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EA Exam Part 1: Individuals

The Plain-English Study Guide for the IRS Special
Enrollment Examination

Kenneth Omoruyi, M. Tax, EA, CPA

An EnrolledAgent.com Study Guide

EA Exam Part 1: Individuals — The Plain-English Study Guide for the IRS Special Enrollment Examination

First edition, for the July 1, 2026 – February 28, 2027 testing window.

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Published by EnrolledAgent.com. Inquiries: info@enrolledagent.com.

Tax-law basis. The IRS states that for examinations taken between July 1, 2026 and February 28, 2027, all references are to the Internal Revenue Code, regulations, IRS forms, instructions, and publications as amended through December 31, 2025, and that unless a question says otherwise, “current tax year” means calendar year 2025. This guide follows that basis. Where a 2026 change exists, it is flagged in a separate “Not on your exam” note so you never mix years.

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PART I

Getting Ready

How this guide works, what the exam tests, and a six-week plan to pass.

About the Author

Kenneth Omoruyi, M. Tax, EA, CPA, is the Managing Partner of CKO CPAs & Advisors, a Texas accounting and advisory firm, and the founder of EnrolledAgent.com, the online platform that connects taxpayers with IRS-licensed Enrolled Agents.

He earned a Bachelor of Science in Accounting from the University of Benin and a Master of Science in Business Taxation from the University of Southern California's Leventhal School of Accounting, and holds a Public Leadership Credential from the Harvard Kennedy School. Before founding his firm he served as a Senior Tax and Financial Analyst at Schlumberger, where he received multiple "Be Outstanding" awards for process improvement and leadership development.

Kenneth is both an Enrolled Agent and a Certified Public Accountant. He teaches as an Adjunct Professor of Accounting at Lone Star College, and in 2025 he was appointed by Texas Governor Greg Abbott to the Texas State Board of Public Accountancy, with Senate confirmation for a six-year term. His recognitions include the AICPA Outstanding Young CPA Award, the AICPA Black CPA 40 Under 40 Award, and the Top 40 Under 40 in the Accounting Profession Award.

He wrote this guide the way he teaches: one rule at a time, with the smallest example that proves the point.

How to Use This Guide

Most Part 1 study materials fail in one of two ways. Either they reprint the Internal Revenue Code with the hard words left in, or they skip the rules and hand you a thousand questions to memorize. This guide takes a third path. Every topic on the official Part 1 content outline is taught the same way:

Feature	What it does for you
The rule	The law restated in one or two plain sentences, with the numbers that matter for 2025.
At a glance	A compact comparison table whenever the exam likes to test two or more things that look alike.
Worked example	A small, round-number scenario that proves the rule. One idea per example. If the math takes more than four lines, the example is too big.
Memory cue	A short phrase or pattern to hold the rule in place under exam pressure.
Exam trap	The specific way the test writers try to make you choose the wrong answer.
New for 2025	A change from the One Big Beautiful Bill Act (Public Law 119-21, enacted July 4, 2025) that applies to the 2025 tax year tested on your exam.
Not on your exam	A rule that changes in 2026 or later. You need to know it does not apply to 2025 so you are not tempted by an answer choice built on it.
Quick check	Short practice at the end of every chapter with full explanations, followed by a 50-question practice exam in Part III.

A family you will get to know. The examples follow the Lopez family of Houston, Texas. Maria and David Lopez file jointly. Their daughter Sofia is 8 and their son Mateo is 16. Maria’s mother, Rosa, is 72 and lives with them. David’s brother Carlos is single, tends bar, and files on his own. Their neighbor Priya is a self-employed consultant. Using the same people throughout lets you focus on the one rule that changes from example to example.

Recommended path.

1. Read “The Exam at a Glance” so you know exactly what is scored and how.
2. Work through Chapters 1 to 6 in order. The chapters follow the official domain order, and later chapters assume earlier ones.
3. Do the Quick Check at the end of each chapter before moving on. Read every explanation, including the ones you got right.

4. Take the practice exam in Part III under timed conditions: 50 questions in 105 minutes mirrors the pace of the real 100-question, 3.5-hour exam.
5. Use Appendix A, “2025 Numbers at a Glance,” as your final-week review sheet.

