Dalton Education
BY CERIFI

The Dalton Review®
Income Tax Planning

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Categorizing Assets for Income Tax
Types of Assets

- Three Types of Assets
  - Capital Assets - most personal use assets and most investment assets.
  - Section 1231 Assets – Section 1245 and Section 1250 Depreciable Business Property used in a trade or business.
  - Ordinary Income Assets – Assets that are not capital assets and not Section 1231 assets

- What is not a capital asset, including:
  - Copyrights and creative works (if held by the creator of such works), and
  - Accounts and notes receivable, and
  - Depreciable property used in a trade or business, and
  - Inventory.

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Determining the Basis
Cost Basis

- Original Cost Basis Includes the sum of the following:
  - Purchase Price
  - FMV of any property given in taxable exchange
  - Sales tax
  - Freight
  - Installation
  - Testing

- When property is acquired subject to a mortgage, the cost basis of the property is calculated as above.

Practice Question 1

Ruby buys a new machine costing $61,000. She pays freight of $5,000 to get the new machine to her factory. She has also paid an additional 6% of the purchase price for sales tax. She hired a local company to install the equipment and paid them $8,000. What is Ruby's basis in her new machine?

A. $61,000
B. $64,660
C. $69,660
D. $77,660

Determining the Basis
Adjustments to Basis

- Increases to Cost Basis
  - Capital Improvements
    - Extend the Life of Asset
      - Not Repairs/Maintenance
- Decreases to Cost Basis
  - Section 179 (covered later)
  - Depreciation

Determining the Basis
Special Basis Rules

- Inherited Property
  - The basis of inherited property is the FMV at date of death or the alternate valuation date, if properly elected by executor.
  - Holding period is always long-term.
- Property Received as a Gift
  - General Rule – The carryover basis - The donee's basis in the gifted property is the same as the donor's basis in the gifted property.
  - Two Exceptions

Determining the Basis
Inherited and Gifted Property

- Exception #1 - Loss Property - At the date of the gift, if the FMV < Donor's basis.
  - Use the Double Basis Rule.
  - If Sales Price > Donor's basis then Donee's basis = Donor's Basis
  - If Sales Price < FMV then Donee's basis = FMV at date of gift
  - If Donor's Basis > Sales Price > FMV then Donee's basis = Sales Price

Determining the Basis
Inherited and Gifted Property, Cont.

- Exception #2 – Appreciated Property with Gift tax paid

$$\text{Donor's Basis} + \frac{\text{Net Appreciation in the Gift}}{\text{Taxable Gift}} \times \text{Gift Tax Paid}$$

- Holding Period for Gifted Property
  - General Rule, Exception #2 and Exception #1 at gain
    - Carryover Holding Period
      - Donee's Holding Period included Donor's Holding Period
  - Exception #1 at loss
    - Donee's holding period starts at date of gift

Determining the Basis Gifted Property Example

Sam received a gift from Andrea on June 15 this year. The FMV of the gift on June 15 is $8,000. Consider the following situations:

- If Andrea's basis in the asset was $10,000 and Sam sells the asset for $11,000, he will have a $1,000 gain ($11,000-$10,000).
- If Andrea's basis in the asset was $10,000 and Sam sells the asset for $7,000, he will have a $1,000 loss ($7,000-$8,000).
- If Andrea's basis in the asset was $10,000 and Sam sells the asset for $9,000, there is no gain or loss.
- If Andrea's basis in the asset was $6,000 and she paid gift tax of $500 on the transfer, Sam's basis in the asset would be $6,125.

Practice Question 2

In addition to his annual gift of $15,000, Joe gave an ice cream store to James. At the time of the gift, the FMV of the store was $250,000 and he had held it for two years. Joe's basis in the store was $100,000 and Joe paid gift tax of $100,000. James had a melt down after six months and sold the ice cream store for $260,000. What is James' gain or loss?

A. $60,000 LTCG
B. $100,000 STCG
C. $100,000 LTCG
D. $160,000 LTCG

Determining the Basis
Divorcing Spouses and Related Parties

- Basis of Property Transferred Between Spouse Incident to Divorce
  - Carryover basis, carryover holding period.
- Related Party Transactions (Section 267)
  - Only affects transactions where there is a loss.
  - Seller's loss is disallowed (never deductible), and
  - Buyer has double basis (FMV for losses, seller's basis for gains).
    - New holding period for buyer in all cases

Determining the Basis
Related Parties

- Related Parties Include:
  - Siblings (include half but not step)
  - Lineal descendants (children & grandchildren)
  - Ancestors (parents & grandparents)
  - Spouse
- Related Parties do not include:
  - Inlaws
  - Aunts/Uncles
  - Cousins

Determining the Basis Related Parties Example

Jack owns 1,200 shares of Bulldog stock. He bought the stock in 2000 for $120,000 ($100.00 per share). The current FMV of the stock is $40,000. Jack sells the Bulldog stock to his brother Pete for $40,000. Pete sells the Bulldog stock to Eddie (a friend) for $55,000 six months later. What are the tax consequences for Jack and Pete?

There is no gain or loss to Jack and there is no gain or loss to Pete. This is really 267 in action. A transferor in a 267 transaction cannot take a loss. Therefore, when Jack sells the stock to Pete (a related party), he cannot take the $80,000 loss. If the FMV is below the transferor's basis, the transferee's basis is FMV for losses and the transferor's basis for gains. Pete had no gain or loss because he had a dual basis and sold the stock at a price between the gain and loss basis.

