

How to use the tables. The following section explains how to use the optional tables.

Figure the depreciation deduction by multiplying your **unadjusted basis** in the property by the percentage shown in the appropriate table. Your unadjusted basis is your depreciable basis without reduction for depreciation previously claimed.

Once you begin using an optional table to figure depreciation, you must continue to use it for the entire recovery period unless there is an adjustment to the basis of your property for a reason other than:

1. Depreciation allowed or allowable, or
2. An addition or improvement that is depreciated as a separate item of property.

Tables 9-2-A, 9-2-B, and 9-2-C. The percentages in these tables take into account the half-year and mid-quarter conventions. Use Table 5-2-A for 5-year property, Table 5-2-B for 7-year property, and Table 5-2-C for 15-year property. Use the percentage in the second column (half-year convention) unless you must use the mid-quarter convention (explained earlier). If you must use the mid-quarter convention, use the column that corresponds to the calendar year quarter in which you placed the property in service.

Example 1

You purchased a stove and refrigerator and placed them in service in June. Your basis in the stove is \$600 and your basis in the refrigerator is \$1,000. Both are 5-year property. Using the half-year convention column in Table 5-2-A, you find the depreciation percentage for year 1 is 20%. For that year, your depreciation deduction is \$120 ($\$600 \times .20$) for the stove and \$200 ($\$1,000 \times .20$) for the refrigerator. For year 2, you find your depreciation percentage is 32%. That year's depreciation deduction will be \$192 ($\$600 \times .32$) for the stove and \$320 ($\$1,000 \times .32$) for the refrigerator.

Example 2

Assume the same facts as in Example 1, except you buy the refrigerator in October instead of June. You must use the mid-quarter convention to figure depreciation on the stove and refrigerator. The refrigerator was placed in service in the last 3 months of the tax year and its basis (\$1,000) is more than 40% of the total basis of all property placed in service during the year ($\$1,600 \times .40 = \640).

Because you placed the refrigerator in service in October, you use the fourth quarter column of Table 5-2-A and find that the depreciation percentage for year 1 is 5%. Your depreciation deduction for the refrigerator is \$50 ($\$1,000 \times .05$).

Because you placed the stove in service in June, you use the second quarter column of Table 5-2-A and find that the depreciation percentage for year 1 is 25%. For that year, your depreciation deduction for the stove is \$150 ($\$600 \times .25$).

Table 5-2-D. Use this table for residential rental property. Find the row for the month that you placed the property in service. Use the percentages listed for that month to figure your depreciation deduction. The mid-month convention is taken into account in the percentages shown in the table.

Example

You purchased a single family rental house for \$185,000 and placed it in service on February 8. Your basis in the house is \$160,000. Using Table 5-2-D, you find that the percentage for property placed in service in February of year 1 is 3.182%. That year's depreciation deduction is \$5,091 ($\$160,000 \times .03182$).

MACRS DEPRECIATION UNDER ADS

If you choose, you can use the ADS method for most property. Under ADS, you use the straight line method of depreciation.

Table 5-1 shows the recovery periods for property used in rental activities that you depreciate under ADS. If your property is not listed, it is considered to have no class life. Under ADS, personal property with no class life is depreciated using a recovery period of 12 years.

Use the mid-month convention for residential rental property and nonresidential real property. For all other property, use the half-year or mid-quarter convention.

Election. For property placed in service during 2023, you choose to use ADS by entering the depreciation on line 20c, Part III of Form 4562.

The election of ADS for one item in a class of property generally applies to all property in that class that is placed in service during the tax year of the election. However, the election applies on a property-by-property basis for residential rental property and nonresidential real property.

Once you choose to use ADS, you cannot change your election.

OTHER RULES ABOUT DEPRECIABLE PROPERTY

In addition to the rules about what methods you can use, there are other rules you should be aware of with respect to depreciable property.

Gain from disposition. If you dispose of depreciable property at a gain, you may have to report, as ordinary income, all or part of the gain.

Alternative minimum tax. If you use accelerated depreciation, you may have to file Form 6251. Accelerated depreciation includes MACRS, ACRS, and any other method that allows you to deduct more depreciation than you could deduct using a straight line method.

VI. Limits On Rental Losses

If you have a loss from your rental real estate activity, two sets of rules may limit the amount of loss you can report on Schedule E. You must consider these rules in the order shown below.

1. **At-risk rules.** These rules are applied first if there is investment in your rental real estate activity for which you are not at risk. This applies only if the real property was placed in service after 1986.
2. **Passive activity limits.** Generally, rental real estate activities are considered passive activities and losses are not deductible unless you have income from other passive activities to offset them. However, there are exceptions.

Excess business loss limitation. The excess business loss limitation under section 461(1) is extended and applies to tax years beginning after December 31, 2020 and before January 1, 2029. For 2023, the amount is \$289,000 (\$578,000 for joint returns).

AT-RISK RULES

You may be subject to the at-risk rules if you have:

- A loss from an activity carried on as a trade or business or for the production of income, and
- Amounts invested in the activity for which you are not fully at risk.

Losses from holding real property (other than mineral property) placed in service before 1987 are not subject to the at-risk rules.

In most cases, any loss from an activity subject to the at-risk rules is allowed only to the extent of the total amount you have at risk in the activity at the end of the tax year. You are considered at risk in an activity to the extent of cash and the adjusted basis of other property you contributed to the activity and certain amounts borrowed for use in the activity.

PASSIVE ACTIVITY LIMITS

In most cases, all rental real estate activities (except those meeting the exception for real estate professionals, below) are passive activities. For this purpose, a rental activity is an activity from which you receive income mainly for the use of tangible property, rather than for services.

Limits on passive activity deductions and credits. Deductions for losses from passive activities are limited. You generally cannot offset income, other than passive income, with losses from passive activities. Nor can you offset taxes on income, other than passive income, with credits resulting from passive activities. Any excess loss or credit is carried forward to the next tax year.

You may have to complete Form 8582 to figure the amount of any passive activity loss for the current tax year for all activities and the amount of the passive activity loss allowed on your tax return.

Real estate professionals. Rental activities in which you materially participated during the year are not passive activities if, for that year, you were a real estate professional.

Exception for Personal Use of Dwelling Unit

If you used the rental property as a home during the year, any income, deductions, gain, or loss allocable to such use is not taken into account for purposes of the passive activity loss limitation. Instead, follow the rules explained in Personal Use of Dwelling Unit (Including Vacation Home), earlier.

Exception for Rental Real Estate Activities with Active Participation

If you or your spouse actively participated in a passive rental real estate activity, you may be able to deduct up to \$25,000 of loss from the activity from your nonpassive income. This special allowance is an exception to the general rule disallowing losses in excess of income from passive activities. Similarly, you can offset credits from the activity against the tax on up to \$25,000 of nonpassive income after taking into account any losses allowed under this exception.

Active participation. You actively participated in a rental real estate activity if you (and your spouse) owned at least 10% of the rental property and you made management decisions or arranged for others to provide services (such as repairs) in a significant and bona fide sense. Management decisions that count as active participation include approving new tenants, deciding on rental terms, approving expenditures, and other similar decisions.

Maximum special allowance. The maximum special allowance is:

- \$25,000 for single individuals and married individuals filing a joint return for the tax year,
- \$12,500 for married individuals who file separate returns for the tax year and lived apart from their spouses at all times during the tax year, and
- \$25,000 for a qualifying estate reduced by the special allowance for which the surviving spouse qualified.

If your modified adjusted gross income is \$100,000 or less (\$50,000 or less if married filing separately), you can deduct your loss up to the amount specified above. If your modified adjusted gross income is more than \$100,000 (more than \$50,000 if married filing separately), your special allowance is limited to 50% of the difference between \$150,000 (\$75,000 if married filing separately) and your modified adjusted gross income.

Generally, if your modified adjusted gross income is \$150,000 or more (\$75,000 or more if you are married filing separately), there is no special allowance.

CHAPTER 5: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. Each of the following payment types is booked as rental income by the property owner except:

- A. advance rent received
- B. security deposits planned to be returned to tenant
- C. lease cancellation fees
- D. expenses paid by tenant

2. Rental property expenses that are typically deductible include which of the following:

- A. local benefit taxes
- B. cost of improvements
- C. uncollected rent if you are a cash basis taxpayer
- D. cost of repairs

3. If during a tax year a dwelling unit is used for both rental and personal home use, what is the maximum number of days that it can be used as a home and still be claimed as a rental property if rented for a total of 100 days during the tax year:

- A. 10 days
- B. 14 days
- C. 21 days
- D. 30 days

4. Each of the following is one of the three factors that determine how much depreciation you can deduct for income producing property except:

- A. your cost basis in the property
- B. the recovery period for the property
- C. the depreciation method used
- D. the age of the property

CHAPTER 5: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.

- A. Incorrect. Include advanced rent in your rental income in the year you receive it regardless of the period covered or the method of accounting used.
- B. **CORRECT**. If you plan to return a security deposit to your tenant at the end of the lease, do not include it in your income when you receive it. If you keep part or all of the security deposit, include the amount you keep in your income for that year.
- C. Incorrect. If your tenant pays you to cancel a lease, the amount you receive is considered rent. Include the payment in your income in the year you receive it regardless of the method of accounting used.
- D. Incorrect. If your tenant pays any of your expenses, the payments are rental income and you must include them in your income. You can deduct the expenses if they are deductible rental expenses.

2.

- A. Incorrect. Generally, you cannot deduct charges for local benefits that increase the value of your property. You must add them to the basis of your property.
- B. Incorrect. You cannot deduct the cost of improvements. You can recover the cost of improvements, however, by taking depreciation.
- C. Incorrect. If you are a cash basis taxpayer, you do not report uncollected rent because you do not include it in your income.
- D. **CORRECT**. You can deduct the cost of repairs to your rental property. A repair keeps your property in good operating condition, but it does not materially add to the value of your property or substantially prolong its life.

3.

- A. Incorrect. A rental property can be used as a home by the owner for more than 10 days during a tax year, even if rented for 100 days.
- B. **CORRECT**. The maximum number of days a rental property can be used as a home and still retain its classification is the greater of 14 days or 10% of the total days it is rented to others at a fair market price. In this scenario, 14 days is the maximum.
- C. Incorrect. A period of 21 days will result in the loss of rental property status.
- D. Incorrect. A period of 30 days is too long and will result in the loss of rental property status.

- 4.
- A. Incorrect. Your cost basis in the property is one of the three factors that determine how much depreciation you can deduct.
 - B. Incorrect. The recovery period for the property is one of the three factors that determine how much depreciation you can deduct.
 - C. Incorrect. The depreciation method used is one of the three factors that determine how much depreciation you can deduct.
 - D. **CORRECT**. The age of the property is not a factor in the determination of how much depreciation you can deduct.

Chapter 6: Retirement Plans, Pensions, And Annuities

Chapter Objective

After completing this chapter, you should be able to:

- Identify various requirements regarding retirement plan taxation.

I. What's New

SECURE ACT AND SECURE ACT 2.0

The SECURE Act, signed into law on December 20, 2019, made the following changes for tax years after 2019: moved the start date for required minimum distributions (RMDs) to the year in which the owner turns 72; ended the 70½ age limit for contributions to a traditional IRA; and shortened the distribution period for non-spouse inherited IRAs to a 10-year maximum.

Subsequently, the SECURE Act 2.0, signed into law on December 29, 2022, further changed the RMD start date to the year in which the owner turns 73, if not 72 prior to January 1, 2023. The SECURE Act 2.0 also decreased the penalty for not taking the RMD from 50% to 25% of the RMD amount, and 10% if corrected timely.

TRADITIONAL IRA AND ROTH IRA CONTRIBUTION PHASEOUT

For 2023, the contribution limit for traditional IRAs and Roth IRAs is \$6,500, or \$7,500 for those age 50 or older.

The deduction limit for 2023 contributions to a traditional IRA is phased out for active plan participants with modified AGI (MAGI) of over \$73,000 and under \$83,000 for a single person or head of household, or over \$116,000 and under \$136,000 for married persons filing jointly. The phaseout range is MAGI over \$218,000 and under \$228,000 for a spouse who is not an active plan participant and files jointly with a spouse who is an active plan participant.

The 2023 Roth IRA contribution limit is phased out for a single person or head of household with MAGI over \$138,000 and under \$153,000, and for married persons filing jointly with MAGI over \$218,000 and under \$228,000.

401K

The elective deferral limit for employees who participate in 401(k), 403(b), or 457(b) plans is \$22,500 in 2023. The catch-up contribution remains at \$7,500 for those age 50 and over for 2023.

II. Introduction

This chapter discusses the tax treatment of distributions you receive from:

1. An employee pension or annuity from a qualified plan,
2. A disability retirement, and
3. A purchased commercial annuity.

What is not covered in this chapter. The following topics are not discussed in this chapter:

1. **The General Rule.** This is the method generally used to determine the tax treatment of pension and annuity income from nonqualified plans (including commercial annuities). If your annuity starting date is after November 18, 1996, you generally cannot use the General Rule for a qualified plan.
2. **Individual retirement arrangements (IRAs).** Information on the tax treatment of amounts you receive from an IRA.

III. General Information

Designated Roth accounts. A designated Roth account is a separate account created under a qualified Roth contribution program to which participants may elect to have part or all of their elective deferrals to a 401(k), 403(b), or 457(b) plan designated as Roth contributions. Elective deferrals that are designated as Roth contributions are included in your income. However, qualified distributions are not included in your income.

More than one program. If you receive benefits from more than one program under a single trust or plan of your employer, such as a pension plan and a profit-sharing plan, you may have to figure the taxable part of each separately. Your former employer or the plan administrator should be able to tell you if you have more than one pension or annuity contract.

Section 457 deferred compensation plans. If you work for a state or local government or for a tax-exempt organization, you may be able to participate in a section 457 deferred compensation plan. If your plan is an eligible plan, you are not taxed currently on pay that is deferred under the plan or on any earnings from the plan's investment of the deferred pay. You are taxed on amounts deferred in an eligible state or local government plan only when they are distributed from the plan. You are taxed on amounts deferred in an eligible tax-exempt organization plan when they are distributed or otherwise made available to you.

Your 457(b) plan may have a designated Roth account option. If so, you may be able to roll over amounts to the designated Roth account or make contributions. Elective deferrals to a designated Roth account are included in your income. Qualified distributions from a designated Roth account are not subject to tax.

Disability pensions. If you retired on disability, you generally must include in income any disability pension you receive under a plan that is paid for by your employer. You must report your taxable disability payments as wages on line 1a of Form 1040 or 1040-SR until you reach minimum retirement age. Minimum retirement age generally is the age at which you can first receive a pension or annuity if you are not disabled.