The Exam at a Glance

What Part 1 is. The Special Enrollment Examination (SEE) has three parts. Part 1 covers individual taxation. Each part has 100 multiple-choice questions, of which 85 are scored and 15 are unscored experimental questions you cannot identify. You have 3.5 hours of testing time. Results are converted to a scaled score from 200 to 800, and the IRS has set the passing score at 500; a passing report shows only “pass,” while a failing report shows the scaled score and diagnostic information by domain. You may take the three parts in any order, up to four attempts per part in each testing window, and you have three years from the date you pass a part to pass the other two. PSI Services LLC administers the exam for the IRS at U.S. test centers and by remote proctoring.

What law is tested. For exams taken July 1, 2026 through February 28, 2027, the exam uses the law as amended through December 31, 2025. Unless a question says otherwise, every amount, threshold, and deadline refers to calendar year 2025. Do not apply any legislation, court decision, or penalty amount that took effect after December 31, 2025.

How the 85 scored questions are distributed.

Domain	Scored questions	Share	Chapter
1. Preliminary Work with Taxpayer Data	14	16%	1
2. Income and Assets	17	20%	2
3. Deductions and Credits	17	20%	3
4. Taxation	15	18%	4
5. Advising the Individual Taxpayer	11	13%	5
6. Specialized Returns for Individuals	11	13%	6
Total	85	100%	

Three habits that raise scores.

- Read for the trigger word. Many questions turn on a single word: “qualifying child” versus “qualifying relative,” “deduction” versus “credit,” “refundable” versus “nonrefundable,” “MAGI” versus “AGI.” This guide teaches the pairs side by side so the trigger word jumps out.
- Know the number and the direction. It is not enough to know that a phaseout exists. Know where it starts, which filing status it uses, and whether it reduces a deduction, a credit, or an exclusion.
- Eliminate the 2026 answer. Because the exam tests 2025 law while you are studying in 2026, the most tempting wrong answer is often the 2026 rule. Every “Not on your exam” note in this guide exists to protect you from that trap.

Registering and sitting for the exam. Obtain a Preparer Tax Identification Number (PTIN), create your account through the PSI link on the IRS “Become an Enrolled Agent” page, and schedule each part separately. The fee is \$317 per part, paid when you schedule. Your name must match your unexpired government-issued photo ID

exactly. You may reschedule or cancel without forfeiting the fee with at least 48 hours' notice; inside 48 hours the fee is forfeited. Testing is not offered in March and April while the exam is updated. After passing all three parts, apply for enrollment on Form 23 and pay the \$140 enrollment fee. Passing the exam does not by itself make you an Enrolled Agent.

A Six-Week Study Plan

This plan assumes about eight to ten hours per week. If you have more time, spread the same sequence across eight weeks and add a second pass through the Quick Checks.

Week	Focus	Target
1	Front matter and Chapter 1 (Preliminary Work)	Filing status and dependency rules cold. Filing-requirement chart memorized.
2	Chapter 2, first half (Income; Retirement income)	Taxable versus excluded income by category. IRA and Roth rules side by side.
3	Chapter 2, second half (Property; Adjustments)	Basis rules for purchase, gift, and inheritance. Capital gain netting. Section 121.
4	Chapter 3 (Deductions and Credits)	Schedule A line by line. Every credit's amount, phaseout, and refundability.
5	Chapters 4 and 5 (Taxation; Advising)	AMT, SE tax, NIIT, Additional Medicare Tax, penalties. Planning questions.
6	Chapter 6 (Specialized Returns), practice exam, Appendix A review	Estate, gift, and international reporting. Timed 50-question exam. Review misses.

PART II

The Six Domains

Chapters 1 through 6 follow the official Part 1 content outline in order. Each chapter opens with the domain's weight on the exam and closes with a Quick Check.

Chapter 1. Preliminary Work with Taxpayer Data

Domain 1 • 14 scored questions (16%)

What the outline tests: using prior-year returns and carryovers; taxpayer identity and residency; filing requirements and due dates; filing status; sources of income, exclusions, adjustments, deductions, credits, and payments; dependency; additional returns (employment, gift, international); special filing situations (foreign income, disaster areas, injured spouse); FBAR and Form 8938; the kiddie tax; and ACA premium tax credit data.

This domain is the interview. Before a single number goes on a return, the preparer must know who the taxpayer is, whether a return is required, what status applies, who counts as a dependent, and what carried over from last year. The exam treats these as separate skills, and so does this chapter.