Practice Question 3

Mike sells his daughter Cassie a stock that has a FMV of $100 for the price of $100. Mike's basis in the stock is $40. If Cassie later sells the stock for $80, what is Cassie's gain or loss?

A. $20 loss
B. No gain or loss
C. $40 gain
D. $80 gain

Practice Question 4

Mike sells his daughter Cassie a stock for the price of $200. Mike's basis in the stock is $300. If Cassie later sells the stock for $160, what is Mike's gain or loss and what is Cassie's gain or loss?

	Mike	Cassie
A)	None	$140 loss
B)	$100 loss	None
C)	None	$40 loss
D)	$100 loss	$40 loss

Tax Rates
LTCG & Qualified Dividends

- 20% / 15% / 0%
  - Long-Term Capital gains and Qualified Dividends

2024 Long-Term Capital Gains Rates (Taxable Income Limits)				
	Single	Married Filing Jointly	Head of Household	Married Filing Separately
0%	Up to $47,025	Up to $94,050	Up to $63,000	Up to $47,025
15%	$47,026 - $518,900	$94,051 - $583,750	$63,001 - $551,350	$47,026 - $291,850
20%	Over $518,900	Over $583,750	Over $551,350	Over $291,850
25%	IRC Section 1250 depreciation recapture			
28%	Collectibles			

Tax Rates
OI Rates

- Ordinary Income Rate (37% Highest)
  - Ordinary Income
  - Section 1245 recapture
  - Short-Term Capital gains

Capital Gains & Losses
Holding Period

- Holding Period
  - Long-Term
    - Held for more than one year
      - “One year, plus one day”

Capital Gains & Losses
Personal Use & Wash Sales

- Personal Use Property – Losses disallowed
  - Losses generated on the sale or exchange of property that is used for personal purposes is disallowed for income tax purposes.
- Wash sale losses are postponed.
  - Wash sales occur when a taxpayer disposes of securities at a loss and acquires substantially identical securities within 30 days before or after the date of the loss sale.
  - The loss at the date of sale is disallowed at that time, but is added to the cost of the new security to determine the new basis of the substantially identical securities. (Allowing the loss at the sale of the subsequent purchase)
  - Wash sale rules do not apply to gains
- Related Party Sales – Seller's loss is disallowed (See Above)

Capital Gains & Losses
Wash Sale Example

Sean bought stock in Hot Stock Company for $80 per share. The stock subsequently fell to $5 per share and Sean sold the stock on December 18th, in order to recognize a $75 per share loss. Sean, thinking the stock would come back bought the stock back on January 5th of the following year for $18 per share.

What are the tax consequences to Sean?

There are two consequences. First, Sean may not recognize the loss due to the wash sale rules. Sean's new basis is $18 plus $75 (disallowed loss) or $93.

Capital Gains & Losses
Gain Recognition

- Gains are Unrealized until Sale or Exchange,
- At Sale or Exchange the gain is Realized, then
  - Recognized – taxable in current tax year
  - Deferred – taxable later (nontaxable exchange)
  - Exclude – never taxable

Capital Gains & Losses
Personal Residence Gain Exclusion

- Personal Residence Gain Exclusion
  - Own and Use home as principal residence for two of the last five years, and
  - Have not used the exclusion within the prior two years
  - Exclusion Amount
    - Single taxpayers may exclude $250,000 of gain from the sale of a principal residence
    - MFJ may exclude $500,000 of gain if:
      - Either spouse meets the 2 year ownership requirement,
      - Both spouses meet the 2 year use requirement

Capital Gains & Losses
Non-qualified use for 121 Treatment

- The Housing Assistance Tax Act of 2008 modified Section 121 allowing the exclusion for only "qualified use" periods.
- Before 2009 if you owned the property but did not use it for a qualified purpose the full exclusion will still apply if the taxpayer met the other tests.
- Beginning in 2009 any appreciation attributed to a non-qualified use period does not qualify for the Section 121 exclusion.

Capital Gains & Losses
Non-qualified use for 121 Treatment

- Example:
- John is single and purchased a vacation home for $200,000. He owned and used this property for 2 years as a vacation home. At the beginning of year 3 John moved into the home and began utilizing it as a principal residence. John then sold the home at the beginning of year 5 after meeting the 2-year use test.
- If the home appreciated by $100,000, then he would owe capital gains tax on $50,000 (2 years of non-qualified use / 4 years of total ownership x $100,000 total gain).

Capital Gains & Losses
Personal Residence

- Exception available for:
  - Change in employment – Qualified move for you or your spouse
  - Change in Health – Diagnosis, Cure, Mitigation, Treatment for parent, grandparent, child, grandchild, sibling, inlaws, aunt, uncle, niece or cousin
  - Unforeseen circumstances is fairly broad. The IRS has put out quite a bit of information on what can be considered unforeseen circumstances. It is likely on the exam, they will say something like, “change of employment or change of health.” Things that have been considered unforeseen include Disaster area, Involuntary Conversion, Death, unemployment, Divorce, multiple births from the same pregnancy, Bullying.
- Pro-rate exclusion for number of months requirement met
- (Number of months met/24) x Available Exclusion = Exclusion Allowed

Capital Gains & Losses
Personal Residence Example

Morris and Doris, who are married filing jointly, purchased a personal residence 21 months ago for $500,000. Morris and Doris sold the residence today for $950,000 and want to know the tax consequences of this transaction. They were required to move because of their employment. How much gain must Morris and Doris recognize this year?