Tip

You may be entitled to a tax credit if you were permanently and totally disabled when you retired.

Beginning on the day after you reach minimum retirement age, payments you receive are taxable as a pension or annuity. Report the payments on Form 1040 or 1040-SR, lines 5a and 5b.

Tip

Disability payments for injuries incurred as a direct result of a terrorist attack directed against the United States (or its allies) are not included in income.

For more information on how to report disability pensions, including military and certain government disability pensions, see Chapter 1.

Railroad retirement benefits. Part of the railroad retirement benefits you receive is treated for tax purposes like social security benefits, and part is treated like an employee pension.

Withholding and estimated tax. The payer of your pension, profit-sharing, stock bonus, annuity, or deferred compensation plan will withhold income tax on the taxable parts of amounts paid to you. You can tell the payer how much to withhold, or not to withhold, by filing Form W-4P. If you choose not to have tax withheld, or you do not have enough tax withheld, you may have to pay estimated tax.

If you receive an eligible rollover distribution, you cannot choose not to have tax withheld. Generally, 20% will be withheld, but no tax will be withheld on a direct rollover of an eligible rollover distribution. See Direct rollover option under Rollovers, later.

Loans. If you borrow money from your retirement plan, you must treat the loan as a nonperiodic distribution from the plan unless certain exceptions apply. This treatment also applies to any loan under a contract purchased under your retirement plan, and to the value of any part of your interest in the plan or contract that you pledge or assign. This means that you must include in income all or part of the amount borrowed. Even if you do not have to treat the loan as a nonperiodic distribution, you may not be able to deduct the interest on the loan in some situations.

Qualified plans for self-employed individuals. Qualified plans set up by self-employed individuals are sometimes called Keogh or H.R. 10 plans. Qualified plans can be set up by sole proprietors, partnerships (but not a partner), and corporations. They can cover self-employed persons, such as the sole proprietor or partners, as well as regular (common-law) employees.

Distributions from a qualified plan are usually fully taxable because most recipients have no cost basis. If you have an investment (cost) in the plan, however, your pension or annuity payments from a qualified plan are taxed under the Simplified Method.

Purchased annuities. If you receive pension or annuity payments from a privately purchased annuity contract from a commercial organization, such as an insurance company, you generally must use the General Rule to figure the tax-free part of each annuity payment.

Tax-free exchange. No gain or loss is recognized on an exchange of an annuity contract for another annuity contract if the insured or annuitant remains the same. However, if an annuity contract is exchanged for a life insurance or endowment contract, any gain due to interest accumulated on the contract is ordinary income.

IV. Cost (Investment In The Contract)

Before you can figure how much, if any, of your pension or annuity benefits is taxable, you must determine your cost (your investment in the contract) in the pension or annuity. Your total cost in the plan includes the total premiums, contributions, or other amounts that you paid. It also includes amounts that were taxable to you when paid. Cost does not include any amounts you deducted or excluded from income.

From this total cost paid or considered paid by you, subtract any refunds of premiums, rebates, dividends, unrepaid loans, or other tax-free amounts you received by the later of the annuity starting date or the date on which you received your first payment.

Your annuity starting date is the later of the first day of the first period for which you received a payment, or the date the plan's obligations became fixed.

Designated Roth accounts. Your cost in these accounts is your designated Roth contributions that were included in your income as wages subject to applicable withholding requirements. Your cost will also include any in-plan Roth rollovers you included in income.

Foreign employment contributions. If you worked in a foreign country and your employer contributed to your retirement plan, special rules apply in determining your cost.

V. Taxation Of Periodic Payments

Fully taxable payments. Generally, if you did not pay any part of the cost of your employee pension or annuity and your employer did not withhold part of the cost from your pay while you worked, the amounts you receive each year are fully taxable. You must report them on your income tax return.

Partly taxable payments. If you paid part of the cost of your annuity, you are not taxed on the part of the annuity you receive that represents a return of your cost. The rest of the amount you receive is generally taxable. You figure the tax-free part of the payment using either the Simplified Method or the General Rule. Your annuity starting date and whether or not your plan is qualified determine which method you must or may use.

If the annuity starting date is after November 18, 1996, and your payments are from a qualified plan, you must use the Simplified Method. Generally, you must use the General Rule if your annuity is paid under a nonqualified plan, and you cannot use this method if your annuity is paid under a qualified plan.

If you had more than one partly taxable pension or annuity, figure the tax-free part and the taxable part of each separately.

If your annuity is paid under a qualified plan and your annuity starting date is after July 1, 1986, and before November 19, 1996, you could have chosen to use either the General Rule or the Simplified Method.

Exclusion limit. Your annuity starting date determines the total amount that you can exclude from your taxable income over the years. Once your annuity starting date is determined, it does not change. If you calculate the taxable portion of your annuity payments using the Simplified Method Worksheet, the annuity starting date determines the recovery period for your cost. That recovery period begins on your annuity starting date and is not affected by the date you first complete the worksheet.

Exclusion limited to cost. If your annuity starting date is after 1986, the total amount of annuity income that you can exclude over the years as a recovery of the cost cannot exceed your total cost.

Exclusion not limited to cost. If your annuity starting date is before 1987, you can continue to take your monthly exclusion for as long as you receive your annuity. If you chose a joint and survivor annuity, your survivor can continue to take the survivor's exclusion figured as of the annuity starting date. The total exclusion may be more than your cost.

SIMPLIFIED METHOD

Under the Simplified Method, you figure the tax-free part of each monthly annuity payment by dividing your cost by the total number of expected monthly payments. For an annuity that is payable for the lives of the annuitants, this number is based on the annuitants' ages on the annuity starting date and is determined from a table. For any other annuity, this number is the number of monthly annuity payments under the contract.

Who must use the Simplified Method. You must use the Simplified Method if your annuity starting date is after November 18, 1996, and you receive pension or annuity payments from a qualified employee plan, qualified employee annuity, or a tax-sheltered annuity (403(b)) plan, and on your annuity starting date, you were either under age 75, or entitled to less than 5 years of guaranteed payments.

Guaranteed payments. Your annuity contract provides guaranteed payments if a minimum number of payments or a minimum amount (for example, the amount of your investment) is payable even if you and any survivor annuitant do not live to receive the minimum. If the minimum amount is less than the total amount of the payments you are to receive, barring death, during the first 5 years after payments begin (figured by ignoring any payment increases), you are entitled to less than 5 years of guaranteed payments.

Example

Bill Smith, age 65, began receiving retirement benefits in 2023, under a joint and survivor annuity. Bill's annuity starting date is January 1, 2023. The benefits are to be paid for the joint lives of Bill and his wife Kathy, age 65. Bill had contributed \$31,000 to a qualified plan and had received no distributions before the annuity starting date. Bill is to receive a retirement benefit of \$1,200 a month, and Kathy is to receive a monthly survivor benefit of \$600 upon Bill's death.

Bill must use the Simplified Method to figure his taxable annuity because his payments are from a qualified plan and he is under age 75. Because his annuity is payable over the lives of more than one annuitant, he

uses his and Kathy's combined ages (and Table 2 at the bottom of the worksheet) in completing line 3 of the Simplified Method Worksheet.

Bill's tax-free monthly amount is \$100 ($\$31,000 / 310$) as shown on line 4 of the worksheet. Upon Bill's death, if Bill has not recovered the full \$31,000 investment, Kathy will also exclude \$100 from her \$600 monthly payment. The full amount of any annuity payments received after 310 payments are paid must be included in gross income.

Who must use the General Rule. You must use the General Rule if you receive pension or annuity payments from:

1. A nonqualified plan (such as a private annuity, a purchased commercial annuity, or a nonqualified employee plan), or
2. A qualified plan if you are age 75 or older on your annuity starting date and your annuity payments are guaranteed for at least 5 years.

Who cannot use the General Rule. You cannot use the General Rule if you receive your pension or annuity from a qualified plan and none of the circumstances described in the preceding discussions apply to you. See Who must use the Simplified Method, earlier.

VI. Taxation Of Nonperiodic Payments

Nonperiodic distributions are also known as amounts not received as an annuity. They include all payments other than periodic payments and corrective distributions.

Corrective distributions of excess plan contributions. Generally, if the contributions made for you during the year to certain retirement plans exceed certain limits, the excess is taxable to you. To correct any excess, your plan may distribute it to you (along with any income earned on the excess).

Figuring the taxable amount of nonperiodic payments. How you figure the taxable amount of a nonperiodic distribution depends on whether it is made before the annuity starting date or on or after the annuity starting date. If it is made before the annuity starting date, its tax treatment also depends on whether it is made under a qualified or nonqualified plan. If it is made under a nonqualified plan, its tax treatment depends on whether it fully discharges the contract or is allocable to an investment you made before August 14, 1982.

Distribution on or after annuity starting date. If you receive a nonperiodic payment from your annuity contract on or after the annuity starting date, you generally must include all of the payment in gross income.

Distribution before annuity starting date. If you receive a nonperiodic distribution before the annuity starting date from a qualified retirement plan, you generally can allocate only part of it to the cost of the contract. You exclude from your gross income the part that you allocate to the cost. You include the remainder in your gross income.

If you receive a nonperiodic distribution before the annuity starting date from a plan other than a qualified retirement plan, it is generally allocated first to earnings (the taxable part) and then to the cost of the contract (the tax-free part). This allocation rule applies, for example, to a commercial annuity contract you bought directly from the issuer.

Caution!

Distributions from nonqualified plans are subject to the NIIT. See the Instructions for Form 8960.

LUMP-SUM DISTRIBUTIONS

Lump-sum distribution defined. A lump-sum distribution is the distribution or payment in 1 tax year of a plan participant's entire balance from all of the employer's qualified plans of one kind (for example, pension, profit-sharing, or stock bonus plans). A distribution from a nonqualified plan (such as a privately purchased commercial annuity or a section 457 deferred compensation plan of a state or local government or tax-exempt organization) cannot qualify as a lump-sum distribution.

The participant's entire balance from a plan does not include certain forfeited amounts. It also does not include any deductible voluntary employee contributions allowed by the plan after 1981 and before 1987. If you receive a lump-sum distribution from a qualified employee plan or qualified employee annuity and the plan participant was born before January 2, 1936, you may be able to elect optional methods of figuring the tax on the distribution. The part from active participation in the plan before 1974 may qualify as capital gain subject to a 20% tax rate. The part from participation after 1973 (and any part from participation before 1974 that you do not report as capital gain) is ordinary income. You may be able to use the 10-year tax option, discussed later, to figure tax on the ordinary income part.

Use Form 4972 to figure the separate tax on a lump-sum distribution using the optional methods. The tax figured on Form 4972 is added to the regular tax figured on your other income. This may result in a smaller tax than you would pay by including the taxable amount of the distribution as ordinary income in figuring your regular tax.

How to treat the distribution. If you receive a lump-sum distribution, you may have the following options for how you treat the taxable part.

- Report the part of the distribution from participation before 1974 as a capital gain (if you qualify) and the part from participation after 1973 as ordinary income.
- Report the part of the distribution from participation before 1974 as a capital gain (if you qualify) and use the 10-year tax option to figure the tax on the part from participation after 1973 (if you qualify).
- Use the 10-year tax option to figure the tax on the total taxable amount (if you qualify).
- Roll over all or part of the distribution. See Rollovers, later. No tax is currently due on the part rolled over. Report any part not rolled over as ordinary income.
- Report the entire taxable part of the distribution as ordinary income on your tax return.

The first three options are explained in the following discussions.

Electing optional lump-sum treatment. You can choose to use the 10-year tax option or capital gain treatment only once after 1986 for any plan participant. If you make this choice, you cannot use either of these optional treatments for any future distributions for the participant.

Taxable and tax-free parts of the distribution. The taxable part of a lump-sum distribution is the employer's contributions and income earned on your account. You may recover your cost in the lump sum and any net unrealized appreciation (NUA) in employer securities tax free.

Cost. In general, your cost is the total of:

1. The plan participant's nondeductible contributions to the plan,
2. The plan participant's taxable costs of any life insurance contract distributed,
3. Any employer contributions that were taxable to the plan participant, and
4. Repayments of any loans that were taxable to the plan participant.

You must reduce this cost by amounts previously distributed tax free.

Capital Gain Treatment

Capital gain treatment applies only to the taxable part of a lump-sum distribution resulting from participation in the plan before 1974. The amount treated as capital gain is taxed at a 20% rate. You can elect this treatment only once for any plan participant, and only if the plan participant was born before January 2, 1936. Complete Part II of Form 4972 to choose the 20% capital gain election.

10-Year Tax Option

The 10-year tax option is a special formula used to figure a separate tax on the ordinary income part of a lump-sum distribution. You pay the tax only once, for the year in which you receive the distribution, not over the next 10 years. You can elect this treatment only once for any plan participant, and only if the plan participant was born before January 2, 1936.

The ordinary income part of the distribution is the amount shown in box 2a of the Form 1099-R given to you by the payer, minus the amount, if any, shown in box 3. You also can treat the capital gain part of the distribution (box 3 of Form 1099-R) as ordinary income for the 10-year tax option if you do not choose capital gain treatment for that part.

Complete Part III of Form 4972 to choose the 10-year tax option. You must use the Special Tax Rates Schedule shown in the instructions for Part III to figure the tax.

VII. Rollovers

If you withdraw cash or other assets from a qualified retirement plan in an eligible rollover distribution, you can defer tax on the distribution by rolling it over to another qualified retirement plan or a traditional IRA, or, after 2 years of participation in a SIMPLE IRA plan sponsored by your employer, a SIMPLE IRA under that plan.

For this purpose, the following plans are qualified retirement plans.

- A qualified employee plan.
- A qualified employee annuity.
- A tax sheltered annuity plan (403(b) plan).
- An eligible state or local government section 457 deferred compensation plan.

Rollovers to SIMPLE retirement accounts. You can roll over amounts from a qualified retirement plan (as described next) or an IRA into a SIMPLE retirement account as follows.

1. During the first 2 years of participation in a SIMPLE retirement account, you may roll over amounts from one SIMPLE retirement account into another SIMPLE retirement account.
2. After 2 years of participation in a SIMPLE retirement account, you may roll over amounts from a SIMPLE retirement, a qualified retirement plan, or an IRA into a SIMPLE retirement account.

Eligible rollover distributions. Generally, an eligible rollover distribution is any distribution of all or any part of the balance to your credit in a qualified retirement plan.

Rollover of nontaxable amounts. You may be able to roll over the nontaxable part of a distribution (such as your after-tax contributions) made to another qualified retirement plan that is a qualified employee plan or a 403(b) plan, or to a traditional or Roth IRA. The transfer must be made either through a direct rollover to a qualified plan or 403(b) that separately accounts for the taxable and nontaxable parts of the rollover or through a rollover to a traditional or Roth IRA.