1.1 Starting with last year's return

A prior-year return is the single most useful document in the interview. The exam expects you to know what you are looking for.

The rule. Compare the prior year for accuracy and for carryovers. Items that carry into 2025 include capital loss carryovers, net operating losses, charitable contribution carryovers (five years), passive activity losses (Form 8582), investment interest expense (Form 4952), the minimum tax credit (Form 8801), negative qualified business income carryover, foreign tax credit carryovers (ten years), adoption credit carryforwards (five years), and nondeductible IRA basis (Form 8606).

Carryover	Where it came from	How long it lasts	Form
Capital loss	Net loss above the \$3,000 (\$1,500 MFS) annual limit	Indefinitely, keeps short- or long-term character	Schedule D
Net operating loss	Business loss exceeding other income	Indefinitely; limited to 80% of taxable income	Form 1045 / Sch. 1
Charitable contributions	Gifts above the AGI percentage limits	5 years	Schedule A
Passive activity loss	Losses from rentals or businesses without material participation	Until passive income or full disposition	Form 8582

Carryover	Where it came from	How long it lasts	Form
Investment interest	Interest above net investment income	Indefinitely	Form 4952
Minimum tax credit	AMT paid on deferral items in a prior year	Indefinitely	Form 8801
Negative QBI	Net loss from qualified businesses	Indefinitely; reduces next year's QBI	Form 8995
Foreign tax credit	Credit above the limitation	Back 1 year, forward 10	Form 1116
Adoption credit (nonrefundable part)	Credit above tax liability	5 years	Form 8839
IRA basis	Nondeductible contributions	Until fully recovered	Form 8606

Worked example. David Lopez's 2024 return shows a \$7,500 net long-term capital loss. He deducted \$3,000 in 2024. In 2025 the Lopezes have no sales of stock. They may still deduct \$3,000 in 2025 against ordinary income, carrying \$1,500 to 2026. The carryover stays long-term.

Memory cue. "Three carry five, two carry ten." The \$3,000 capital loss carries forever; charitable and adoption carry 5 years; the foreign tax credit carries 10.

Exam trap. A question says a taxpayer "had no income from the activity this year" and asks whether a carryover is lost. Carryovers are not lost for lack of use. They wait.

1.2 Identity, IP PINs, and documentation

The rule. Gather name, date of birth, Social Security number (SSN) or Individual Taxpayer Identification Number (ITIN), marital status at year end, dependents' identifying numbers, and any Identity Protection PIN (IP PIN). A paid preparer must also complete Form 8867 due diligence when a return claims the earned income credit, the child tax credit/additional child tax credit/credit for other dependents, the American opportunity credit, or head of household status.

- An **IP PIN** is a six-digit number issued by the IRS to protect a taxpayer against identity theft. A return filed without a required IP PIN is rejected (e-file) or delayed (paper). The IP PIN changes every year. Taxpayers can obtain one through their IRS online account or, if they cannot verify online, with Form 15227 (income limits apply) or in person.
- An **ITIN** (Form W-7) is for individuals who need a taxpayer number but are not eligible for an SSN, such as nonresident alien spouses or dependents. An ITIN does not authorize work and does not qualify a person for the earned income credit. ITINs not used on a return for three consecutive years expire.

- **Social Security number timing matters.** For the child tax credit, the child's SSN must be valid for employment and issued before the due date of the return including extensions. For the earned income credit, the taxpayer, spouse, and each qualifying child must have SSNs valid for employment.

Exam trap. Form 8867 due diligence covers four benefits (EITC, CTC/ACTC/ODC, AOTC) plus head of household status. The penalty is per benefit, per return: a return claiming EITC, CTC, and head of household with no due diligence on any of them carries three penalties. For returns filed in 2026, each failure costs the preparer \$650.

1.3 Residency and citizenship

The exam asks who files Form 1040 and who files Form 1040-NR. U.S. citizens and resident aliens are taxed on worldwide income on Form 1040. Nonresident aliens are taxed on U.S.-source income on Form 1040-NR.

The rule. An alien is a **resident** for tax purposes if either test is met: the **green card test** (lawful permanent resident at any time during the year) or the **substantial presence test**: present at least 31 days in the current year and at least 183 days using the weighted formula (all days this year, plus one-third of last year's days, plus one-sixth of the days two years ago).