Because Morris and Doris sold their house due to employment reasons, they are eligible for a reduced exclusion even though they did not meet the two-year rules. Morris and Doris realized a gain of $450,000 on the sale of their house ($950,000 - $500,000). However, they are eligible for a reduced exclusion of $437,500 ($500,000 x 21/24). Because their realized gain exceeds their reduced exclusion, they will have recognized a gain of $12,500 on the sale of their home. If Morris and Doris had not been eligible for the reduced exclusion, all $450,000 of their realized gain would have been recognized.

Capital Gains & Losses
Worthless Securities

- Loss on Worthless Securities - deductible in the year in which the securities become completely worthless.
  - Artificial sale date is the last day of the year in which the securities became worthless.
  - Always 12/31 for Calendar year taxpayers!

Capital Gains & Losses
Recognition Rules

Property Type	Personal Use	Capital Asset	Trade or Business	Trade or Business
Gains/Income	Short term or long term capital gain (depends on holding period).	Short term or long term capital gain (depends on holding period).	Short term or long term capital gain (depends on holding period).	Ordinary Income
Losses	Losses may not be recognized or deducted.	Capital loss (deductible to the extent of capital gains, plus $3,000)	Ordinary loss (deductible against ordinary income).	Ordinary loss (deductible against ordinary income).

Capital Gains & Losses Netting

- Net gains and losses by holding period (long term against long term, etc.).
- First, net long term capital gains and long-term capital losses.
- Second, net short term capital gains and short-term capital losses.
  - If both long-term net gains and short-term net gains, the net long-term gain and the net short-term gain should be recognized.
  - If long term net gains and short-term net losses, offset LT gains with ST losses (vice-versa also)
- Net capital losses of individuals are deductible FOR AGI to the extent of $3,000 per year.

Capital Gains & Losses Netting Example

- Tim had the following gains and losses from the current year:
- Long-Term Capital Gains = $10,000
- Short-Term Capital Gains = $5,000
- Long-Term Capital Losses = $3,000
- Short-Term Capital Losses = $6,000

Exam Tip: If LT and ST nets are different (gains/losses) then just net them!

- Tim has a Long-Term Capital
- Gain of $6,000, which will be
- taxed in the current year at 15%.

LTCG	$10,000	STCG	$5,000
LTCL	<$3,000>	STCL	<$6,000>
Net LTCG	$7,000	Net STCL	<$1,000>
Net LTCG $6,000 ($7,000 - $1,000)			

Sample Question

Pat had the following capital transactions:

STCG of $4,000 from ABC

LTCG of $10,000 from BCD

STCL of $13,000 from CDE

LTCL of $6,000 from DEF

What is Pat's net capital gain or loss?

A. STCL $9,000

B. LTCG $4,000

C. STCL $5,000

D. STCL $2,000

STCG	$4,000	LTCG	$10,000
STCL	<$13,000>	LTCL	<$6,000>
Net STCL	<$9,000>	Net LTCG	$4,000
Net STCL of <$5,000> ($4,000-$9,000)			

Capital Gains & Losses Limitations on Losses - 1244

- Sec. 1244, a single taxpayer can deduct up to $50,000 ($100,000 for married individuals filing jointly) of the loss on small business stock as an ordinary loss in any give year if the following requirements are met:
  - The stock represents ownership in a domestic corporation.
  - The corporation was a small business corporation (less than $1 million in total capital contributions plus paid-in capital).
  - The loss was sustained by the original owner of the stock.

Exam Tip: Section 267, 1244 and wash sales do not apply to gains – losses only.

Capital Gains & Losses
Limitations on Losses – 1244 Example

- Three years ago, Abby invests in Fish Corp. stock costing $110,000. (Total Fish Corp. stock outstanding is 850,000.) This year Abby sells all the stock for $40,000. The stock is Section 1244 stock. Abby, a single taxpayer, has the following tax consequences:

- $50,000 ordinary loss this year
- $20,000 long-term capital loss ($3,000 currently deductible).

Section 1202

- Prior to 2009 the taxable gain associated with Qualifying Small Business Stock (Section 1202) was excluded at 50% and the remaining amount was taxed at 28% if the holding period is at least five years.
  - Several tax acts have changed the provision over time. The amount of gain you can exclude is:
    - 50% if the QSBS is acquired before Feb. 18, 2009;
    - 75% if the QSBS is acquired after Feb. 17, 2009, and before Sept. 28, 2010;
    - 100% if the QSBS is acquired after Sept. 27, 2010 (made permanent by PATH 2015)
  - The amount eligible for the exclusion by an individual is the greater of:
    - 10 times the taxpayer’s basis in the stock, or
    - 10 million (reduced by the amount of gain eligible for exclusion in prior years)
  - The stock must have been acquired at original issue and held for at least 5 years.

Nontaxable Exchanges
Involuntary Conversions

- Section 1033 - Deferral of gain on an involuntary conversion of property due to destruction, theft, seizure, condemnation.
  - Defer gains to the extent the proceeds received are reinvested in replacement property within the appropriate time period:
  - - Time period starts at date of realization of involuntary conversion or threat of condemnation
  - - Time period ends 2 years (3 years for condemnation of realty) from the year-end of year that gain is realized

- To the extent proceeds are not reinvested gain must be recognized.