If you roll over only part of a distribution that includes both taxable and nontaxable amounts, the amount you roll over is treated as coming first from the taxable part of the distribution.

Any after-tax contributions that you roll over into your traditional IRA become part of your basis (cost) in your IRAs. To recover your basis when you take distributions from your IRA, you must complete Form 8606 for the year of the distribution.

Direct rollover option. You can choose to have any part or all of an eligible rollover distribution paid directly to another qualified retirement plan that accepts rollover distributions or to a traditional or Roth IRA. If you choose the direct rollover option, or have an automatic rollover, no tax will be withheld from any part of the distribution that is directly paid to the trustee of the other plan.

Payment to you option. If an eligible rollover distribution is paid to you, 20% generally will be withheld for income tax. However, the full amount is treated as distributed to you even though you actually receive

only 80%. You generally must include in income any part (including the part withheld) that you do not rollover within 60 days to another qualified retirement plan or to a traditional or Roth IRA.

If you are under age 59½ when a distribution is paid to you, you may have to pay a 10% tax (in addition to the regular income tax) on the taxable part (including any tax withheld) that you do not roll over.

Caution!

If you decide to roll over an amount equal to the distribution before withholding, your contribution to the new plan or IRA must include other money (for example, from savings or amounts borrowed) to replace the amount withheld.

Time for making rollover. You generally must complete the rollover of an eligible distribution paid to you by the 60th day following the day on which you receive the distribution from your employer's plan. (If an amount distributed to you becomes a frozen deposit in a financial institution during the 60-day period after you receive it, the rollover period is extended for the period during which the distribution is in a frozen deposit in a financial institution.)

The administrator of a qualified plan must give you a written explanation of your distribution options within a reasonable period of time before making an eligible rollover distribution.

Tip

The IRS may waive the 60-day requirement where the failure to do so would be against equity or good conscience, such as in the event of a casualty, disaster, or other event beyond your reasonable control.

Qualified domestic relations order. You may be able to roll over all or any part of a distribution from a qualified retirement plan that you receive under a qualified domestic relations order (QDRO). If you receive the distribution as an employee's spouse or former spouse (not as a nonspousal beneficiary), the rollover rules apply to you as if you were the employee. You can roll over the distribution from the plan into a traditional IRA or to another eligible retirement plan.

Rollover by surviving spouse. You may be able to roll over tax free all or part of a distribution from a qualified retirement plan you receive as the surviving spouse of a deceased employee. The rollover rules apply to you as if you were the employee. You can roll over a distribution into a qualified retirement plan or a traditional IRA or Roth IRA.

A distribution paid to a beneficiary other than the employee's surviving spouse is generally not an eligible rollover distribution. However, see Rollovers by nonspouse beneficiary, next.

Rollovers by nonspouse beneficiary. If you are a designated beneficiary (other than a surviving spouse) of a deceased employee, you may be able to roll over tax free all or a portion of a distribution you receive from an eligible retirement plan of a deceased employee. The distribution must be a direct trustee-to-trustee transfer to your traditional or Roth IRA that was set up to receive the distribution. The transfer will be treated as an eligible rollover distribution and the receiving plan will be treated as an inherited IRA.

Designated Roth accounts. You can roll over an eligible distribution from a designated Roth account only into another designated Roth account or a Roth IRA. If you want to roll over the part of the distribution that is not included in income, you must make a direct rollover of the entire distribution or you can roll over the entire amount (or any portion) to a Roth IRA.

In-plan rollovers to designated Roth accounts. If you are a participant in a 401(k), 403(b), or 457(b) plan, your plan may permit you to roll over amounts in those plans to a designated Roth account within the same plan. The rollover of any untaxed money must be included in income in the year you receive the distribution.

Rollovers to Roth IRAs. You can roll over distributions directly from a qualified retirement plan (other than a designated Roth account) to a Roth IRA.

You must include in your gross income distributions from a qualified retirement plan (other than a designated Roth account) that you would have had to include in income if you had not rolled them over into a Roth IRA. You do not include in gross income any part of a distribution from a qualified retirement plan that is a return of contributions to the plan that were taxable to you when paid. In addition, the 10% tax on early distributions does not apply.

VIII. Special Additional Taxes

To discourage the use of pension funds for purposes other than normal retirement, the law imposes additional taxes on early distributions of those funds and on failures to withdraw the funds timely. Ordinarily, you will not be subject to these taxes if you roll over all early distributions you receive, as explained earlier, and begin drawing out the funds at a normal retirement age, in reasonable amounts over your life expectancy. These special additional taxes are the taxes on:

- Early distributions, and
- Excess accumulation (not receiving minimum distributions).

These taxes are discussed in the following sections.

If you must pay either of these taxes, report them on Form 5329. However, you do not have to file Form 5329 if you owe only the tax on early distributions and your Form 1099-R shows a “1” in box 7. Instead, enter 10% of the taxable part of the distribution on Schedule 2 (Form 1040), line 8. Also, check the box on line 8 to indicate that you do not have to file Form 5329.

Even if you do not owe any of these taxes, you may have to complete Form 5329 and attach it to your Form 1040 or 1040-SR. This applies if you meet an exception to the tax on early distributions but box 7 of your Form 1099-R does not indicate an exception.

Tax on Early Distributions

Most distributions (both periodic and nonperiodic) from qualified retirement plans and nonqualified annuity contracts made to you before you reach age 59½ are subject to an additional tax of 10%. This tax applies to the part of the distribution that you must include in gross income.

For this purpose, a qualified retirement plan is:

- A qualified employee plan,
- A qualified employee annuity plan,
- A tax-sheltered annuity plan, or
- An eligible state or local government section 457 deferred compensation plan (to the extent that any distribution is attributable to amounts the plan received in a direct transfer or rollover from one of the other plans listed here or on IRA).

5% rate on certain early distributions from deferred annuity contracts. If an early withdrawal from a deferred annuity is otherwise subject to the 10% additional tax, a 5% rate may apply instead. A 5% rate applies to distributions under a written election providing a specific schedule for the distribution of your interest in the contract if, as of March 1, 1986, you had begun receiving payments under the election. On line 4 of Form 5329, multiply the line 3 amount by 5% instead of 10%. Attach an explanation to your return.

Exceptions to tax. Certain early distributions are excepted from the early distribution tax. If the payer knows that an exception applies to your early distribution, distribution code “2,” “3,” or “4” should be shown in box 7 of your Form 1099-R and you do not have to report the distribution on Form 5329. If an exception applies but distribution code “1” (early distribution, no known exception) is shown in box 7, you must file Form 5329. Enter the taxable amount of the distribution shown in box 2a of your Form 1099-R

on line 1 of Form 5329. On line 2, enter the amount that can be excluded and the exception number shown in the Form 5329 instructions.

General exceptions. The tax does not apply to distributions that are:

- Made as part of a series of substantially equal periodic payments (made at least annually) for your life (or life expectancy) or the joint lives (or joint life expectancies) of you and your designated beneficiary (if from a qualified retirement plan, the payments must begin after your separation from service),
- Made because you are totally and permanently disabled, or
- Made on or after the death of the plan participant or contract holder.

Additional exceptions for qualified retirement plans. The tax does not apply to distributions that are:

- From a qualified retirement plan (other than an IRA) after your separation from service in or after the year you reached age 55 (age 50 for qualified public safety employees),
- From a qualified retirement plan (other than an IRA) to an alternate payee under a qualified domestic relations order,
- From a qualified retirement plan to the extent you have deductible medical expenses that exceed 7.5% of your adjusted gross income, whether or not you itemize your deductions for the year,
- From an employer plan under a written election that provides a specific schedule for distribution of your entire interest if, as of March 1, 1986, you had separated from service and had begun receiving payments under the election,
- From an employee stock ownership plan for dividends on employer securities held by the plan,
- From a qualified retirement plan due to an IRS levy of the plan,
- From elective deferral accounts under 401(k) or 403(b) plans or similar arrangements that are qualified reservist distributions,
- Phased retirement annuity payments made to federal employees, or
- From a qualified retirement plan (other than an IRA) for a qualified birth or adoption.

Qualified reservist distributions. A qualified reservist distribution is not subject to the additional tax on early distributions. A qualified reservist distribution is a distribution: (a) from elective deferrals under a section 401(k) or 403(b) plan or similar arrangement, (b) to an individual ordered or called to active duty (because he or she is a member of a reserve component) for a period of more than 179 days or for an indefinite period, and (c) made during the period beginning on the date of the order or call and ending at the close of the active duty period. You must be ordered or called to active duty after September 11, 2001.

Tax on Excess Accumulation

To make sure that most of your retirement benefits are paid to you during your lifetime, rather than to your beneficiaries after your death, the payments that you receive from qualified retirement plans must begin no later than on your required beginning date (defined later). The payments each year cannot be less than the required minimum distribution.

Required distributions not made. If the actual distributions to you in any year are less than the minimum required distribution for that year, you are subject to an additional tax. The tax equals 25% of the part of the required minimum distribution that was not distributed.

Note

A provision in the SECURE Act 2.0 reduced the amount of this additional tax from 50% to 25%, and possibly to 10% if the RMD is timely corrected within 2 years.

For this purpose, a qualified retirement plan includes a:

1. Qualified employee plan,
2. Qualified employee annuity plan,

3. An eligible section 457 deferred compensation plan, or
4. Tax-sheltered annuity plan (403(b) plan) (for benefits accruing after 1986).

Required beginning date. Unless the rule for 5% owners applies, you generally must begin to receive distributions from your qualified retirement plan by April 1 of the year that follows the later of:

1. The calendar year in which you reach age 72, (73 if you are not 72 before January 1, 2023), or
2. The calendar year in which you retire from employment with the employer maintaining the plan.

However, your plan may require you to begin to receive distributions by April 1 of the year that follows the year in which you reach age 72 (73 if applicable) even if you have not retired.

If you reached age 72 in 2022, you may be required to receive your first distribution by April 1, 2023. Your required distribution then must be made for 2023 by December 31, 2023. If you reach age 73 in 2024, you may be required to receive your first distribution by April 1, 2025. Your required distribution for 2025 then must be made by December 31, 2025.

5% owners. If you are a 5% owner of the company maintaining your qualified retirement plan, you must begin to receive distributions by April 1 of the calendar year that follows the year in which you reach age 72 (73 if applicable).

You are a 5% owner if, for the plan year ending in the calendar year in which you reach age 72 (73 if applicable), you own (or are considered to own under section 318 of the Internal Revenue Code) more than 5% of the outstanding stock (or more than 5% of the total voting power of all stock) of the employer, or more than 5% of the capital or profits interest in the employer.

Required distributions. By the required beginning date, as explained above, you must either:

- Receive your entire interest in the plan (for a tax-sheltered annuity, your entire benefit accruing after 1986), or
- Begin receiving periodic distributions in annual amounts calculated to distribute your entire interest (for a tax-sheltered annuity, your entire benefit accruing after 1986) over your life or life expectancy or over the joint lives or joint life expectancies of you and a designated beneficiary (or over a shorter period).

Form 5329. You must file a Form 5329 if you owe a tax because you did not receive a minimum required distribution from your qualified retirement plan.

CHAPTER 6: TEST YOUR KNOWLEDGE

The following question is designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). It is included as an additional tool to enhance your learning experience and does not need to be submitted in order to receive CE credit.

We recommend that you answer the question and then compare your response to the suggested solution on the following page before answering the final exam question(s) related to this chapter (assignment).

1. If an eligible rollover distribution is paid directly to an individual, 10% will be withheld for income tax.

- A. true
- B. false

2. Generally, at what age would most distributions made to you from a qualified retirement plan no longer be subject to an early distribution tax of 10%:

- A. 50 years
- B. 55 years
- C. 59½ years
- D. 65 years

CHAPTER 6: SOLUTION AND SUGGESTED RESPONSES

Below is the solution and suggested responses for the question on the previous page. If you choose an incorrect answer, you should review the page(s) as indicated for the question to ensure comprehension of the material.

1.
 - A. Incorrect. A sum is withheld for income tax, but it is greater than 10%.
 - B. **CORRECT**. The sum withheld for income tax is 20%, not 10%. Even though the individual actually receives only 80%, the full amount is treated as distributed, and the individual must include in income any part (including the part withheld) that he or she does not rollover within 60 days to another qualified retirement plan or to a traditional or Roth IRA.

2.
 - A. Incorrect. Avoiding an early distribution tax at age 50 is not generally available. However certain qualified public safety employees, after a separation in service, may qualify.
 - B. Incorrect. An exception rule for distributions at age 55 after separation from service can apply to payments made from a qualified retirement plan, but this is not the age in general.
 - C. **CORRECT**. Early distribution taxes no longer apply to individuals receiving qualified retirement plan payments upon reaching the age of 59½.
 - D. Incorrect. Age 65 has no significance with regard to determining an early distribution tax liability.

Chapter 7: Social Security And Equivalent Railroad Retirement Benefits

Chapter Objective

After completing this chapter, you should be able to:

- Recognize key taxation thresholds related to social security income.

I. Introduction

This chapter explains the federal income tax rules for social security benefits and equivalent tier 1 railroad retirement benefits. It explains:

- How to figure whether your benefits are taxable,
- How to report your taxable benefits,
- How to use the social security benefits worksheet (with examples), and
- How to treat repayments that are more than the benefits you received during the year.

Social security benefits include monthly survivor and disability benefits. They do not include supplemental security income (SSI) payments, which are not taxable.

Equivalent tier 1 railroad retirement benefits are the part of tier 1 benefits that a railroad employee or beneficiary would have been entitled to receive under the social security system. They are commonly called the social security equivalent benefit (SSEB) portion of tier 1 benefits.

If you received these benefits during 2023, you should receive a Form SSA-1099 or Form RRB-1099 (Form SSA-1042S or Form RRB-1042S if you are a nonresident alien). These forms show the amounts received and repaid, and taxes withheld for the year. You may receive more than one of these forms for the same year. You should add the amounts shown on all Forms SSA-1099 and Forms RRB-1099 you receive for the year to determine the “total” amounts received and repaid, and taxes withheld for that year.

Note

When the term “benefits” is used in this chapter, it applies to both social security benefits and the SSEB portion of tier 1 railroad retirement benefits.

What is not covered in this chapter. This chapter does not cover the tax rules for the following railroad retirement benefits:

- Non-social security equivalent benefit (NSSEB) portion of tier 1 benefits,
- Tier 2 benefits,
- Vested dual benefits, and
- Supplemental annuity benefits.