	Resident alien	Nonresident alien
Form	1040	1040-NR
Income taxed	Worldwide	U.S.-source only (plus effectively connected income)
Standard deduction	Yes	No (exception: certain students from India under treaty)
Filing jointly	Yes	No, unless electing to treat NRA spouse as resident
Dependents	Normal rules	Generally none (treaty exceptions for Canada, Mexico, South Korea, India students)

Worked example. Anil moved to Houston on an H-1B visa. He was present 120 days in 2025, 120 days in 2024, and 120 days in 2023. Weighted days: $120 + (120 \times 1/3 = 40) + (120 \times 1/6 = 20) = 180$. He fails the 183-day test, so he is a nonresident for 2025 even though he passes the 31-day test. Had he been present 125 days each year, the total would be $125 + 41.67 + 20.83 = 187.5$, and he would be a resident.

- **Exempt individuals.** Days as a student (F, J, M, Q visas, generally five calendar years), teacher or trainee (two of the last six years), foreign government-related individual, or professional athlete in a charitable event do not count toward substantial presence. Also excluded: days a person could not leave because of a medical condition that arose in the U.S., and days in transit under 24 hours.

- **Closer connection exception.** Even if the 183-day formula is met, an individual present fewer than 183 days in the current year with a tax home in and closer connection to a foreign country may claim nonresident status on Form 8840.
- **Dual-status year.** In the year of arrival or departure, the taxpayer may be a resident for part of the year and a nonresident for the rest. A dual-status taxpayer cannot use the standard deduction or file jointly, unless an election is made.
- **Nonresident spouse election.** A U.S. citizen or resident married to a nonresident may elect under section 6013(g) to treat the spouse as a resident for the whole year and file jointly, which brings the spouse's worldwide income into the return.

Memory cue. “Thirty-one now, one-eighty-three weighted; all, a third, a sixth.”

1.4 Who must file, and when

The rule. A return is required when gross income reaches the filing threshold for the taxpayer's filing status and age, when net self-employment earnings are \$400 or more, or when a special tax or situation applies regardless of income. Gross income means all income not exempt from tax, including worldwide income and the full gain on a home sale even if excludable.

2025 filing requirement chart (most taxpayers).

Filing status	Age at end of 2025	File if gross income is at least
Single	Under 65	\$15,750
Single	65 or older	\$17,750
Head of household	Under 65	\$23,625
Head of household	65 or older	\$25,625
Married filing jointly	Both under 65	\$31,500
Married filing jointly	One spouse 65 or older	\$33,100
Married filing jointly	Both 65 or older	\$34,700
Married filing separately	Any age	\$5
Qualifying surviving spouse	Under 65	\$31,500
Qualifying surviving spouse	65 or older	\$33,100

A taxpayer born before January 2, 1961 is 65 at the end of 2025. Blindness does not raise the filing threshold, although it does raise the standard deduction.

Dependents have their own chart. A single dependent under 65 and not blind must file if unearned income exceeds \$1,350, earned income exceeds \$15,750, or gross income exceeds the larger of \$1,350 or earned income (up to \$15,300) plus \$450.

Must file regardless of income if any of the following apply: net self-employment earnings of \$400 or more; church employee income of \$108.28 or more; owe special taxes such as the alternative minimum tax, household employment taxes, additional tax on an IRA or HSA, uncollected Social Security or Medicare tax on tips, or the first-time homebuyer credit repayment; received advance premium tax credit payments; or had wages of \$5 or more while married filing separately from a spouse who itemizes.

Worked example. Carlos, single and 34, earned \$14,900 in wages and \$300 in bank interest in 2025. Gross income is \$15,200, below \$15,750, so he is not required to file. If he also had \$450 of net earnings from a weekend side business, he must file because self-employment earnings are at least \$400, even though the income total is still below the chart.

Exam trap. “Gross income” for the filing test includes the gross amount of a home sale and gross business receipts, not net. A taxpayer who sold a home for \$300,000 that qualifies for the full section 121 exclusion still has \$300,000 of gross income for the filing-requirement test, although the gain is excluded on the return.

Due dates for the 2025 return.

Event	Date
Form 1040 due	April 15, 2026
Automatic six-month extension (Form 4868)	October 15, 2026
Automatic two-month extension for citizens/residents living and working abroad or on military duty abroad on April 15	June 15, 2026 (interest still runs from April 15)
Estimated tax installments	April 15, June 15, September 15, 2026; January 15, 2027
Gift tax return (Form 709)	April 15, 2026 (extended with the income tax return)
FBAR (FinCEN Form 114)	April 15, 2026, automatic extension to October 15

An extension to file is never an extension to pay. Tax not paid by April 15 accrues interest and the failure-to-pay penalty. A taxpayer in a combat zone or contingency operation receives at least 180 days after leaving the zone to file and pay.