Nontaxable Exchanges
Insurance Policies

- Section 1035
  - Deferral of gain available for exchanges of:
  - - Life policy for Life Policy
  - - Annuity for Annuity
  - - Life policy for Annuity
  - Gain must be recognized for exchange of:
  - - Annuity for Life Policy

Introduction to Individual Taxation Basic Tax Formula

Income (broadly conceived)	$xx,xxx
Less: Exclusions from Gross Income	(x,xxx)
Gross Income	$xx,xxx
Less: Deductions for AGI	(x,xxx)
AGI	$xx,xxx
Less: The Greater of-	
1) Total itemized deductions, or 2) standard deduction	(x,xxx)
Less: Deduction for Pass-thru Entity, if applicable	(x,xxx)
Taxable Income	**$xx,xxx**
Tax on Taxable Income	
Less: Tax Credits (including Federal income tax withheld and other prepayments of Federal income tax)	(x,xxx)
Tax Due (or Refund Due)	$x,xxx

Introduction to Individual Taxation Accounting Periods & Methods

- Taxpayers are either
  - cash basis taxpayers, or
  - accrual basis taxpayers.
- Constructive receipt rules require that income is taxable when it is:
  - Readily available to the taxpayer, and
  - That income is not subject to substantial limitations or restrictions

Introduction to Individual Taxation Filing Status

- Single – Not married, Not QW, Not HOH
- Married filing jointly
- Married filing separately
- Head of household – Single with Dependent
- Qualifying widower – Available for 2 years after death of spouse with dependent child

- Usually determined on last day of tax year

Introduction to Individual Taxation Standard Deduction

- Standard Deduction (2024)

Filing Status	2024 Basic Standard Deduction	2024 Additional Standard Deduction
Single	$14,600	$1,950
Married filing jointly	$29,200	$1,550
Qualifying widow(er)	$29,200	$1,550
Head of Household	$21,900	$1,950
Married filing separately	$14,600	$1,550

Introduction to Individual Taxation Additional Standard Deduction

- Age 65 or older or blind
  - See previous slide for amounts.
- Age 65 or older and blind
  - Two additional standard deductions available
    - i.e. Single, age 67 and blind = $3,900 (2024)
- Dependents of other taxpayers have a limited standard deduction.
  - Discussed with "Kiddie Tax"
- Casualty loss for those that do not itemize
  - Net loss is the lessor of decline in FMV or ATB, with $100 per casualty floor

Introduction to Individual Taxation

- For years after 12/31/2017, there is no personal or dependent exemption per TCJA 2017.
- However, a credit for the following may be allowed for:
  - Qualifying child $2,000
  - Child does not provide more the 50% of their support
    - Child is under age 17
    - Child lived with taxpayer for more than 50% of the year
  - Qualifying relative $500
    - Does not necessarily need to live with you

Introduction to Individual Taxation Dependency Exemptions

- A qualifying child (this is not for the $2,000 credit) meets all of the following tests:
  - Relationship: taxpayer's child, grandchild, stepbrother, stepsister, half brother, half sister
  - Support: Child does not provide more than ½ of their own support
  - Age: Child is under the age of 19 or student under the age of 24
  - Abode: Child lived with taxpayer for more than ½ of the year

Introduction to Individual Taxation Dependency Exemptions, Cont.

- A qualifying relative meets all of the following tests:
  - Relationship (or household member): Children, Grandchildren, siblings, parents, grandparents, parent's sibling OR anyone that lives with you all year even if they are not related
  - Support: Provide more than ½ of the support of a dependent
  - Gross income: Dependent's gross income must be less than $5,050 (2024)
  - Not a qualifying child test: A dependent cannot be a qualifying child of any taxpayer for the tax year

Exam Tip: No cousins unless in same household!

Items Specifically Included in Gross Income

- Compensation for services (including certain fringe benefits),
- Gross income derived from business,
- Gains derived from dealings in property (discussed earlier),
- Interest & Dividends,
- Rents & Royalties,
- Income from life insurance and endowment contracts,
- Pensions,
- Discharge of indebtedness (unless under bankruptcy),
- Distributive share of partnership gross income,
- Unemployment benefits
- Income in respect of a decedent,
- Income from an interest in an estate or trust
- Annuity payments (next slide),
- Alimony and Separate Maintenance Payments (dated prior to 2019)
- Below Market Rate Loans (detailed coming slide).

Gross Income Inclusions
Annuity Payments

- Taxation of Annuity Payments
  - The Exclusion Ratio determines the portion of each payment excluded from taxation and is calculated at the starting date of the annuity.

$$\text{Exclusion Ratio} = \frac{\text{Investment in the Contract}}{\text{Expected Total Return}}$$

  - Inclusion Ratio = 1 – Exclusion Ratio

Gross Income Inclusions
Annuity Payments Example

- Jeff pays $15,000 for an annuity that will pay $2,000 a year, starting this year. If the annuity is for a term of 10 years, Jeff will have $500 of taxable income from the annuity each year.
- To calculate Jeff's taxable income from the annuity, the exclusion ratio must first be determined as follows:

$$\frac{\$15{,}000}{\$20{,}000} = .75 \text{ (Exclusion Ratio)}$$

- Therefore, 75%, or $1,500, of each annual annuity payment will be excluded from Jeff's gross income and $500 will be included in Jeff's gross income.

Gross Income Inclusions
Annuity Payments Example, Cont.