II. Are Any Of Your Benefits Taxable?

To find out whether any of your benefits are taxable, compare the base amount for your filing status with the total of:

1. One-half of your benefits, plus
2. All your other income, including tax-exempt interest.

When making this comparison, do not reduce your other income by any **exclusions** for:

- Interest from qualified U.S. savings bonds,
- Employer-provided adoption benefits,
- Foreign earned income or foreign housing, or
- Income earned by bona fide residents of American Samoa or Puerto Rico.

Figuring total income. To figure the total of one-half of your benefits plus your other income, use the worksheet later in this discussion. If the total is more than your base amount, part of your benefits may be taxable.

If you are married and file a joint return for 2023, you and your spouse must combine your incomes and your benefits to figure whether any of your combined benefits are taxable. Even if your spouse did not receive any benefits, you must add your spouse's income to yours to figure whether any of your benefits are taxable.

Base amount. Your base amount is:

- \$25,000 if you are single, head of household, or qualifying widow(er),
- \$25,000 if you are married filing separately and lived apart from your spouse for all of 2023,
- \$32,000 if you are married filing jointly, or
- \$-0- if you are married filing separately and lived with your spouse at any time during 2023.

Tax withholding and estimated tax. You can choose to have federal income tax withheld from your social security benefits and/or the SSEB portion of your tier 1 railroad retirement benefits. If you choose to do this, you must complete a Form W-4V.

If you do not choose to have income tax withheld, you may have to request additional withholding from other income or pay estimated tax during the year.

III. How To Report Your Benefits

If part of your benefits are taxable, you must use Form 1040 or 1040-SR.

Reporting on Form 1040 or 1040-SR Report your net benefits (the amount in box 5 of your Forms SSA-1099 or Form RRB-1099) on line 6a and the taxable part on line 6b. If you are married filing separately and you lived apart from your spouse for all of 2023, also enter "D" to the right of the word "benefits" on line 6a.

Benefits not taxable. Report your net benefits (the total amount from box 5 of all your Forms SSA-1099 and Forms RRB-1099) on Form 1040 or 1040-SR, line 6a. Enter -0- on Form 1040 or 1040-SR, line 6b. If you are married filing separately and you lived apart from your spouse for all of 2023, also enter "D" to the right of the word "benefits" on Form 1040 or 1040-SR, line 6a.

HOW MUCH IS TAXABLE?

If part of your benefits are taxable, how much is taxable depends on the total amount of your benefits and other income. Generally, the higher that total amount, the greater the taxable part of your benefits.

Maximum taxable part. Generally, up to 50% of your benefits will be taxable. However, up to 85% of your benefits can be taxable if either of the following situations applies to you.

1. The total of one-half of your benefits and all your other income is more than \$34,000 (\$44,000 if you are married filing jointly).
2. You are married filing separately and lived with your spouse at any time during 2023.

Lump-sum election. You must include the taxable part of a lump-sum (retroactive) payment of benefits received in 2023 in your 2023 income, even if the payment includes benefits for an earlier year.

Tip

This type of lump-sum benefit payment should not be confused with the lump-sum death benefit that both the SSA and RRB pay to many of their beneficiaries. No part of the lump-sum death benefit is subject to tax.

Generally, you use your 2023 income to figure the taxable part of the total benefits received in 2023. However, you may be able to figure the taxable part of a lump-sum payment for an earlier year separately, using your income for the earlier year. You can elect this method if it lowers your taxable benefits.

Making the election. If you received a lump-sum benefit payment in 2023 that includes benefits for one or more earlier years, follow the instructions in Publication 915 under Lump-Sum Election to see whether making the election will lower your taxable benefits. That discussion also explains how to make the election.

Caution!

Because the earlier year's taxable benefits are included in your 2023 income, no adjustment is made to the earlier year's return. **Do not** file an amended return for the earlier year.

CHAPTER 7: TEST YOUR KNOWLEDGE

The following question is designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). It is included as an additional tool to enhance your learning experience and does not need to be submitted in order to receive CE credit.

We recommend that you answer the question and then compare your response to the suggested solution on the following page before answering the final exam question(s) related to this chapter (assignment).

1. Which of the following is correct regarding social security benefits:

- A. they are never taxable
- B. they are taxable in full as ordinary income
- C. they are taxable in full as capital income
- D. they may be taxable based on the base amount of your filing status

CHAPTER 7: SOLUTION AND SUGGESTED RESPONSES

Below is the solution and suggested responses for the question on the previous page. If you choose an incorrect answer, you should review the page(s) as indicated for the question to ensure comprehension of the material.

1.

- A. Incorrect. Social security benefits may be taxable depending on the base amount for your filing status.
- B. Incorrect. Social security benefits may be taxable, but they would not be 100% taxable. The calculation of determining if any of the benefits are taxable begins with one-half of your benefits.
- C. Incorrect. Social security benefits that may be taxable would not be taxed as capital gain income.
- D. **CORRECT.** To find out if any of your benefits are taxable, you compare the base amount for your filing status with the total of one-half of your benefits plus all of your other income, including tax-exempt interest.

Chapter 8: Other Income

Chapter Objective

After completing this chapter, you should be able to:

- Identify the taxability of various types of other income.

I. Reminder

Repeal of deduction for alimony payments. You cannot deduct alimony or separate maintenance payments made under a divorce or separation agreement (1) executed after 2018, or (2) executed before 2019 but later modified if the modification expressly states the repeal of the deduction for alimony payments applies to the modification. Alimony and separate maintenance payments you receive under such an agreement are not included in your gross income.

II. Introduction

This chapter discusses many kinds of income and explains whether they are taxable or nontaxable.

- Income that is taxable must be reported on your tax return and is subject to tax.
- Income that is nontaxable may have to be shown on your tax return but is not taxable.

This chapter begins with discussions of the following income items.

- Canceled debts.
- Life insurance proceeds.
- Partnership income.
- S Corporation income.
- Recoveries (including state income tax refunds).
- Rents from personal property.
- Repayments.
- Royalties.
- Unemployment benefits.

These discussions are followed by brief discussions of many income items arranged in alphabetical order.

III. Canceled Debts

In most cases, if a debt you owe is canceled or forgiven, other than as a gift or bequest, you must include the canceled amount in your income. You have no income from the canceled debt if it is intended as a gift to you. A debt includes any indebtedness for which you are liable or which attaches to property you hold. If the debt is a nonbusiness debt, report the canceled amount on Schedule 1 (Form 1040), line 8c. If it is a business debt, report the amount on Schedule C (Form 1040) (or on Schedule F, Profit or Loss From Farming (Form 1040), if the debt is farm debt and you are a farmer).

Form 1099-C. If a federal government agency, financial institution, or credit union cancels or forgives a debt you owe of \$600 or more, you will receive a Form 1099-C, Cancellation of Debt. The amount of the canceled debt is shown in box 2.

Interest included in canceled debt. If any interest is forgiven and included in the amount of canceled debt in box 2, the amount of interest will also be shown in box 3. Whether or not you must include the interest portion of the canceled debt in your income depends on whether the interest would be deductible when you paid it.

If the interest would not be deductible (such as interest on a personal loan), include in your income the amount from box 2 of Form 1099-C. If the interest would be deductible (such as on a business loan), include in your income the net amount of the canceled debt (the amount shown in box 2 less the interest amount shown in box 3).

Discounted mortgage loan. If your financial institution offers a discount for the early payment of your mortgage loan, the amount of the discount is canceled debt. You must include the canceled amount in your income.

Mortgage relief upon sale or other disposition. If you are personally liable for a mortgage (recourse debt), and you are relieved of the mortgage when you dispose of the property, you may realize gain or loss up to the fair market value of the property. To the extent the mortgage discharge exceeds the fair market value of the property, it is income from discharge of indebtedness unless it qualifies for exclusion. Report any income from discharge of indebtedness on nonbusiness debt that does not qualify for exclusion as other income on Schedule 1 (Form 1040), line 8c.

If you are not personally liable for a mortgage (nonrecourse debt), and you are relieved of the mortgage when you dispose of the property (such as through foreclosure), that relief is included in the amount you realize. You may have a taxable gain if the amount you realize exceeds your adjusted basis in the property. Report any gain on nonbusiness property as a capital gain.

Note

One of the provisions of the Further Consolidated Appropriations Act of 2020 includes a provision for the exclusion from gross income of cancellation of qualified principal residence indebtedness for 2019 and 2020. The Further Consolidated Appropriations Act of 2021 extended this exclusion through the year 2025.

Stockholder debt. If you are a stockholder in a corporation and the corporation cancels or forgives your debt to it, the canceled debt is a constructive distribution that is generally dividend income to you.

If you are a stockholder in a corporation and you cancel a debt owed to you by the corporation, you generally do not realize income. This is because the canceled debt is considered as a contribution to the capital of the corporation equal to the amount of debt principal that you canceled.

Repayment of canceled debt. If you included a canceled amount in your income and later pay the debt, you may be able to file a claim for refund for the year the amount was included in income. You can file a claim on Form 1040-X if the statute of limitations for filing a claim is still open. The statute of limitations generally does not end until 3 years after the due date of your original return.

IV. Life Insurance Proceeds

Life insurance proceeds paid to you because of the death of the insured person are not taxable unless the policy was turned over to you for a price. This is true even if the proceeds were paid under an accident or health insurance policy or an endowment contract. However, interest income received as a result of life insurance proceeds may be taxable.

Proceeds not received in installments. If death benefits are paid to you in a lump sum or other than at regular intervals, include in your income only the benefits that are more than the amount payable to you at the time of the insured person's death. If the benefit payable at death is not specified, you include in your income the benefit payments that are more than the present value of the payments at the time of death.

Proceeds received in installments. If you receive life insurance proceeds in installments, you can exclude part of each installment from your income.

To determine the excluded part, divide the amount held by the insurance company (generally the total lump sum payable at the death of the insured person) by the number of installments to be paid. Include anything over this excluded part in your income as interest.

Surviving spouse. If your spouse died before October 23, 1986, and insurance proceeds paid to you because of the death of your spouse are received in installments, you can exclude up to \$1,000 a year of the interest included in the installments. If you remarry, you can continue to take the exclusion.

Surrender of policy for cash. If you surrender a life insurance policy for cash, you must include in income any proceeds that are more than the cost of the life insurance policy. In most cases, your cost (or investment in the contract) is the total of premiums that you paid for the life insurance policy, less any refunded premiums, rebates, dividends, or unrepaid loans that were not included in your income.

You should receive a Form 1099-R showing the total proceeds and the taxable part. Report these amounts on lines 5a and 5b of Form 1040 or 1040-SR.

ENDOWMENT CONTRACT PROCEEDS

Endowment proceeds paid in a lump sum to you at maturity are taxable only if the proceeds are more than the cost of the policy. To determine your cost, add the aggregate amount of premiums (or other consideration) paid for the contract and subtract any amount that you previously received under the contract and excluded from your income. Include in your income the part of the lump sum payment that is more than your cost in your income.

ACCELERATED DEATH BENEFITS

Certain amounts paid as accelerated death benefits under a life insurance contract or viatical settlement before the insured's death are excluded from income if the insured is terminally or chronically ill.

Viatical settlement. This is the sale or assignment of any part of the death benefit under a life insurance contract to a viatical settlement provider. A viatical settlement provider is a person who regularly engages in the business of buying or taking assignment of life insurance contracts on the lives of insured individuals who are terminally or chronically ill and who meets the requirements of section 101(g)(2)(B) of the Internal Revenue Code.

Exclusion for terminal illness. Accelerated death benefits are fully excludable if the insured is a terminally ill individual. This is a person who has been certified by a physician as having an illness or physical condition that can reasonably be expected to result in death within 24 months from the date of the certification.

Exclusion for chronic illness. If the insured is a chronically ill individual who is not terminally ill, accelerated death benefits paid on the basis of costs incurred for qualified long-term care services are fully excludable. Accelerated death benefits paid on a per diem or other periodic basis are excludable up to a limit. This limit applies to the total of the accelerated death benefits and any periodic payments received from long-term care insurance contracts.

Exception

The exclusion does not apply to any amount paid to a person (other than the insured) who has an insurable interest in the life of the insured because the insured:

- Is a director, officer, or employee of the other person, or
- Has a financial interest in the person's business.

V. Partnership Income

A partnership generally is not a taxable entity. The income, gains, losses, deductions, and credits of a partnership are passed through to the partners based on each partner's distributive share of these items.

Schedule K-1 (Form 1065). Although a partnership generally pays no tax, it must file an information return on Form 1065, U.S. Return of Partnership Income, and send Schedule K-1 (Form 1065) to each partner. In addition, the partnership will send each partner a copy of the Partner's Instructions for Schedule K-1 (Form 1065) to help each partner report his or her share of the partnership's income, deductions, credits, and tax preference items.

Records. Keep Schedule K-1 (Form 1065) for your records. Do not attach it to your Form 1040 or 1040-SR, unless you are specifically required to do so.

VI. S Corporation Income

In most cases, an S corporation does not pay tax on its income. Instead, the income, losses, deductions, and credits of the corporation are passed through to the shareholders based on each shareholder's pro rata share.

Schedule K-1 (Form 1120S). An S corporation must file a return on Form 1120-S, U.S. Income Tax Return for an S Corporation, and send Schedule K-1 (Form 1120-S) to each shareholder. In addition, the S corporation will send each shareholder a copy of the Shareholder's Instructions for Schedule K-1 (Form 1120-S) to help each shareholder report his or her share of the S corporation's income, losses, credits, and deductions.

Records. Keep Schedule K-1 (Form 1120-S) for your records. Do not attach it to your Form 1040 or 1040-SR, unless you are required to do so.

For more information on S corporations and their shareholders, see the instructions for Form 1120-S.

VII. Recoveries

A recovery is a return of an amount you deducted or took a credit for in an earlier year. The most common recoveries are refunds, reimbursements, and rebates of deductions itemized on Schedule A (Form 1040). You may also have recoveries of non-itemized deductions (such as payments on previously deducted bad debts) and recoveries of items for which you previously claimed a tax credit.

Tax benefit rule. You must include a recovery in your income in the year you receive it up to the amount by which the deduction or credit you took for the recovered amount reduced your tax in the earlier year. For this purpose, any increase to an amount carried over to the current year that resulted from the deduction or credit is considered to have reduced your tax in the earlier year.

Federal income tax refund. Refunds of federal income taxes are not included in your income because they are never allowed as a deduction from income.

State income tax refund. If you received a state or local income tax refund (or credit or offset) in 2023, you generally must include it in income if you deducted the tax in an earlier year. The payer should send Form 1099-G, Certain Government Payments, to you by January 31, 2024. The IRS will also receive a copy of the Form 1099-G. Use the State and Local Tax Refund Worksheet in the 2023 Form 1040 or 1040-SR Instructions for Schedule 1 to figure the amount (if any) to include in your income.