1.5 Filing status

Filing status drives the standard deduction, the tax brackets, and eligibility for most credits. Marital status is determined on the last day of the year; a taxpayer whose spouse died during the year is treated as married for the whole year.

The rule. There are five statuses. Choose the most favorable one the taxpayer qualifies for, in this order of preference: married filing jointly or qualifying surviving spouse, then head of household, then single or married filing separately.

Status	Core requirements	2025 standard deduction
Single	Unmarried (or legally separated under a decree) on December 31 and not qualifying for another status	\$15,750
Married filing jointly (MFJ)	Married on December 31, or spouse died during 2025 and the survivor did not remarry; both spouses sign and are jointly and severally liable	\$31,500
Married filing separately (MFS)	Married; each spouse reports own income; if one itemizes, both must	\$15,750
Head of household (HOH)	Unmarried or “considered unmarried” on December 31; paid more than half the cost of keeping up a home that was the main home of a qualifying person for more than half the year	\$23,625
Qualifying surviving spouse (QSS)	Spouse died in 2023 or 2024; did not remarry; has a dependent child or stepchild who lived in the home all year; paid more than half the cost of the home	\$31,500

Head of household in detail.

- **Considered unmarried.** A married person may file HOH if all of these are true: files a separate return, paid more than half the cost of the home, the spouse did not live in the home during the last six months of the year, the home was the main home of the taxpayer’s child, stepchild, or foster child for more than half the year, and the taxpayer can claim the child as a dependent (or could but for the release to the noncustodial parent).
- **Qualifying person.** A qualifying child, or a qualifying relative who is related to the taxpayer (not someone who qualifies only by living in the household all year). A dependent parent is the one qualifying person who does not need to live with the taxpayer, provided the taxpayer pays more than half the cost of the parent’s home, including a nursing home.
- **Cost of keeping up a home** includes rent, mortgage interest, property taxes, insurance, repairs, utilities, and food eaten in the home. It does not include clothing, education, medical care, vacations, life insurance, transportation, or the rental value of a home the taxpayer owns.

- A nonresident alien spouse does not prevent HOH status if the taxpayer otherwise qualifies with a qualifying person other than that spouse.

Qualifying surviving spouse in detail. The year of death is filed MFJ. The next two years may be QSS if the surviving spouse has a dependent child living in the home all year and does not remarry. After that, the survivor usually qualifies for HOH.

Worked example. David's cousin Ana's husband died in March 2024. She has not remarried and her 10-year-old son lives with her. For 2024 she files MFJ. For 2025 and 2026 she may file as a qualifying surviving spouse. In 2027, if the son still lives with her, she files head of household.

Worked example. Carlos is single and pays all the costs of the apartment he shares with his girlfriend, who lived with him all of 2025 and earned \$3,000. She is his qualifying relative (member of household all year, gross income under \$5,200, more than half support). He may claim her as a dependent and take the \$500 credit for other dependents, but he cannot file as head of household, because a person who qualifies only through the member-of-household test is not a qualifying person for HOH.

Memory cue. "HOH needs a relative; a roommate-dependent is not enough." And "Death gives one joint year and two surviving-spouse years."

Exam trap. A married taxpayer whose spouse moved out in August cannot be "considered unmarried," because the spouse lived in the home during the last six months of the year. The status is MFS (or MFJ if both agree), not HOH.

1.6 Dependents: qualifying child and qualifying relative

Dependency drives the child tax credit, the credit for other dependents, head of household status, the earned income credit, the dependent care credit, and medical expense deductions. The exam tests the two sets of rules side by side, and this table is the most important one in the chapter.

The rule. Every dependent must pass three threshold tests: the taxpayer cannot be a dependent of someone else (dependent taxpayer test), the dependent cannot file a joint return except solely to claim a refund of withheld or estimated tax (joint return test), and the dependent must be a U.S. citizen, U.S. national, or resident of the U.S., Canada, or Mexico (citizen or resident test). Then the person must be either a qualifying child or a qualifying relative.