- If the annuity term is for life and Jeff's life expectancy is 10 years, then Jeff will have the same tax consequences for the first 10 years of the annuity. If Jeff lives longer than 10 years, the annuity payments will be 100% taxable beginning in year 11. The annuity was designed to return Jeff's capital to him over a 10 year period. If he lives beyond 10 years, he is no longer entitled to a tax-free return of capital.
- If the annuity term is for life and Jeff's life expectancy is 10 years, Jeff will be entitled to a deduction from his adjusted gross income if he fails to live for 10 years after the start date of the annuity. If Jeff only lives for 8 years, he will have a deduction of $3,000 on his last return ($15,000 - ($1,500 x 8)) representing the return of Jeff's remaining capital.

Gross Income Inclusions
Social Security Benefits

- Social Security Benefits
  - Up to 85% of an individual's Social Security benefits may be taxable.
  - The taxability of an individual's Social Security benefits is based on taxpayer's Modified AGI.
  - To calculate the taxable portion of the Social Security benefits, MAGI plus one-half of the taxpayer's Social Security benefits must be compared to the hurdle amounts, which are listed in the following chart.

	Married Filing Jointly	**All Other Taxpayers, Except MFS = 0**
1st Hurdle	$32,000	$25,000
2nd Hurdle	$44,000	$34,000

Gross Income Inclusions
Social Security Benefits

- If MAGI plus one half of Social Security benefits exceeds the first hurdle but not the second, the taxable amount of Social Security benefits is the lesser of:
  - 50% Social Security Benefits or
  - 50% [MAGI + 0.50 (Social Security Benefits) - Hurdle 1].
- If MAGI plus one-half the Social Security benefits exceeds the second hurdle, the taxable amount of Social Security benefits is the lesser of:
  - 85% Social Security Benefits, or
  - 85% [MAGI + 0.50 (Social Security Benefits) - Hurdle 2], plus the lesser of:
    - $6,000 for MFJ or $4,500 for all other taxpayers, or
    - The taxable amount calculated under the 50% formula and only considering Hurdle 1.

Gross Income Inclusions
Below Market Loans

- Below-Market Rate Loans

Loan	Imputed Interest
$0 ≤ $10,000	$0
$10,001 ≤ $100,000	The lesser of: •Borrower's Net investment income, or •Interest calculated using AFR less interest calculated using stated rate of the loan Exception: If borrower's net investment income < $1,000, $0 imputed interest.
> $100,000	Interest calculated using AFR less interest calculated using stated rate of the loan.

AFR – Applicable Federal Rate

Gross Income Inclusions
Below Market Loans Example

- Edward makes the following loans:

Loan	Amount of Loan	Borrower's Net Invst. Income	Interest per AFR (8%)	Impute to Lender (Edward)	Reason
1	$7,500	N/A	$600	$0	Loan is less than $10,000
2	$30,000	$820	$2,400	$0	Borrower has less than $1,000 of unearned income.
3	$50,000	$3,300	$4,000	$3,300	Impute lesser of NII (Net Investment) Income) or AFR.
4	$110,000	$7,000	$8,800	$8,800	Because loan is >$100,000, must impute AFR.

Gross Income
Items Specifically Excluded

- Gifts and Inheritances
- Life Insurance Proceeds
- Scholarships (tuition, fees, books)
- Gain on Sale of Personal Residence
- Qualifying Distributions from Roth IRAs and Roth 401(k)/403(b) Plans
- Compensation for Injuries and Sickness

Gross Income Exclusions
Employee Benefits

- Meals and Lodging furnished for the convenience of the employer and on the employer's premises.
  - Lodging must be condition of employment.
- Employer-Sponsored Accident and Health Plans
  - Medical
  - Group Term Life Insurance
    - Cost of the first $50,000 of coverage is not taxable to the employee.
    - The cost of excess coverage is taxable determined by Uniform Premium Table I.

Practice Question 5

Ted, age 48, gets 2.5 x his annual salary of $100,000 in group term life insurance. $30 per month is deducted from Ted's paycheck for the insurance. Ted has named his niece and nephew as joint and equal beneficiaries. What, if any, amount must be included in Ted's gross income as a result of this group term life insurance? Assume the Table 1 rate is $0.20 and the employer pays the premium of $4,000 annually.

A. None.
B. $120.
C. $480.
D. $3,200.

Gross Income Exclusions Employee Benefits

- Other Employee Fringe Benefits
  - Athletic Facilities (on employer premises)
  - Educational Assistance Programs (limited to $5,250/year)
  - Flexible Spending Accounts are permitted $3,200 **(2024)** per year whereas Dependent Care Spending Accounts are permitted a $5,000 maximum contribution per year.
  - Classes of Nontaxable Employee Benefits
    - No-additional-cost services
    - Qualified employee discounts (Service – 20%; Products – Profit %)
    - Working condition fringe benefits
    - De Minimis fringe benefits

Gross Income Exclusions
Muni Bonds & Bankruptcy

- Interest on Certain State and Local Government Obligations (Municipal Bonds)
  - Income from private activity bonds are an AMT preference (does not apply to private activity bonds issued in 2009-10)
- Discharge of Indebtedness in bankruptcy

Deductions
Above the Line Deductions (For AGI)

- Deductions for AGI include:
  - Deductions from losses on sale or exchange of property
  - Deductions from rental and royalty property
  - One-half of self-employment tax paid
  - 100% of health insurance premiums paid by a self-employed individual
  - Contributions to pension, profit sharing, annuity plans, IRAs, etc.
  - Penalty on premature withdrawals from time savings accounts or deposits

Deductions
Above the Line Deductions (For AGI)