If you could choose to deduct for a tax year either:

- State and local income taxes, or
- State and local general sales taxes, then

the maximum refund that you may have to include in income is limited to the excess of the tax you chose to deduct for that year over the tax you did not choose to deduct for that year.

Mortgage interest refund. If you received a refund or credit in 2023 of mortgage interest paid in an earlier year, the amount should be shown in box 4 of your Form 1098, Mortgage Interest Statement. Do not

subtract the refund amount from the interest you paid in 2023. You may have to include it in your income under the rules explained in the following discussions.

Interest on recovery. Interest on any of the amounts you recover must be reported as interest income in the year received. For example, report any interest you received on state or local income tax refunds on Form 1040 or 1040-SR, line 2b.

Recovery and expense in same year. If the refund or other recovery and the expense occur in the same year, the recovery reduces the deduction or credit and is not reported as income.

Recovery for 2 or more years. If you receive a refund or other recovery that is for amounts you paid in 2 or more separate years, you must allocate, on a pro rata basis, the recovered amount between the years in which you paid it. This allocation is necessary to determine the amount of recovery from any earlier years and to determine the amount, if any, of your allowable deduction for this item for the current year.

VIII. Rents From Personal Property

If you rent out personal property, such as equipment or vehicles, how you report your income and expenses is generally determined by:

1. Whether or not the rental activity is a business, and
2. Whether or not the rental activity is conducted for profit.

In most cases, if your primary purpose is income or profit and you are involved in the rental activity with continuity and regularity, your rental activity is a business.

Reporting business income and expenses. If you are in the business of renting personal property, report your income and expenses on Schedule C (Form 1040). The form instructions have information on how to complete them.

Reporting nonbusiness income. If you are not in the business of renting personal property, report your rental income on Schedule 1 (Form 1040), line 8I.

Reporting nonbusiness expenses. If you rent personal property for profit, include your rental expenses in the total amount you enter on Schedule 1 (Form 1040), line 24b.

If you do not rent personal property for profit, your deductions are limited and you cannot report a loss to offset other income.

IX. Repayments

If you had to repay an amount that you included in your income in an earlier year, you may be able to deduct the amount repaid from your income for the year in which you repaid it. Or, if the amount you repaid is more than \$3,000, you may be able to take a credit against your tax for the year in which you repaid it. Generally, you can claim a deduction or credit only if the repayment qualifies as an expense or loss incurred in your trade or business or in a for-profit transaction.

Type of deduction. The type of deduction you are allowed in the year of repayment depends on the type of income you included in the earlier year. You generally deduct the repayment on the same form or schedule on which you previously reported it as income. For example, if you reported it as selfemployment income, deduct it as a business expense on Schedule C (Form 1040) or Schedule F (Form 1040). If you reported it as a capital gain, deduct it as a capital loss on Schedule D (Form 1040). If you reported it as wages, unemployment compensation, or other nonbusiness income, you may be able to deduct it as an other itemized deduction if the amount repaid is over \$3,000.

Caution!

In 2023, you cannot claim any miscellaneous itemized deductions, so if the amount repaid was \$3,000 or less, you are not able to deduct it from your income in the year you repaid it.

Repayment – \$3,000 or less. If the amount you repaid was \$3,000 or less, deduct it from your income in the year you repaid it.

Repayment over \$3,000. If the amount you repaid was more than \$3,000, you can deduct the repayment as an other itemized deduction on Schedule A (Form 1040), line 16, if you included the income under a claim of right. This means that at the time you included the income, it appeared that you had an unrestricted right to it. However, you can choose to take a credit for the year of repayment. Figure your tax under both methods and compare the results. Use the method (deduction or credit) that results in less tax.

Caution!

When determining whether the amount you repaid was more or less than \$3,000, consider the total amount being repaid on the return. Each instance of repayment is not considered separately.

Method 1. Figure your tax for 2023 claiming a deduction for the repaid amount. If you deduct it as an other itemized deduction, enter it on Schedule A (Form 1040), line 16.

Method 2. Figure your tax for 2023 claiming a credit for the repaid amount. Follow these steps.

1. Figure your tax for 2023 without deducting the repaid amount.
2. Refigure your tax from the earlier year without including in income the amount you repaid in 2023.
3. Subtract the tax in (2) from the tax shown on your return for the earlier year. This is the credit.
4. Subtract the answer in (3) from the tax for 2023 figured without the deduction (Step 1).

If method 1 results in less tax, deduct the amount repaid. If method 2 results in less tax, claim the credit figured in (3) above on Schedule 3 (Form 1040), line 13d, by adding the amount of the credit to any other credits on this line, and see the instructions there.

X. Royalties

Royalties from copyrights, patents, and oil, gas, and mineral properties are taxable as ordinary income. In most cases, you report royalties in Part I of Schedule E (Form 1040). However, if you hold an operating oil, gas, or mineral interest or are in business as a self-employed writer, inventor, artist, etc., report your income and expenses on Schedule C (Form 1040).

Copyrights and patents. Royalties from copyrights on literary, musical, or artistic works, and similar property, or from patents on inventions, are amounts paid to you for the right to use your work over a specified period of time. Royalties are generally based on the number of units sold, such as the number of books, tickets to a performance, or machines sold.

Oil, gas, and minerals. Royalty income from oil, gas, and mineral properties is the amount you receive when natural resources are extracted from your property. The royalties are based on units, such as barrels, tons, etc., and are paid to you by a person or company who leases the property from you.

Depletion. If you are the owner of an economic interest in mineral deposits or oil and gas wells, you can recover your investment through the depletion allowance.

Coal and iron ore. Under certain circumstances, you can treat amounts you receive from the disposal of coal and iron ore as payments from the sale of a capital asset, rather than as royalty income.

Sale of property interest. If you sell your complete interest in oil, gas, or mineral rights, the amount you receive is considered payment for the sale of section 1231 property, not royalty income. Under certain

circumstances, the sale is subject to capital gain or loss treatment on Schedule D (Form 1040). For more information on selling section 1231 property, see chapter 3 of Publication 544. If you retain a royalty, an overriding royalty, or a net profit interest in a mineral property for the life of the property, you have made a lease or a sublease, and any cash you receive for the assignment of other interests in the property is ordinary income subject to a depletion allowance.

Part of future production sold. If you own mineral property but sell part of the future production, you generally treat the money you receive from the buyer at the time of the sale as a loan from the buyer. Do not include it in your income or take depletion based on it.

When production begins, you include all the proceeds in your income, deduct all the production expenses, and deduct depletion from that amount to arrive at your taxable income from the property.

XI. Unemployment Benefits

The tax treatment of unemployment benefits you receive depends on the type of program paying the benefits.

Unemployment compensation. You must include in your income all unemployment compensation you received. You should receive a Form 1099-G, Certain Government Payments, showing in box 1 the total unemployment compensation paid to you. In most cases, you enter unemployment compensation on Schedule 1 (Form 1040), line 7.

Types of unemployment compensation. Unemployment compensation generally includes any amount received under an unemployment compensation law of the United States or of a state. It includes the following benefits.

- Benefits paid by a state or the District of Columbia from the Federal Unemployment Trust Fund.
- State unemployment insurance benefits.
- Railroad unemployment compensation benefits.
- Disability payments from a government program paid as a substitute for unemployment compensation. (Amounts received as workers' compensation for injuries or illness are not unemployment compensation. See Chapter 1 for more information.)
- Trade readjustment allowances under the Trade Act of 1974.
- Unemployment assistance under the Disaster Relief and Emergency Assistance Act.
- Unemployment assistance under the Airline Deregulation Act of 1978 program.

Governmental program. If you contribute to a governmental unemployment compensation program and your contributions are not deductible, amounts you receive under the program are not included as unemployment compensation until you recover your contributions. If you deducted all of your contributions to the program, the entire amount you receive under the program is included in your income.

Repayment of unemployment compensation. If you repaid in 2023 unemployment compensation you received in 2023, subtract the amount you repaid from the total amount you received and enter the difference on line 7 of Schedule 1 (Form 1040). On the dotted line next to your entry enter "Repaid" and the amount you repaid. If you repaid unemployment compensation in 2023 that you included in income in an earlier year, you can deduct the amount repaid on Schedule A (Form 1040), line 16 if you itemize deductions and if the amount is more than \$3,000.

Tax withholding. You can choose to have federal income tax withheld from your unemployment compensation. To make this choice, complete Form W-4V, Voluntary Withholding Request, and give it to the paying office. Tax will be withheld at 10% of your payment.

Supplemental unemployment benefits. Benefits received from an employer-financed fund (to which the employees did not contribute) are not unemployment compensation. They are taxable as wages. Report these payments on Form 1040 or 1040-SR, line 1.

Repayment of benefits. You may have to repay some of your supplemental unemployment benefits to qualify for trade readjustment allowances under the Trade Act of 1974. If you repay supplemental unemployment benefits in the same year you receive them, reduce the total benefits by the amount you repay. If you repay the benefits in a later year, you must include the full amount of the benefits received in your income for the year you received them.

Deduct the repayment in the later year as an adjustment to gross income on Form 1040 or 1040-SR. Include the repayment on Schedule 1 (Form 1040), line 24e. If the amount you repay in a later year is more than \$3,000, you may be able to take a credit against your tax for the later year instead of deducting the amount repaid. For more information on this, see Repayments, earlier.

Private unemployment fund. Unemployment benefit payments from a private fund to which you voluntarily contribute are taxable only if the amounts you receive are more than your total payments into the fund. Report the taxable amount on Schedule 1 (Form 1040), line 8z.

Payments by a union. Benefits paid to you as an unemployed member of a union from regular union dues are included in your gross income on Schedule 1 (Form 1040), line 8z. However, if you contribute to a special union fund and your payments to the fund are not deductible, the unemployment benefits you receive from the fund are includible in your income only to the extent they are more than your contributions.

Guaranteed annual wage. Payments you receive from your employer during periods of unemployment, under a union agreement that guarantees you full pay during the year, are taxable as wages. Include them on Form 1040 or 1040-SR, line 1a.

State employees. Payments similar to a state's unemployment compensation may be made by the state to its employees who are not covered by the state's unemployment compensation law. Although the payments are fully taxable, do not report them as unemployment compensation. Report these payments on Schedule 1 (Form 1040), line 8z.

XII. Other Income

The following brief discussions are arranged in alphabetical order. Income items that are discussed in greater detail in another publication include a reference to that publication.

Activity not for profit. You must include on your return income from an activity from which you do not expect to make a profit. An example of this type of activity is a hobby or a farm you operate mostly for recreation and pleasure. Enter this income on Schedule 1 (Form 1040), line 8j. Deductions for expenses related to the activity are limited. They cannot total more than the income you report and can be taken only if you itemize deductions on Schedule A (Form 1040).

Alimony. Include in your income on Schedule 1 (Form 1040), line 2a any taxable alimony payments you receive. Amounts you receive for child support are not income to you. Alimony and child support payments are discussed in chapter 18.

Caution!

Do not include alimony payments you receive under a divorce or separation agreement (1) executed after 2018, or (2) executed before 2019 but later modified if the modification expressly states the repeal of the deduction for alimony payments applies to the modification.

Campaign contributions. These contributions are not income to a candidate unless they are diverted to his or her personal use. To be nontaxable, the contributions must be spent for campaign purposes or kept in a fund for use in future campaigns. However, interest earned on bank deposits, dividends received on contributed securities, and net gains realized on sales of contributed securities are taxable and must be

reported on Form 1120-POL, U.S. Income Tax Return for Certain Political Organizations. Excess campaign funds transferred to an office account must be included in the officeholder's income on Schedule 1 (Form 1040), line 8z, in the year transferred.

Cash rebates. A cash rebate you receive from a dealer or manufacturer of an item you buy is not income, but you must reduce your basis by the amount of the rebate.

Example

You buy a new car for \$24,000 cash and receive a \$2,000 rebate check from the manufacturer. The \$2,000 is not income to you. Your cost is \$22,000. This is your basis on which you figure gain or loss if you sell the car, and depreciation if you use it for business.

Court awards and damages. To determine if settlement amounts you receive by compromise or judgment must be included in your income, you must consider the item that the settlement replaces. The character of the income as ordinary income or capital gain depends on the nature of the underlying claim. Include the following as ordinary income.

1. Interest on any award.
2. Compensation for lost wages or lost profits in most cases.
3. Punitive damages, in most cases. It does not matter if they relate to a physical injury or physical sickness.
4. Amounts received in settlement of pension rights (if you did not contribute to the plan).
5. Damages for:
 - a) Patent or copyright infringement,
 - b) Breach of contract, or
 - c) Interference with business operations.
6. Back pay and damages for emotional distress received to satisfy a claim under Title VII of the Civil Rights Act of 1964.
7. Attorney fees and costs (including contingent fees) where the underlying recovery is included in gross income.
8. Attorney fees and costs relating to whistleblower awards where the underlying recovery is included in gross income.

Do not include in your income compensatory damages for personal physical injury or physical sickness (whether received in a lump sum or installments).

Emotional distress. Damages you receive for emotional distress due to a physical injury or sickness are treated as received for the physical injury or sickness. Do not include them in your income. If the emotional distress is due to a personal injury that is unrelated to a physical injury or sickness (for example, employment discrimination or injury to reputation), you must include the damages in your income, except for any damages that are not more than amounts paid for medical care due to that emotional distress. Emotional distress includes physical symptoms that result from emotional distress, such as headaches, insomnia, and stomach disorders.

Credit card insurance. In most cases, if you receive benefits under a credit card disability or unemployment insurance plan, the benefits are taxable to you. These plans make the minimum monthly payment on your credit card account if you cannot make the payment due to injury, illness, disability, or unemployment. Report on Schedule 1 (Form 1040), line 8z, the amount of benefits you received during the year that is more than the amount of the premiums you paid during the year.

Energy conservation subsidies. You can exclude from gross income any subsidy provided, either directly or indirectly, by public utilities for the purchase or installation of an energy conservation measure for a dwelling unit.

Energy conservation measure. This includes installations or modifications that are primarily designed to reduce consumption of electricity or natural gas, or improve the management of energy demand.

Dwelling unit. This includes a house, apartment, condominium, mobile home, boat, or similar property. If a building or structure contains both dwelling and other units, any subsidy must be properly allocated.

Estate and trust income. An estate or trust, unlike a partnership, may have to pay federal income tax. If you are a beneficiary of an estate or trust, you may be taxed on your share of its income distributed or required to be distributed to you. However, there is never a double tax. Estates and trusts file their returns on Form 1041, U.S. Income Tax Return for Estates and Trusts, and your share of the income is reported to you on Schedule K-1 of Form 1041.