Test	Qualifying child	Qualifying relative
Relationship	Son, daughter, stepchild, eligible foster child, brother, sister, half- or step-sibling, or a descendant of any of them	Any of the qualifying-child relatives plus parents, grandparents, aunts, uncles, nieces, nephews, and in-laws; or any person who lived in the taxpayer's household all year
Age	Under 19 at year end, or under 24 and a full-time student for any part of five months, or any age if permanently and totally disabled; must be younger than the taxpayer (unless disabled)	No age test
Residency	Lived with the taxpayer more than half the year (temporary absences for school, illness, military service, and vacation count as living at home)	Only for the "any person" category: all year
Support	Child did not provide more than half of his or her own support (scholarships are not counted)	Taxpayer provided more than half of the person's support
Gross income	No test	Less than \$5,200 for 2025 (tax-exempt income such as nontaxable Social Security does not count)
Not a qualifying child	—	Cannot be the qualifying child of the taxpayer or of anyone else

Worked example. Maria's mother, Rosa, 72, lives with the Lopezes. She received \$14,000 of Social Security, none of it taxable, and \$1,900 of bank interest. Her gross income for the test is \$1,900, below \$5,200. The Lopezes paid \$11,000 toward her support; Rosa spent \$8,000 of her own money on herself. They provided more than half, so Rosa is their qualifying relative. She qualifies them for the \$500 credit for other dependents, not the child tax credit.

Worked example. Mateo Lopez, 16, earned \$6,000 at a summer job and spent all of it on a car. His parents spent \$12,000 supporting him. He did not provide more than half of his own support (\$6,000 of \$18,000), so he remains a qualifying child. The gross income test does not apply to a qualifying child, so his \$6,000 of wages is irrelevant.

Tie-breaker rules. When a child is the qualifying child of more than one person and they cannot agree, the child is treated as the qualifying child of: the parent; if both are parents who do not file jointly, the parent with whom the child lived longer during the year; if the same, the parent with the higher AGI; if no parent claims the child, the person with the highest AGI; and a non-parent may claim the child only if that person's AGI is higher than any parent's AGI.

Children of divorced or separated parents. The custodial parent (the one with whom the child spent more nights) is treated as the parent entitled to the child. The custodial parent may release the exemption to the noncustodial parent on **Form 8332**, which transfers the child tax credit and the credit for other dependents only. Head of household status, the earned income credit, the dependent care credit, and the exclusion for dependent care benefits always stay with the custodial parent.

Multiple support agreements (Form 2120). When no single person provides more than half of a relative's support but a group together does, any member who provided more than 10% may claim the dependent if every other member who provided more than 10% signs a waiver.

Memory cue. For the qualifying child, “the child cannot pay for himself.” For the qualifying relative, “you must pay for her.” The direction of the support test flips.

Exam trap. A 20-year-old who is not a student and earned \$8,000 cannot be a qualifying child (age) or a qualifying relative (gross income is \$5,200 or more). A 20-year-old full-time student who earned \$8,000 and lived at home can be a qualifying child because the gross income test does not apply to a qualifying child. The exam swaps those two facts constantly.

1.7 Mapping sources of income, adjustments, deductions, credits, and payments

The outline expects you to recognize where each item lives on the return. Think of Form 1040 as a staircase.

Step	What goes here	Common sources
Gross income	Everything taxable	W-2 wages, 1099-INT interest, 1099-DIV dividends, 1099-R retirement distributions, 1099-NEC/1099-K/Schedule C business income, Schedule E rents and K-1 pass-through income, Schedule D gains, taxable Social Security, alimony from pre-2019 agreements, unemployment
Exclusions (never reach the return)	Statutorily tax-free	Gifts and inheritances, life insurance proceeds, municipal bond interest, child support, workers' compensation, qualified scholarships, employer health insurance, combat pay, foreign earned income exclusion (Form 2555)