- Interest on student loans
  - $2,500 deduction regardless of filing status. May be used for higher education expenses related to tuition, fees, room & board, necessary fees for people at least half time. Phaseout Single 80-95k/ MFJ 165-195k for **2024**
- Health Savings Accounts
- Trade or business expenses
- Alimony payments – divorced before 2019

Above the Line Deductions
Trade or Business Expense

- Trade or Business Expenses
  - In order for expenses to be deductible, they must be:
    - **Ordinary**: normal, usual, or customary for others in similar business, and not capital in nature
    - **Necessary**: prudent businessperson would incur same expense
    - **Reasonable**: question of fact

Above the Line Deductions
Other Ordinary & Necessary

- Other Ordinary and Necessary
  - Business Gifts - Limited to $25 each plus shipping.
  - Entertainment Expenses: Deductions except for meals are eliminated for years after 2017.
    - 50% limit on meals
    - 100% of transportation costs
    - Entertainment expenses are no longer deductible

Above the Line Deductions
Alimony

- For alimony paid under an agreement signed on or before 12/31/2018
- Alimony paid is a deduction FOR AGI
  - Payment for support.
  - Payments in cash that do not extend beyond death of payee.
- Alimony received is earned income (provides for IRA funding), if divorced on or before 12/31/2018
- Alimony cannot be property settlement
  - No deduction is available for property transferred among spouses
- For agreements signed (or significantly modified with an election to follow the new tax treatment) after 12/31/2018- Alimony is no longer deductible or taxable.

Above the Line Deductions Moving

- Changes since TCJA
  - Under TCJA, moving expenses are no longer deductible except for armed services relocating to a permanent duty station.
  - If employer pays or reimburses moving expenses then employer must include the amounts paid in the employees gross income.

Deductions Below the Line Deductions (From AGI)

- Greater of Sum of Itemized Deductions or Standard Deduction
  - Standard Deduction – given amount for tax year
  - Itemized Deductions (aka Sch A and Below the Line)
    - Charitable Contributions
    - Limited Casualty Losses (see next slide)
    - Medical Expenses in excess of 7.5% of AGI (made permanent)
    - Limited Miscellaneous itemized deductions
    - Interest on mortgage and investments, subject to limitations
    - Mortgage Insurance Premiums
    - Taxes (State/Sales & Use, Local, US Property) capped at $10,000
- Qualified Business Income Deduction

Below the Line Deductions
Itemized – Casualty Losses

- Only available for Federally declared disaster areas.
  - Sudden and unexpected loss
    - Not available for erosion or termite damage
  - Loss equal to
    - Lesser of
      - Decline in FMV or Adjusted Taxable Basis
    - Less $100 per incident
    - Subject to 10% of AGI floor
  - Estate Administration losses and Business casualty losses still exist; not subject to the same restrictions

Below the Line Deductions
Itemized - Misc Itemized Deductions

- Not subject to 2% AGI threshold
    - Income in Respect of Decedent
    - Gambling Losses to extent of Gambling Winnings
    - Impairment Related Work Expenses for Handicapped
    - Annuity losses for decedent annuitant
- * ABSOLUTELY need to know the deductions not subject to 2%
- Miscellaneous deductions previously subject to the 2% AGI limit are no longer deductible.

Below the Line Deductions Itemized - Interest

- Interest
  - Mortgage Interest
    - Interest on up to $1,000,000 of indebtedness on primary residence and one other property for property financed prior to 12/15/2017.
      - Interest on up to $750,000 of indebtedness on primary residence and one other property for property financed after 12/15/2017.
    - No home equity interest is deductible unless used to improve the property.

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Below the Line Deductions Itemized - Interest

- Interest, Continued.
  - Investment Interest
    - To the extent of net investment income
      - Not including qualified dividends and long-term capital gains
        - Special election to tax these at ordinary income tax rate will include in net investment income

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Practice Question 6

Hank purchased his home 20 years ago for $250,000, taking out a mortgage for $240,000 at 6.7%. Today he is trying to pay for his daughter's college education, so he decides to refinance his home. The balance on the mortgage is $110,000 and he takes out a new loan for $225,000. How much of the new loan is deductible home equity indebtedness?

A. None
B. $100,000
C. $115,000
D. $130,000

Below the Line Deductions
Itemized - Taxes

- Taxes
  - Examples
    - State Income Taxes OR Sales & Use Tax
    - City Income Taxes
    - Ad valorem taxes - Property Taxes (house/vehicles, etc.) for US property
    - Deduction when paid (cash basis)
    - No foreign taxes are deductible
  - Deductible only by tax bill recipient
  - Capped at $10,000

Below the Line Deductions
Itemized – Charity Contributions

Type of Property Donated	Valuation for Purposes of Charitable Deduction	Ceiling for Public Charities, Private Operating Foundations and Certain Private Nonoperating Foundations	Ceiling for Other Private Nonoperating Foundations (PNOF)
Cash		60%	30%
Ordinary Income Property Short-Term Capital Gain Property All Loss Property	Lesser of the adjusted basis or the fair market value	50%	30%
Long-Term Capital Gain Property: - Intangible (stocks, bonds, etc.) - Real Property - Tangible Personalty (Related use)	Either fair market value or the adjusted basis	30% if FMV 50% if Basis	20% Must Use Basis
Long-Term Capital Gain Property: - Tangible Personalty (Unrelated use)	Lesser of the adjusted basis or the fair market value	50%	20%

Below the Line Deductions
Itemized – Charity Example

Evelyn makes a cash donation of $100,000 to the Red Cross. Evelyn's AGI is $150,000. Evelyn's charitable deduction this year is limited to $90,000 (60% of her AGI – TCDTR Act). Therefore, Evelyn can deduct up to $90,000 of cash contributions this year.