Current income required to be distributed. If you are the beneficiary of a trust that must distribute all of its current income, you must report your share of the distributable net income, whether or not you actually received it.

Current income not required to be distributed. If you are the beneficiary of an estate or trust and the fiduciary has the choice of whether to distribute all or part of the current income, you must report:

- All income that is required to be distributed to you, whether or not it is actually distributed, plus
- All other amounts actually paid or credited to you,

up to the amount of your share of distributable net income.

Losses. Losses of estates and trusts generally are not deductible by the beneficiaries.

Grantor trust. Income earned by a grantor trust is taxable to the grantor, not the beneficiary, if the grantor keeps certain control over the trust. (The grantor is the one who transferred property to the trust.) This rule applies if the property (or income from the property) put into the trust will or may revert (be returned) to the grantor or the grantor's spouse.

Generally, a trust is a grantor trust if the grantor has a reversionary interest valued (at the date of transfer) at more than 5% of the value of the transferred property.

Fees for services. Include all fees for your services in your income. Examples of these fees are amounts you receive for services you perform as:

- A corporate director,
- An executor, administrator, or personal representative of an estate,
- A manager of a trade or business you operated before declaring Chapter 7 bankruptcy,
- A notary public, or
- An election precinct official.

Nonemployee compensation. If you are not an employee and the fees for your services from the same payer total \$600 or more for the year, you may receive a Form 1099-NEC. You may need to report your fees as self-employment income.

Corporate director. Corporate director fees are self-employment income. Report these payments on Schedule C (Form 1040).

Personal representatives. All personal representatives must include in their gross income fees paid to them from an estate. If you are not in the trade or business of being an executor (for instance, you are the executor of a friend's or relative's estate), report these fees on Schedule 1 (Form 1040), line 8z. If you provide the services as a trade or business, report them as self-employment income on Schedule C (Form 1040). The fee is not includible in income if it is waived.

Gambling winnings. You must include your gambling winnings in income on Schedule 1 (Form 1040), line 8b. If you itemize your deductions on Schedule A (Form 1040), you can deduct gambling losses you had during the year, but only up to the amount of your winnings. If you are in the trade or business of gambling, use Schedule C (Form 1040).

Lotteries and raffles. Winnings from lotteries and raffles are gambling winnings. In addition to cash winnings, you must include in your income the fair market value of bonds, cars, houses, and other noncash prizes.

Form W-2G. You may have received a Form W-2G, Certain Gambling Winnings, showing the amount of your gambling winnings and any tax taken out of them. Include the amount from box 1 on Schedule 1 (Form 1040), line 8b. Include the amount shown in box 4 on line 25c of Form 1040 or 1040-SR as federal income tax withheld.

Gifts and inheritances. In most cases, property you receive as a gift, bequest, or inheritance is not included in your income. However, if property you receive this way later produces income such as interest, dividends, or rents, that income is taxable to you. If property is given to a trust and the income from it is paid, credited, or distributed to you, that income is also taxable to you. If the gift, bequest, or inheritance is the income from the property, that income is taxable to you.

Inherited pension or IRA. If you inherited a pension or an individual retirement arrangement (IRA), you may have to include part of the inherited amount in your income.

Hobby losses. Losses from a hobby are not deductible from other income. A hobby is an activity from which you do not expect to make a profit. See Activity not for profit, earlier.

Interest on qualified savings bonds. You may be able to exclude from income the interest from qualified U.S. savings bonds you redeem if you pay qualified higher educational expenses in the same year.

Job interview expenses. If a prospective employer asks you to appear for an interview and either pays you an allowance or reimburses you for your transportation and other travel expenses, the amount you receive is generally not taxable. You include in income only the amount you receive that is more than your actual expenses.

Jury duty. Jury duty pay you receive must be included in your income on Schedule 1 (Form 1040), line 8h. If you gave any of your jury duty pay to your employer because your employer continued to pay your salary while you served jury duty, include the amount you gave your employer as income adjustment on Schedule 1 (Form 1040), line 24a.

Kickbacks. You must include kickbacks, side commissions, push money, or similar payments you receive in your income on Schedule 1 (Form 1040), line 8z, or on Schedule C (Form 1040), if from your self-employment activity.

Example

You sell cars and help arrange car insurance for buyers. Insurance brokers pay back part of their commissions to you for referring customers to them. You must include the kickbacks in your income.

Medical savings accounts (MSAs). In most cases, you do not include in income amounts you withdraw from your Archer MSA or Medicare Advantage MSA if you use the money to pay for qualified medical expenses. Generally, qualified medical expenses are those you can deduct on Schedule A (Form 1040).

Prizes and awards. If you win a prize in a lucky number drawing, television or radio quiz program, beauty contest, or other event, you must include it in your income. For example, if you win a \$50 prize in a photography contest, you must report this income on Schedule 1 (Form 1040), line 8i. If you refuse to accept a prize, do not include its value in your income.

Prizes and awards in goods or services must be included in your income at their fair market value.

Employee awards or bonuses. Cash awards or bonuses given to you by your employer for good work or suggestions generally must be included in your income as wages. However, certain noncash employee achievement awards can be excluded from income.

Pulitzer, Nobel, and similar prizes. If you were awarded a prize in recognition of past accomplishments in religious, charitable, scientific, artistic, educational, literary, or civic fields, you generally must include the value of the prize in your income. However, you do not include this prize in your income if you meet **all** of the following requirements.

- You were selected without any action on your part to enter the contest or proceeding.

- You are not required to perform substantial future services as a condition to receiving the prize or award.
- The prize or award is transferred by the payer directly to a governmental unit or tax-exempt charitable organization as designated by you.

Qualified Opportunity Fund (QOF). Effective December 22, 2017, Code section 1400Z-2 provides a temporary deferral on inclusion in gross income for capital gains invested in QOFs, and permanent exclusion of capital gains from the sale or exchange of an investment in the QOF if the investment is held for at least 10 years. See the Instructions for Form 8949 on how to report your election to defer eligible gains invested in a QOF. See the instructions for Form 8997, Initial and Annual Statement of Qualified Opportunity Fund (QOF) Investments, for reporting information.

Qualified tuition programs. A qualified tuition program (also known as a 529 program) is a program set up to allow you to either prepay, or contribute to an account established for paying, a student's qualified higher education expenses at an eligible educational institution.

The part of a distribution representing the amount paid or contributed to a QTP is not included in income. This is a return of the investment in the program.

In most cases, the beneficiary does not include in income any earnings distributed from a QTP established and maintained by a state (or an agency or instrumentality of the state) if the total distribution is less than or equal to adjusted qualified higher education expenses.

Sale of home. You may be able to exclude from income all or part of any gain from the sale or exchange of your main home.

Sale of personal items. If you sold an item you owned for personal use, such as a car, refrigerator, furniture, stereo, jewelry, or silverware, your gain is taxable as a capital gain. Report it on Schedule D (Form 1040). You cannot deduct a loss.

However, if you sold an item you held for investment, such as gold or silver bullion, coins, or gems, any gain is taxable as a capital gain and any loss is deductible as a capital loss.

Scholarships and fellowships. A candidate for a degree can exclude amounts received as a qualified scholarship or fellowship. A qualified scholarship or fellowship is any amount you receive that is for:

- Tuition and fees to enroll at or attend an educational institution, or
- Fees, books, supplies, and equipment required for courses at the educational institution.

Amounts used for room and board do not qualify for the exclusion.

Department of Veterans Affairs (VA) payments. Allowances paid by the VA are not included in your income. These allowances are not considered scholarship or fellowship grants.

Prizes. Scholarship prizes won in a contest are not scholarships or fellowships if you do not have to use the prizes for educational purposes. You must include these amounts in your income on Schedule 1 (Form 1040), line 8i, whether or not you use the amounts for educational purposes.

Union benefits and dues. Amounts deducted from your pay for union dues, assessments, contributions, or other payments to a union cannot be excluded from your income.

Strike and lockout benefits. Benefits paid to you by a union as strike or lockout benefits, including both cash and the fair market value of other property, are usually included in your income as compensation. You can exclude these benefits from your income only when the facts clearly show that the union intended them as gifts to you.

CHAPTER 8: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. You must include unemployment compensation (subject to exclusions) that you receive in your income. Which of the following payments is not a type of unemployment compensation:

- A. benefits paid from the Federal Unemployment Trust Fund
- B. benefits paid from state unemployment insurance benefits
- C. trade readjustment allowances under the Trade Act of 1974
- D. payments from a worker's compensation fund for a work-related injury

2. Benefits paid to you by a union as strike or lockout benefits are always included in your income as compensation.

- A. true
- B. false

CHAPTER 8: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.

- A. Incorrect. Benefits paid from the Federal Unemployment Trust Fund are categorized as unemployment benefits and must be reported as taxable income, subject to exclusions.
- B. Incorrect. Benefits paid by state unemployment insurance funds are categorized as unemployment benefits and must be reported as taxable income, subject to any exclusions.
- C. Incorrect. Payments made under the 1974 Trade Act are considered unemployment compensation within this context.
- D. **CORRECT**. Disability payments paid as worker's compensation for injury or illness is not unemployment compensation.

2.

- A. Incorrect. Usually, benefits paid to you by a union as strike or lockout benefits, including both cash and the fair market value of other property, are included in your income as compensation, but there is an exclusion.
- B. **CORRECT**. You can exclude these benefits from your income when the facts clearly show that the union intended them as gifts to you.

GLOSSARY

401(k) plan. A deferred compensation plan, authorized by Section 401(k) of the Internal Revenue Code, under which a percentage of an employee's salary is withheld and placed in a savings account or the company's profit-sharing plan. Income accumulates on the deferred amount until withdrawn by the employee at age 59½ or when the employee retires or leaves the company.

Accelerated cost recovery system (ACRS). A statutory method of depreciation allowing accelerated rates for most types of property used in business and income-producing activities during the years 1981 through 1986. It has been superseded by the modified accelerated cost recovery system (MACRS) for assets placed in service after 1986.

Accelerated death benefit. Certain payments received under a life insurance contract on the life of a terminally or chronically ill individual before the individual's death.

Accelerated depreciation. A method of depreciation that allows a person to deduct the cost of property more rapidly than straight-line depreciation. Accelerated depreciation rates are included in ACRS rates and most Modified Accelerated Cost Recovery System (MACRS) rates if a person wants to use them.

Accountable plan. An employer's plan for reimbursing employees for business – related expenses, under which the employees are required to substantiate each business expense to the employer and return any reimbursement in excess of the substantiated expenses. Reimbursements received under an accountable plan are generally excluded from wages and are not subject to employment taxes.

Accrual method. A business method of accounting requiring income to be reported when earned and expenses to be deducted when incurred. However, deductions generally may not be claimed until economic performance has occurred.

Acquisition debt. Debt used to buy, build, or construct a principal residence or second home and that generally qualifies for a full interest expense deduction.

Active participation. The level of activity necessary to claim rental losses up to \$25,000 from real estate rental activities.

Adjusted basis. A statutory term describing the cost used to determine your profit or loss from a sale or exchange of property. It is generally your original cost, increased by capital improvements, and decreased by depreciation, depletion, and other capital write-offs.

Adjusted gross income (AGI). Important tax term representing gross income less allowable adjustments, such as IRA, alimony, and Keogh deductions. AGI determines whether various tax benefits are phased out, such as, itemized deductions and the rental loss allowance. Also see modified adjusted gross income (MAGI).

Administrator. Person who is usually appointed by the court if no will exists, if no executor was named in the will, or if the named executor cannot or will not serve. The administrator will have to administer the estate (property or debts left by the decedent) and distribute properties as the decedent has directed.

Alimony. Payments made to a separated or divorced spouse as required by a decree or agreement.

Alternate payee. The recipient of qualified retirement benefits under a court order, judgment, decree, or approved property settlement constituting a qualified domestic relations order.

Alternative Depreciation System (ADS). A way of depreciating assets using the straight-line depreciation method and longer recovery period than are available under MACRS. Mandatory for such items as foreign assets, luxury automobiles, and tax-exempt use property.

Alternative Minimum Tax (AMT). A tax that may apply in lieu of income tax when a taxpayer has tax preference items or certain deductions allowed in determining regular taxable income.

Amended return. Filed on Form 1040X within a three-year period to correct a mistake made on an original or previously amended return.

American Opportunity credit. The maximum credit is generally \$2,500 per student, and it is allowed for the first four years of post-secondary education. The phaseout of the credit applies if modified adjusted gross income is between \$80,000 and \$90,000, or between \$160,000 and \$180,000 on a joint return.

Amortization. A deductible expense allowed as a means of recovering the investment in an intangible asset. Compare with depreciation.

Amount realized. The fair market value of property, including money (at face value), received in a sale or an exchange.

Amount recognized. The amount of gain reportable and subject to tax. On certain tax-free exchanges of property, gain is not recognized in the year it is realized.

Annual gift tax exclusion. An exclusion that applies to gifts of present interests on a per donee basis.

Annualized rate. A rate for a period of less than a year computed as though for a full year.

Annuity. A sum of money paid periodically that includes the return of the invested capital plus income generated by it. An annuity is frequently purchased by an individual for investment purposes and is used by retirement plans to pay pensions.

Applicable federal rate. Interest rate fixed by the Treasury for determining imputed interest on transactions providing for below-market interest.

Archer Medical Savings Account (MSA). A type of medical plan combining high deductible medical insurance protection with an IRA-type savings account fund to pay unreimbursed medical expenses.

Assessment. The IRS action of fixing tax liability that sets in motion collection procedures, such as charging interest, imposing penalties, and, if necessary, seizing property.

At-risk limitations. Generally, partnership losses are deductible up to the amount you have a risk in the activity. The amount at risk is your basis in the activity and any amounts borrowed for use in the activity for which you are personally liable.

At-risk rules. Rules limiting loss deductions to cash investments and personal liability notes. An exception for real estate treats certain nonrecourse commercial loans as amounts “at risk.”

Audit. An IRS examination of your tax return, generally limited to a three-year period after you file.

Average cost method. A method of figuring the basis of shares in mutual funds for purposes of determining gain or loss on the sale of less than one’s entire holdings in a fund.

Bad debt. An amount owed you representing a cash outlay or an item already included in income that you are unable to collect.

Basis. Generally, the amount paid for property or the cost of an asset. Needed to figure gain or loss on a sale.

Below market loans. Demand loans on which interest is payable at a rate below the applicable federal rate or term loans where the amount loaned exceeds the present value of all payments due under the loan (using a discount rate equal to the applicable federal rate).

Cafeteria plan. A plan that allows employees to choose between cash and certain qualified benefits.

Calendar year. A year that begins on January 1st and ends on December 31st . Most individual taxpayers are required to file their returns on the basis of such a year. Compare to fiscal year.