Step	What goes here	Common sources
Adjustments (Schedule 1, Part II)	“Above the line,” reduce AGI	Educator expenses, HSA contributions, half of self-employment tax, self-employed health insurance, SEP/SIMPLE/qualified plan contributions, IRA deduction, student loan interest, alimony paid under pre-2019 agreements, moving expenses for active-duty military, penalty on early withdrawal of savings
Deductions (from AGI)	Standard or itemized, plus QBI	Schedule A: medical, taxes, interest, charity, casualty; Form 8995: 20% QBI deduction
New 2025 deductions (Schedule 1-A)	Available whether or not the taxpayer itemizes	Qualified tips, qualified overtime, car loan interest, enhanced deduction for seniors
Tax and other taxes	Regular tax, AMT, SE tax, NIIT, Additional Medicare Tax, household employment tax, early-distribution penalties	Form 6251, Schedule SE, Form 8960, Form 8959, Schedule H, Form 5329
Nonrefundable credits	Reduce tax to zero but not below	Child tax credit, credit for other dependents, dependent care credit, education credits (LLC and 60% of AOTC), foreign tax credit, saver’s credit, adoption credit (nonrefundable part), residential energy credits
Payments and refundable credits	Can create a refund	Withholding, estimated payments, extension payment, earned income credit, additional child tax credit, 40% of AOTC, premium tax credit, refundable adoption credit (up to \$5,000), excess Social Security withholding

New for 2025. The One Big Beautiful Bill Act created four deductions claimed on new Schedule 1-A: up to \$25,000 of qualified tips, up to \$12,500 (\$25,000 MFJ) of qualified overtime premium pay, up to \$10,000 of interest on a loan for a new U.S.-assembled personal-use vehicle, and a \$6,000 enhanced deduction for each spouse age 65 or older. They are available to both itemizers and non-itemizers, but they are deductions from AGI, not adjustments to AGI, so they do not lower AGI-based phaseouts. Details appear in Chapter 3.

1.8 Additional returns the interview should surface

Situation	Return	Threshold or trigger
Household employee paid cash wages	Schedule H with Form 1040	\$2,800 or more in 2025 to any one employee (Social Security and Medicare); \$1,000 or more in any calendar quarter (FUTA)
Gifts to one person above the annual exclusion	Form 709	More than \$19,000 to any donee in 2025; any gift of a future interest; any gift-splitting election
Foreign financial accounts	FinCEN Form 114 (FBAR)	Aggregate value exceeded \$10,000 at any time during the year
Specified foreign financial assets	Form 8938 with Form 1040	Unmarried in U.S.: more than \$50,000 on December 31 or \$75,000 at any time; MFJ in U.S.: \$100,000 / \$150,000; living abroad: \$200,000 / \$300,000 single, \$400,000 / \$600,000 MFJ
Gifts from foreign persons or foreign trust dealings	Form 3520	More than \$100,000 from a nonresident alien or foreign estate; more than \$19,570 from foreign corporations or partnerships (2025)
Ownership in foreign corporations	Form 5471	Officer, director, or 10%-or-more shareholder in certain situations
Business payments to nonemployees	Form 1099-NEC	\$600 or more paid in the course of a trade or business
Cash received in a trade or business	Form 8300	More than \$10,000 in one transaction or related transactions

1.9 Special filing situations

Presidentially declared disaster areas. The IRS postpones filing and payment deadlines for affected taxpayers. Personal casualty losses are deductible only for federally declared disasters, and a taxpayer may elect to deduct a disaster loss on the prior-year return (by amending) to get the refund sooner. Qualified disaster losses have a \$500 per-casualty floor and no 10%-of-AGI floor.

Injured spouse (Form 8379). When a joint refund will be applied to one spouse's past-due federal tax, state tax, child support, or federal nontax debt such as a student loan, the other spouse may file Form 8379 to recover his or her share of the refund. This is a refund-allocation form, not a liability-relief form. It can be filed with the return or afterward.

Innocent spouse (Form 8857). Relief from joint and several liability for tax understatements attributable to the other spouse. Covered in Chapter 5.

Taxpayers abroad. Worldwide income is still reported. Form 2555 (foreign earned income exclusion), Form 1116 (foreign tax credit), and the June 15 automatic extension apply.

Exam trap. Injured spouse and innocent spouse are different problems. Injured spouse: “the refund was taken for my spouse’s old debt.” Innocent spouse: “the IRS says we owe more because of my spouse’s unreported income.” The forms are 8379 and 8857, respectively.

1.10 The kiddie tax

The rule. A child’s unearned income above \$2,700 (2025) is taxed at the parents’ marginal rate if the child is under 18, or is 18 with earned income that does not exceed half of his or her support, or is 19 to 23, a full-time student, and has earned income that does not exceed half of support. At least one parent must be alive at year end, and the child must not file a joint return. The tax is computed on **Form 8615**, attached to the child’s return.