If instead of donating cash, Evelyn had donated $100,000 (FMV) worth of medical supplies (LTCG Tangible Use) to the Red Cross, her deduction would be limited to $45,000 this year, and she would be able to carry the remaining $55,000 forward for up to five years.

Deduction Clustering

A tax planning strategy in which itemized deductions are clustered (or bunched) into a single tax year, allowing the client to claim the itemized deductions one year and the standard deduction the next year.

Deduction Clustering Example

Jenna, a single taxpayer typically makes annual charitable gifts of $7,000, and her total itemized deductions, including the charitable gifts, are expected to be $11,000 this year and $11,000 next year. Since this amount is below the standard deduction, she will take the standard deduction in both years and receive no tax benefit from her charitable contributions.

Deduction Clustering Example, Cont.

- However, if she makes 2 years of charitable gifts in 2024 (totaling $14,000), her total itemized deductions for 2024 will increase to $18,000. Jenna will take itemized deductions of $18,000 in 2024. and will still take the standard deduction in 2025, increasing her total deductions over the 2-year period by nearly $6,000. Alternatively, Jenna could make a charitable gift of $21,000 to a donor-advised fund in 2024 (increasing her itemized deductions to $25,000), and distributions can be made from the donor-advised fund to Jenna's selected charities in 2025 and 2026 while Jenna takes the standard deduction in those years.

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Tax Credits
Refundable vs Nonrefundable

- Credits are dollar-for-dollar reductions of calculated tax
  - Refundable credits
    - Credit may eliminate all tax and provide additional payments to taxpayer
    - Negative income tax
  - Nonrefundable Credits
    - Credit may only reduce tax to zero
    - Any credit amount in excess of total tax is lost

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Tax Credits
Adoption Credit

- Adoption Expense Credit
  - Credit for adoptions expenses incurred up to $16,810 (2024).
    - Credit is phased-out ratably for modified AGI between $252,150 – 292,150 (2024).
  - An eligible child is one that is:
    - Less than 18 years of age, or
    - Physically or mentally handicapped.

Child Tax Credit (1 of 2)

- A partially refundable child tax credit of $2,000 is available to an individual taxpayer for each qualifying child under the age of 17.
- Qualifying Child:
  - Is the son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, half brother, half sister, or a descendent of any of them (for example, grandchild),
  - Was under the age of 17 at the end of the tax year
  - Did not provide over half of his support for the tax year
  - Lived with the taxpayer for more than half the year, and
  - Was a U.S. citizen, a U.S. national, or a resident of the United States.

Child Tax Credit (2 of 2)

- Under TCJA, up to $1,700 for each qualifying child credit may be refundable – in 2024.
- AGI Phase outs were increased to $400,000 MFJ and $200,000 for all other taxpayers
- To be eligible, the child must have a social security number
- Qualifying children without social security numbers or 17 or older may be eligible for the qualifying dependent credit

Qualifying Dependent Tax Credit

- Qualifying Dependent Credit for years after 12/31/2017
- A $500 nonrefundable credit will be allowed for qualifying dependents
- Qualifying dependents includes dependents as defined under present law except for qualifying children under age 17. So assume qualifying relatives AND qualifying children age 17 and over are eligible.
- A social security number is not required for this credit.

Tax Credits
Child & Dependent Care Credit

- Credit of 20% (usually) of the expenses paid (limited) for the care of the following:
  - Dependent under age 13, or
  - Spouse or dependent with a handicap.
- Expenses considered are limited to
  - 1) The lesser of actual costs or $3,000 for one qualified individual, and $6,000 for two or more qualified individuals, and
  - 2) The earned income of the lower earning spouse
- Utilizing the Dependent Care Expense Account usually will provide a greater tax savings.

Taxable Income - Kiddie Tax

- Applies to unearned income of dependent children under age 19 living with parent or under age 24 and a full-time student.
- Unearned income in excess of $2,600 (2024) is taxed at the Parent's rate
- Unearned income between $1,300 and $2,600, is taxable at the child's rate
- Earned income above the standard deduction is taxed at the child's rate.
  - Apply standard deduction for a dependent
    - Greater of $1,300 or Earned Income Plus $450 (limited to $14,600 in 2024)

Taxable Income
Kiddie Tax Example

Ben is the 10-year-old son of Mr. and Mrs. Reese. In 2024, Ben had $2,900 of unearned income and no earned income.

- The first $1,300 of Ben's unearned income is covered by Ben's standard deduction.
- The next $1,300 of Ben's unearned income is taxed at Ben's marginal rate.
- The last $300 of Ben's unearned income is taxed at the parent's income tax rate.

Practice Question 7

Jordan, age 7, has unearned income from a trust of $4,000. She also works as a voice finder when her mother loses her voice, for which she is paid earned income of $1,000 per year (assume this is the FMV of Jordan's services).

How much of Jordan's income is taxable at her parent's rate?

A. $1,300
B. $1,400
C. $2,600
D. $4,000

Practice Question 8

Jordan, age 7, has unearned income from a trust of $4,000. She also works as a voice finder when her mother loses her voice, for which she is paid earned income of $1,000 per year (assume this is the FMV of Jordan's services).

How much is Jordan's standard deduction?