Cancellation of debt. Release of a debt without consideration by a creditor. Cancellations of debts are generally taxable.

Capital asset. In general, property held for personal purposes or investment, rather than for business purposes. Property subject to capital gain or loss treatment. Almost all assets you own are considered capital assets except for certain business assets or works you created.

Capital expenses. Costs that are not currently deductible and that are added to the basis of property. A capital expense generally increases the value of property. When added to depreciable property, the cost is deductible over the life of the asset.

Capital gain dividend (capital gain distribution). A distribution to shareholders in a mutual fund of a capital gain realized by the fund on the sale of a part of its investment portfolio.

Capital gain or loss. A gain or loss arising from the sale or exchange of capital assets. Computed by comparing the amount realized on the sale or exchange of an asset with the adjusted basis of the asset.

Capital loss carryover. The excess of capital losses over capital gains that cannot be deducted in a particular year and must be carried over to the succeeding year.

Capitalization. Adding a cost or expense to the basis of the property.

Carryback. A tax technique for receiving a refund of back taxes by applying a deduction or credit from a current tax year to a prior tax year.

Carryforward. A tax technique of applying a loss or credit from a current year to a later year. For example, a business net operating loss may be carried forward indefinitely.

Cash method. Reporting income when actually or constructively received and deducting expenses when paid. Certain businesses may not use the cash method.

Casualty loss. Loss from an unforeseen and sudden event that is deductible, subject to a 10% income floor and \$100 reduction for losses attributable to a federally declared disaster.

Charitable contributions. An itemized deduction is allowed for donations to qualifying charities. For property donations, the deductible amount depends on the type of property and donee organization, the holding period, and in some cases how the property is used.

Child and dependent care credit. A credit of up to 35% based on certain care expenses incurred that allow the taxpayer to work.

Child support. Payments to support a minor child generally to a custodial parent under a divorce or separation decree or agreement. The payments cannot be deducted from gross income and are not taxable to the recipient parent. Starting in 1985, the parent with custody of the child is generally entitled to claim the dependent unless such a right is expressly waived.

Child tax credit. For tax years beginning after 1997, a tax credit is allowed against income with respect to each qualifying child for taxpayers with modified adjusted gross income below certain thresholds.

Community income. Income earned by persons domiciled in community property states and treated as belonging equally to husband and wife.

Community property. Property that belongs equally to husband and wife. This concept of property ownership is currently used in Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

Condemnation. The seizure of property by a public authority for a public purpose. Tax on gain realized on many conversions may be deferred.

Constructive receipt. Income you are taxed on because it was made available to you to draw on, even if it has not yet been physically transferred to you.

Coverdell Education Savings Account. A special account set up to fund education expenses of a student.

Credit. A tax credit directly reduces tax liability, as opposed to a deduction that reduces income subject to tax.

Declining balance depreciation. A method of accelerated depreciation by which each year's depreciation is a percentage of the reduced basis of the asset.

Deductions. Items directly reducing income. Personal deductions such as for mortgage interest, state and local taxes, and charitable contributions are allowed only if deductions are itemized on Schedule A, but deductions such as for certain alimony, capital losses, business losses, student loan interest, and IRA and Keogh deductions are deducted from gross income even if itemized deductions are not claimed.

Deferred compensation. A portion of earnings withheld by an employer or put into a retirement plan for distribution to the employee at a later date. If certain legal requirements are met, the deferred amount is not taxable until actually paid, for example, after retirement.

Deferred gain. A gain realized but not recognized as taxable income until a later time.

Deficiency. The excess of the tax assessed by the IRS over the amount reported on your return.

Defined benefit plan. A retirement plan that pays fixed benefits based on actuarial projections.

Defined contribution plan. A retirement plan that pays benefits based on contributions to individual accounts, plus accumulated earnings. Contributions are generally based on a percentage of salary or earned income.

Dependent. A person supported by another person.

Depletion. A deductible expense that reflects the decrease of a depletable natural resource, such as oil and gas, as it is extracted.

Depreciable property. A business or income-production asset with a useful life exceeding one year.

Depreciation. Writing off the cost of depreciable property over a period of years, usually its class life or recovery period specified in the tax law.

Depreciation recapture. An amount of gain on the sale of certain depreciable property that is treated as ordinary income in the case of personal property. Recapture is computed on Form 4797.

Designated beneficiary. A person, trust, tax-exempt organization or estate named to receive qualified plan benefits or IRAs after a taxpayer's death. In some cases, the designated beneficiary enables a taxpayer to figure required minimum distributions over joint lives (or joint life expectancy).

Direct rollover. An eligible rollover distribution that is paid directly to an eligible retirement plan for the benefit of the distributee.

Disaster losses. Casualty losses, such as from a storm, in areas declared by the President to warrant federal assistance. An election may be made to deduct the loss in the year before the loss or the year of the loss.

Dividend. A distribution made by a corporation to its shareholders generally of company earnings or surplus. Most dividends are taxable but exceptions do exist.

Domicile. The place that an individual intends to be his or her permanent residence.

Dual-status alien. An individual who is a nonresident alien for part of the year and a resident alien or U.S. citizen for the rest of the year.

Earned income. Compensation for performing personal services. You must have earned income for a deductible IRA, or to claim the earned income credit. Earned income does not include amounts received from an annuity or a pension.

Earned income credit. A credit allowed to taxpayers with earned income or adjusted gross income (AGI) below certain thresholds.

Education credits. There are two education credits: the American opportunity credit and the lifetime learning credit.

Education savings account. A trust or custodial account created for the purpose of paying the qualified higher education expenses of the designated beneficiary of the account.

Electronic Federal Tax Payment System (EFTPS). A tax deposit method using electronic transfers of funds from bank accounts that must be used by certain businesses with substantial employment tax liability.

Eligible retirement plan. A qualified retirement plan, an individual retirement account, or an individual retirement annuity.

Estate tax. A tax imposed on the value of a decedent's taxable estate, after deductions and credits.

Estimated tax. Advance payment of current tax liability based either on wage withholdings or installment payments of your estimated tax liability. To avoid penalties, you generally must pay to the IRS either 90% of your final tax liability, or either 100% or 110% of the prior year's tax liability, depending on your adjusted gross income.

Exclusion. An amount that is excluded from gross income.

Executor. Person named in the decedent's will to administer the estate (property or debts left by the decedent) and distribute properties as the decedent has directed.

Fair market value (FMV). What a willing buyer would pay to a willing seller when neither is under any compulsion to buy or sell.

Fiduciary. A personal or corporation such as a trustee, executor, or guardian who manages property for another person.

Flexible spending arrangements (FSAs). A salary reduction plan that allows employees to pay for enhanced medical coverage or dependent care expenses on a tax-free basis.

Foreign earned income exclusion. Foreign earned income exempt from tax if a foreign residence or physical presence test is met.

Foreign tax credit. A credit allowed for income taxes paid to a foreign tax jurisdiction (e.g., a foreign country) to mitigate double taxation.

Gift tax. Gifts in excess of a \$17,000 per donee annual exclusion are subject to gift tax, but the tax may be offset by a unified gift and estate tax credit.

Gross income. The total amount of income received from all sources before exclusions and deductions.

Gross receipts. Total business receipts reported on Schedule C before deducting adjustments for returns and allowances and costs of goods sold.

Group-term life insurance. Employees are not taxed on up to \$50,000 of group-term coverage.

Head of household. A taxpayer who is unmarried and pays more than 50% of the cost of maintaining a residence for the entire year for a qualifying individual. If you are a head of household, you qualify for special tax rates.

Holding period. The length of time an asset is held. The holding period of a capital asset determines whether a sale or an exchange results in a long-term or a short-term capital gain or loss.

Home equity debt. Debt secured by a principal residence or second home to the extent of the excess of fair market value over acquisition debt.

Home sale exclusion. The tax-free amount of gain on the sale of a principal residence where certain ownership and use tests are satisfied.

Imputed interest. Interest deemed to have been earned or charged on a debt if the stated interest rate is below the rate set by law.

Incentive stock option. A type of stock option that can be received and exercised without recognition of income until the option stock is sold, if certain statutory requirements are met.

Income in respect of a decedent. Income earned by a person before death but taxable to an estate or heir who receives it.

Income shifting. A strategy to direct income to a taxpayer in a lower tax bracket to produce an overall tax savings for both parties involved in the shift.

Independent contractor. One who controls his or her own work and reports as a self-employed person.

Individual retirement account (IRA). A retirement account to which a specific amount may be contributed annually, but deductions for the contribution are restricted if you are covered by a company retirement plan. Earnings accumulate tax free.

Innocent spouse relief. Reduction or forgiveness of joint and several liability for the tax on a joint return for the requesting spouse who meets certain requirements.

Installment sale. A sale of property that allows for tax deferral if at least one payment is received after the end of the tax year in which the sale occurs. The installment method does not apply to year-end sales of publicly traded securities. Dealers may not use the installment method. Investors with very large installment balances could face a special tax.

Intangible assets. Intangible assets that come within Section 197, such as goodwill, are amortizable over a 15-year period.

Internal Revenue Service. The division of the U.S. Treasury Department that is responsible for the enforcement of the tax laws.

Investment interest. Interest on debt used to carry investments, but not including interest expenses from a passive activity. Deductions are limited to net investment income.

Involuntary conversion. Forced disposition of property due to condemnation, theft, or casualty. Upon conversion, you usually receive cash through insurance proceeds or condemnation awards. Tax on gain from involuntary conversion may be deferred if replacement property is purchased.

Itemized deductions. Items, such as interest, state and local taxes, charitable contributions, and medical deductions, claimed on Schedule A for Form 1040. Itemized deductions are subtracted from adjusted gross income to arrive at taxable income.

Joint return. A return filed by a married couple reporting their combined income and deductions. Joint return status provides tax savings to many couples.

Joint tenants. Ownership of property by two persons. When one dies, the decedent's interest passes to the survivor.

Keogh plan. Retirement plan set up by a self-employed person that provides tax-deductible contributions, tax-free income accumulations until withdrawal, and favorable averaging for qualifying lump-sum distributions.

Kiddie tax. The tax on the investment income in excess of \$2,500 (2023) of a dependent child, based on the parent's marginal tax rate and computed on Form 8615.

Legally separated. A husband and wife who are required to live apart from each other by the terms of a decree of separate maintenance. Payments under the decree are deductible by the payor and taxable to the payee as alimony.

Lifetime learning credit. 20% credit for up to \$10,000 of qualified tuition and related expenses for undergraduate or graduate level courses.

Like-kind exchange. An exchange of similar assets used in a business or held for investment on which gain may be deferred.

Long-term capital gain or loss. Gain or loss on the sale or exchange of a capital asset that has been held for a legislatively mandated holding period.

Long-term care. A type of medical care for chronically ill individuals which generally is not covered by Medicare.

Long-term care insurance contract. Insurance contract that only provides coverage for qualified longterm care services.

Lump-sum distribution. Payments within one tax year of the entire amount due to a participant in a qualified retirement plan. Qualifying lump-sums may be directly rolled over tax free, or, in some cases, are eligible for current tax under a favorable averaging method.

Marginal tax rate. The tax rate at which each additional dollar of income over a specified ceiling is taxed.

Marital deduction. An estate tax and gift tax deduction for assets passing to a spouse. It allows estate and gift transfers completely free of tax.

Market discount. The difference between face value of bond and lower market price, attributable to rising interest rates. On a sale, gain on the bond is generally taxed as ordinary income to the extent of the discount.

Material participation. The level of participation required to deduct losses from trade or business activities otherwise subject to the passive activity loss limitations.

Miscellaneous itemized deductions. A class of itemized deductions (e.g., investment expenses, fee for tax advice, union dues) that previously were deductible to the extent that the total exceeded 2% of adjusted gross income.

Modified ACRS (MACRS). Depreciation methods applied to assets placed in service after 1986.

Modified adjusted gross income (MAGI). This is generally adjusted gross income increased by certain items such as tax-free foreign earned income. MAGI usually is used to determine phaseouts of certain deductions and credits.

Mortgage interest. Fully deductible interest on up to two residences if acquisition debt secured by a home up to certain limits of indebtedness.

Mutual fund. A company that is in the business of investing its shareholder's funds, usually in stocks or bonds; sometimes known as a regulated investment company.

Net operating loss. A loss taken in a period where a company's allowable tax deductions are greater than its taxable income. When more expenses than revenues are incurred during the period, the net operating loss for the company can generally be used to recover past tax payments.

Nonperiodic distributions. A 20% withholding rule applies to nonperiodic distributions, such as lumpsum distributions, paid directly to employees from an employer plan.

Nonqualified stock option. A type of stock option that when exercised creates ordinary income for the taxpayer.

Nonrecourse financing. Debt on which a person is not personally liable. In case of non-payment, the creditor must foreclose on property securing the debt. At-risk rules generally bar losses where there is nonrecourse financing, but an exception applies to certain nonrecourse financing for real estate.

Nonresident alien. A person who is not a United States citizen or a permanent resident. Tax is generally limited to income from U.S.

Nontaxable exchange. An exchange of property in which no gain or loss is recognized for tax purposes.

Offers in compromise. Arrangements in which the IRS agrees to accept less than full payment of taxes because it realizes that full payment may never be made.

Ordinary gain or loss. A gain or loss other than a capital gain or loss.

Ordinary income. Income that does not arise from the sale or exchange of a capital asset or a Section 1231 asset and is not subject to any preferential tax treatment.

Ordinary loss. A loss other than a capital loss.

Original issue discount (OID). The difference between the face value of a bond and its original issue price. OID is reported on an annual basis as interest income.

Owner-employee. An employee who is the proprietor of a business. Also, a partner who owns more than 10% of either the capital or the profit interest in a partnership.

Partnership. An unincorporated business or income-producing entity organized by two or more persons. A partnership is not subject to tax but passes through to the partners all income, deductions, and credits, according to the terms of the partnership agreement.

Passive activity loss. A loss from a trade or a business in which the taxpayer is not a material participant. Passive activity losses are subject to deduction limitations. Passive activities include rental activities and investments in limited partnerships.

Pension. Payments to employees from an employer-funded retirement plan for past services. Percentage depletion. A method of calculating depletion that applies a fixed percentage to the gross income generated by the mineral property.

Personal interest. Tax term for interest on personal loans and consumer purchases. Such interest is not deductible.

Personal-use property. Property that is not held for investment or use in a trade or a business.

Placed in service. The time when a depreciable asset is ready to be used. The date fixes the beginning of the depreciation period.

Points. Certain charges paid by a borrower, calculated as a percentage of the loan proceeds; each point is 1%. They are also called loan origination fees, maximum loan charges, or premium charges. Depending on the type of loan, points may be currently deductible or amortized over the life of the loan.

Premature distributions. Withdrawals before age 59½ from qualified retirement plans are subject to penalties unless specific exceptions are met.

Profit-sharing plan. A defined contribution plan under which the amount contributed to the employee's accounts is based on a percentage of the employer's profits.

Proprietor. An individual who is the sole owner of his or her trade or business.

Qualified business income deduction. For taxable years beginning after December 31, 2017, taxpayers other than corporations may be entitled to a deduction of up to 20 percent of their qualified business income from a qualified trade or business under the Tax Cuts and Jobs Act. This deduction can be taken in

addition to the standard or itemized deductions. The deduction is subject to multiple limitations based on the type of trade or business, the taxpayer's taxable income, the amount of W-2 wages paid with respect to the qualified trade or business, and the unadjusted basis of qualified property held by the trade or business. Notwithstanding these limitations, however, taxpayers with qualified business income (which does not include income from performing services as an employee) and with taxable income under \$182,100 (2023) or \$364,200 (2023) for joint returns, will generally be eligible for the deduction.

Qualified charitable organization. A nonprofit philanthropic organization specifically approved by the U.S. Treasury as a recipient of charitable contributions that are deductible for tax purposes.

Qualified domestic relations order (QDRO). A court order, judgment, decree or approved property agreement which specifies the amount of qualified plan benefits to be paid to an alternate payee and which are not taxable to the plan participant.

Qualified improvement property. As of the TCJA, a combination of previously identified qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property.

Qualified plan. An employee benefit plan established by an employer that meets certain requirements and therefore qualifies for certain tax benefits.

Qualified tuition programs. State-sponsored plans to allow for higher education savings on a taxadvantaged basis. While there is no federal tax deduction for contributions to these programs, states may provide a deduction from state income tax.

Qualifying widow or widower. A filing status entitling the taxpayer with dependents to use joint tax rates for up to two tax years after the death of a spouse.

Real estate professionals. Taxpayers who are exempt from the passive activity loss limitations because of their level of involvement with real estate activities.

Real property (real estate). Physical property that is permanent and nonmovable in nature. Two examples are land and buildings.

Realized gain or loss. The difference between the amount you are entitled to receive on a sale or exchange of property and the adjusted basis of the property.

Recognized gain or loss. The amount of gain or loss to be reported on a tax return. Gain may not be recognized on certain exchanges of property.

Refundable tax credit. A credit that entitles you to a refund even if you owe no tax for the year.

Regulated investment company. An investment company subject to Security and Exchange

Commission regulations. If the investment company distributes its income to its shareholders, it does not pay any taxes.

Remainder interest. An interest in property or a trust that is left after the income beneficiaries have received their income interest.

Required minimum distributions. Distributions from qualified plans and IRAs that generally must commence at age 73 to avoid a 25% penalty (as of 2023).

Resident alien. An individual who is not a citizen of the United States but is a permanent resident of the United States.

Residential rental property. Real property in which 80% or more of the gross income is from dwelling units. Under MACRS, depreciation is claimed over 27.5 years under the straight-line methods.

Return of capital. A distribution of your investment that is not subject to tax unless the distribution exceeds your investment.

Rollover. A distribution from a qualified plan that is reinvested tax-free in another qualified plan or IRA within 60 days of the date of receipt.

Roth IRA. Contributions to a Roth IRA are nondeductible, and, if certain specified conditions are met, distributions are tax free. The contribution may be limited by certain threshold amounts.

Royalty income. Income received for the use of certain kinds of property (e.g., mineral and literary properties, patents).

Salvage value. The estimated value of an asset at the end of its useful life. Salvage value is ignored by ACRS and MACRS rules.

Scholarships. Grants to degree candidates receive tax-free treatment if awarded after August 16, 1986 and used for tuition and course-related expenses, but not room and board.

Section 1231 assets. Generally, depreciable assets used in a trade or a business and held for the required long-term holding period. Net gains from the sale or exchange of Section 1231 assets (after recapture of depreciation), are treated as capital gains; net losses are treated as ordinary losses.

Section 179 expensing. Allows a taxpayer to elect to deduct the cost of certain types of property on their income taxes as an expense, rather than requiring the cost of the property to be capitalized and depreciated.

Section 457 plan. Deferred compensation plan set up by a state or local government, or tax-exempt organization, which allows tax-free deferrals of salary.

Section 529 plans. Qualified tuition plans set up by states or private institutions as either prepaid tuition plans or savings-type plans. While contributions are not deductible for federal income tax purposes, distributions used to pay qualified higher education costs are tax free.

Self-employed person. An individual who operates a business or profession as a proprietor or independent contractor and reports self-employment income on Schedule C.

Self-employment tax. Tax paid by self-employed persons to finance Social Security coverage.

Separate maintenance payments. Payments made from one spouse to another when they are living apart. The payments are made in accordance with a court order or an agreement between the parties.

Separate return. Return filed by a married person who does not file a joint return. Filing separately may save taxes where each spouse has separate deductions, but certain tax benefits require a joint return.

Short-term capital gain or loss. A gain or loss on the sale or exchange of a capital asset that has been held for less than the legislatively mandated holding period.

SIMPLE plans. Qualified retirement plans restricted to small employers that can be either SIMPLE IRAs or SIMPLE 401(k) plans. These plans have easy nondiscrimination rules and no heavy reporting requirements.

Simplified Employee Pension (SEP). IRA-type plan set up by an employer, rather than the employee. Single. The filing status of an individual who is not married on December 31 of the year for which a return is filed.

Standard deduction. A deduction used to reduce income by taxpayers who do not itemize their deductions. The amount of the deduction depends on ones filing status, whether they are 65 or older or blind, and whether they can be claimed as a dependent on another taxpayer's return. Adjusted annually for inflation since 1989.

Standard mileage rate. An IRS-approved optional amount used to claim a deduction for business transportation expenses in lieu of deducting actual expenses (not including parking, tolls, interest, and taxes).

Statute of limitations. The time period within which the IRS can assess and collect taxes and taxpayers can file for refunds.

Statutory employees. Certain employees, such as full-time life insurance salesperson, who may report income and deductions on Schedule C.

Stock dividend. A distribution of additional shares of a corporation's stock to its shareholders. Stock option. A right to buy stock at a fixed price.

Straight-line depreciation. A method of depreciation in which the cost or other basis of the asset is deducted in equal amounts over the property's useful life.

Sum of the years' digits depreciation. A method of accelerated depreciation that is based on a formula developed from the expected useful life of the property.

Support. Payments made for the care and maintenance of a dependent. Expenditures for support include payments for food, lodging, medical expenses and so on.

Tax attributes. When debts are canceled in bankruptcy cases, the canceled amount is excluded from gross income. Tax attributes are certain losses, credits, and property basis that must be reduced to the extent of the exclusion.

Tax credit carryforward (or carryover). Tax credit that you were unable to use to reduce previous year's tax and that can be applied to offset future tax.

Tax deferral. Shifting income to a later year, such as where you defer taxable interest to the following year by purchasing a T-bill or savings certificate maturing after the end of the current year. Investments in qualified retirement plans provide tax deferral.

Tax preference items. Items that may subject a taxpayer to the alternative minimum tax (AMT). Two examples are accelerated depreciation of real property and percentage depletion.

Tax year. A period (generally 12 months) for reporting income and expenses.

Taxable income. Net income after claiming all deductions from gross income and adjusted gross income, such as IRA deductions, itemized deductions, or the standard deduction.

Taxpayer identification number. For an individual, his or her social security number; for businesses, fiduciaries, and other non-individual taxpayers, the employer identification number.

Tax-exempt income. Income that is not subject to federal income tax. An example is income for state and municipal bonds.

Tax-sheltered annuity. A type of retirement annuity offered to employees of charitable organizations and educational systems, generally funded by employee salary-reduction contributions.

Trade date. The date on which a purchase or sale of securities occurs. The trade date is used in determining the holding period of a security.

Trust. An arrangement under which one person transfers legal ownership of assets to another person or corporation (the trustee) for the benefit of one or more third persons (beneficiaries).

Undistributed capital gains. Capital gains that investors in mutual funds must report but for which they can claim a tax credit for their share of tax paid by the fund.

Useful life. For property not depreciated under ACRS and MACRS, the estimate of time in which a depreciable asset will be used.

Wash sales. Sales on which losses are disallowed because you recover your market position within a 61-day period.

Withholding. An amount taken from income as pre-payment of an individual's tax liability for the year. In the case of wages, the employer withholds part of every wage payment. Backup withholding from dividend or interest income is required if you do not provide the payer with a correct taxpayer identification number. Withholding on pensions and IRAs is automatic unless you elect to waive withholding.

FINAL EXAM

Income

The following exam is attached only for your convenience. To access the official exam for this self-study course, please log into your account online and take the Final Exam from the course details page. A passing score of 70 percent or better will receive course credit and a Certificate of Completion.

1. Which of the following is not a de minimis employee benefit that an employer would typically ignore when reporting employee fringe benefit compensation:

- A. the pro-rata cost of a company picnic
- B. a Christmas turkey given to each employee
- C. food discounts at a company cafeteria
- D. a \$250 holiday gift certificate

2. Which of the following transportation fringe benefits can be excluded from income for 2023:

- A. transit passes of unlimited amounts
- B. qualified parking up to \$300 per month
- C. qualified bicycle commuting cash reimbursement up to \$150 per month
- D. all commuter highway vehicle expense reimbursements

3. Which of the following is fully exempt from tax:

- A. retirement plan benefits you receive based on your age, length of service, or prior contributions to the plan
- B. payments received as continuation of pay for up to 45 days under the Federal Employees' Compensation Act (FECA) while a claim is being decided
- C. payments received as sick pay under the Railroad Unemployment Insurance Act
- D. amounts received as workers' compensation for an occupational sickness paid under a workers' compensation act

4. Which of the following is correct regarding tip income:

- A. tip income is not subject to federal income tax
- B. only cash tips received are considered income
- C. most noncash tips received are not considered income
- D. tips received under a tip-splitting arrangement are considered income

5. Generally, the amounts you receive from money market funds should be reported as which of the following:

- A. operating income
- B. capital gains
- C. interest
- D. dividends

6. Which of the following is correct regarding interest on U.S. savings bonds:

- A. interest on U.S. savings bonds is not taxable

- B. interest on U.S. savings bonds is taxable when received, regardless of the accounting method used by the taxpayer
- C. interest on U.S. savings bonds is taxable each year as it accrues, regardless of the accounting method used by the taxpayer
- D. interest on U.S. savings bonds is taxable each year as it accrues for an accrual method taxpayer but not for a cash method taxpayer

7. Unless a corporation informs you otherwise, you can assume that any dividend you receive on common or preferred stock is which of the following:

- A. an ordinary dividend
- B. a liquidating distribution
- C. a capital gains dividend
- D. a qualified dividend

8. What tax rate are qualified dividends subject to for a single filer with \$100,000 of income:

- A. 0%
- B. 15%
- C. 20%
- D. 28%

9. How should advance rent be recorded:

- A. in the period it covers if you use the accrual method
- B. in the period it covers if you use the cash method
- C. in the year it was received regardless of the period covered only if you use the cash method
- D. in the year it was received regardless of the period covered or the method used

10. Expenses you can deduct from your rental income include all of the following except:

- A. taxes
- B. charges for putting in streets
- C. utilities
- D. commissions for the collection of rent

11. When figuring the number of days of personal use for rental property, the owner must count each day that any of the following occur except:

- A. when a family member uses the property
- B. when the use of this unit is traded for the use of another property elsewhere
- C. when working substantially full time repairing and maintaining the property
- D. when the property is rented at less than the fair market price

12. Which of the following is correct regarding limits on rental losses:

- A. all losses on rental real estate activity are deductible
- B. rental activities (except for those by real estate professionals) are passive activities
- C. a taxpayer can generally offset any income with losses from passive activities
- D. passive activity losses and credits cannot be carried forward to the next tax year

13. What is the maximum amount a 52-year-old employee can contribute to a 401k in 2023:

- A. \$6,500
- B. \$7,500

- C. \$22,500
- D. \$30,000

14. Which of the following is a taxpayer's annuity starting date:

- A. the first day of the first period for which the taxpayer received a payment
- B. the date the plan's obligations became fixed
- C. the later of A and B above
- D. the earlier of A and B above

15. For a rollover distribution of a qualified retirement plan to be considered eligible, it generally must be completed by the _____ day following the day on which you receive the distribution from your employer's plan.

- A. 30th
- B. 60th
- C. 90th
- D. 120th

16. For 2023, if actual distributions from a qualified retirement plan received in any year are less than the minimum required distribution for that year, a tax is assessed on the part of the required minimum distribution not distributed equal to what percentage if it is not timely corrected:

- A. 6%
- B. 10%
- C. 25%
- D. 50%

17. If you are married filing jointly, what is your social security benefits base amount:

- A. \$0
- B. \$25,000
- C. \$32,000
- D. \$42,000

18. What is the maximum percentage of your social security benefits that may be taxable:

- A. 25%
- B. 50%
- C. 85%
- D. 100%

19. Which of the following is correct regarding the cancellation of qualified principal residence indebtedness for 2023:

- A. the entire amount of indebtedness canceled must be included in gross income
- B. 50% of the amount of indebtedness canceled must be included in gross income
- C. 10% of the amount of indebtedness canceled must be included in gross income
- D. the entire amount canceled can be excluded from gross income

20. Which of the following refunds or recoveries do not have to be included in your taxable income:

- A. federal income tax refund
- B. state income tax refund if deducted in an earlier year
- C. interest income on recoveries

D. all of the above

21. Which of the following is considered income that must be included on your federal income tax return in 2023:

- A. alimony resulting from an agreement executed prior to 2019
- B. cash rebates
- C. energy conservation subsidies
- D. property received as a gift

22. Which of the following payments received as a member of a military service is generally taxed as a pension:

- A. Standard pay
- B. Bonus
- C. Retirement pay
- D. All income is taxed as a pension

23. Rental property expenses that are typically deductible include which of the following:

- A. local benefit taxes
- B. cost of improvements
- C. uncollected rent if you are a cash basis taxpayer
- D. cost of repairs

24. Each of the following is one of the three factors that determine how much depreciation you can deduct for income producing property except:

- A. your cost basis in the property
- B. the recovery period for the property
- C. the depreciation method used
- D. the age of the property

25. You must include unemployment compensation (subject to exclusions) that you receive in your income. Which of the following payments is not a type of unemployment compensation:

- A. benefits paid from the Federal Unemployment Trust Fund
- B. benefits paid from state unemployment insurance benefits
- C. trade readjustment allowances under the Trade Act of 1974
- D. payments from a worker's compensation fund for a work-related injury