A. $0
B. $1,300
C. $1,450
D. $5,450

Taxable Income AMT

- AMT
  - Regular Taxable Income
  - +- Adjustments
  - + Preferences
  - Less AMT Exemptions (2024):
    - $133,300 for married taxpayers, filing jointly.
    - $85,700 for single and unmarried head of household.
    - $66,650 for married filing separately.
- AMT Tax Rates (2024) for Individuals
  - 26% for first $232,600 (all filing status except MFS) of taxable income subject to AMT.
  - 28% on income in excess of $232,600 (MFJ/QW/S/HOH), 116,300 (MFS)

Taxable Income AMT Adjustments

- AMT Adjustments (examples)
  - Accelerated depreciation for real and personal property that is allowable for regular tax purposes.
  - The standard deduction if itemized deductions are not used
  - Taxes (State, Local, Property)
  - Incentive Stock Option bargain element
    - Positive at Exercise
    - Negative at Sale

Taxable Income AMT Preference

- Preference Items
  - Percentage depletion
  - Intangible drilling costs
  - Interest on private activity bonds

  - Note that PATH 2015 makes permanent the provision that states that the gain excluded from Section 1202 Stock is no longer an AMT preference.

Taxable Income
Hobby Losses

- All ordinary, necessary, and reasonable business expenses are deductible against income. To be classified as a business activity, the taxpayer must have a profit motive.
- When there is no profit motive and the activity is classified as a hobby, all of the hobby income must be included in gross income.
- For years after 12/31/17 through 2025, hobby expenses associated with the activity are not deductible- not even to the extent of hobby income – as a miscellaneous itemized deduction, subject to the 2% AGI limit.

Taxable Income
Hobby Losses, Cont.

- No profit in 3 years out of 5 years; presumed a hobby.
- Hobby activities cannot generate deductible losses.

- * The hobby rules may still be tested as it relates to when an activity is deemed a hobby and as it relates to mixed use real estate rentals.

Tax Deductions for Pass Through Entities

- New Tax deductions created under TCJA for years after 12/31/17 for pass thru entities, including sole proprietors, and income from rental real estate
- Creates a 20% deduction based on qualified business income
- The deduction reduces taxable income, not AGI
- The use of the credit where the income threshold exceeds $191,950 single; ($383,900 MFJ) for 2024
  - Is subject to limitations for service-based businesses AND
  - Is subject to a revised calculation which incorporates a wage limit calculation and depreciable asset limitation

Taxable Income
Flow through Entities

- At Risk Rules and Passive Activity Treatment
  - There are three types of income:
    - Active,
    - Passive, and
    - Portfolio.
  - Under the At Risk Rules, which apply before the passive activity rules, losses can only be deducted to the extent of property/money that is at risk.
  - Passive losses can only offset passive income and/or gains.
  - Passive Activity Defined:
    - No material participation.
    - Rental activities - even with material participation.
    - Exception: Real estate dealers are not considered a passive activity

Taxable Income
Flow through Entities

- If the real estate is actively managed, then the taxpayer can deduct up to $25,000 from ordinary income subject to a phase-out of $1 for every $2 AGI exceeds $100,000.
- Material Participation
  - Greater than 500 hours per year, OR
  - Greater than 100 hours and the most of any participant.
- Suspended Losses at Risk
  - If suspended losses are from “At Risk” activity, they are NOT Deductible until the at risk amount is positive from additions or income.
  - If losses are suspended under passive activity rules, the losses are deductible upon disposition.

Practice Question 9

Anna has salary of $50,000 and two investments, Limited Partnership Investment A and B. She does not materially participate in either investment. Her basis in the partnerships are:

LLP A - $50,000; LLP A had a $75,000 gain in the current year

LLP B - $25,000. LLP B had a $100,000 loss.

What is the net gain or loss for the two investments that will be recognized on the current tax return?

A. $3,000 loss
B. $25,000 loss
C. $0 gain or loss
D. $50,000 gain

Practice Question 10

Christian has the following investments:
- Publicly traded Limited Partnership A - $10,000 loss
- Publicly traded Limited Partnership B - $15,000 Income
- Non-publicly traded Limited Partnership C - $22,000 loss
- Non-publicly traded Limited partnership D - $16,000 Income

Christian does not materially participate in these investments. Assuming Christian has the appropriate amount at risk to take any necessary losses what is the total suspended loss/losses for the current year?

A. $1,000 suspended loss
B. $6,000 suspended loss
C. $10,000 suspended loss
D. $16,000 suspended loss

Election to Expense Assets Section 179

- Can elect to immediately expense up to $1,220,000 (for 2024) of business tangible property placed in service during the year.
- Expense limitation ($1,220,000 for 2024) is reduced by amount of Section 179 property placed in service during year that exceeds $3,050,000.
- The result is a dollar-for-dollar reduction.
- Election to expense cannot exceed taxable income (before Sec. 179) of taxpayer’s trades or businesses. Therefore, a taxpayer cannot create a loss using Section 179.
  - Excess of limitation over taxable income limitation may be carried over to subsequent year(s).
  - Amount carried over still reduces basis currently.
- §179 applies before MACRS.

Election to Expense Assets Section 179 Example

In 2024, Adam placed $3,200,000 worth of Section 179 property into service. Adam's taxable income was $6,000,000. Because Adam placed more than $3,050,000 of Section 179 property into service, his expense limitation is reduced, and Adam may only expense $1,080,000.

$1,220,000 – ($3,200,000-$3,050,000)

$1,220,000 – 150,000 = $1,070,000

End of Income Tax Planning

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