How the first \$2,700 is treated. The first \$1,350 is sheltered by the child’s standard deduction. The next \$1,350 is taxed at the child’s own rate. Only unearned income above \$2,700 goes to the parents’ rate. Earned income is always taxed at the child’s rate.

Worked example. Sofia Lopez, 8, has \$4,200 of dividends from a custodial account and no earned income. First \$1,350: standard deduction, no tax. Next \$1,350: taxed at Sofia’s 10% rate, \$135. Remaining \$1,500: taxed at Maria and David’s 22% rate, \$330. Total tax \$465.

Parent’s election (Form 8814). Instead of filing a return for the child, parents may report the child’s income on their own return if the child’s gross income consists only of interest, dividends, and capital gain distributions, was more than \$1,350 but less than \$13,500, no estimated payments or withholding were made in the child’s name, and no backup withholding applied. The election can increase the parents’ AGI and reduce AGI-based benefits, so it is not always wise.

Memory cue. “Thirteen-fifty, thirteen-fifty, then Mom and Dad.” Standard deduction, child’s rate, parents’ rate.

1.11 Affordable Care Act data

A taxpayer who enrolled in Marketplace coverage receives **Form 1095-A** and must reconcile advance premium tax credit (APTC) on **Form 8962**. The interview must capture household income (the taxpayer’s MAGI plus the MAGI of every dependent required to file), family size, and months of coverage for each person. Household income is compared to the federal poverty line for the family size to determine the applicable percentage of income the family is expected to pay toward the benchmark plan.

Key 2025 facts: the enhanced subsidy rules remain in effect for 2025, so taxpayers with household income above 400% of the federal poverty line may still qualify for a credit; repayment of excess APTC is capped for households below 400% of the poverty line and uncapped above it. Married taxpayers must file jointly to claim the credit, with an exception for victims of domestic abuse or spousal abandonment. A taxpayer who received APTC must file a return even if income is below the filing threshold.

Not on your exam. The enhanced premium tax credit percentages expire after 2025, and repayment limitations are removed for tax years beginning after December 31, 2025. Those are 2026 changes. For 2025 questions, use the enhanced rules described above.

Quick Check: Chapter 1

1. Lena, 30 and single, had \$15,400 of wages and \$500 of interest in 2025. She also had \$350 of net earnings from selling crafts online. Must she file a 2025 return?
 - A. No, her gross income is below \$15,750.
 - B. Yes, because her self-employment earnings exceed \$400.
 - C. Yes, because her gross income is at least \$15,750.
 - D. No, because interest is excluded from gross income for the filing test.
2. Which taxpayer may file as head of household for 2025?
 - A. Tom, married, whose wife moved out in September 2025 and whose son lives with him.
 - B. Rita, unmarried, who paid more than half the cost of her father's nursing home; her father is her dependent and does not live with her.
 - C. Sam, unmarried, who supports his girlfriend who lived with him all year and had no income.
 - D. Kim, whose husband died in 2025 and who has a dependent child at home.
3. Which person is a qualifying relative of Pat for 2025, assuming Pat provided more than half of each person's support?
 - A. Pat's 22-year-old son, a full-time student, who lived with Pat all year.
 - B. Pat's 68-year-old mother who lives in her own apartment and had \$5,400 of taxable pension income.
 - C. Pat's 40-year-old cousin who lived with Pat all year and had \$4,000 of wages.
 - D. Pat's 17-year-old niece who lived with Pat for four months and had no income.
4. Jorge, a citizen of Argentina, was present in the United States 150 days in 2025, 60 days in 2024, and 60 days in 2023. He holds no green card. For 2025 he is:
 - A. A resident alien under the substantial presence test.
 - B. A nonresident alien because the weighted total is below 183 days.
 - C. A dual-status alien.
 - D. A resident alien because he was present more than 120 days in 2025.

5. Nina, age 12, has \$3,900 of interest income and no earned income in 2025. Her parents are in the 24% bracket. How much of Nina's income is taxed at her parents' rate?
- A. \$0
 - B. \$1,200
 - C. \$2,550
 - D. \$3,900
6. Which carryover item would a preparer **not** find on a prior-year return?
- A. Capital loss carryover.
 - B. Charitable contribution carryover.
 - C. Standard deduction carryover.
 - D. Minimum tax credit carryforward.
7. The custodial parent signs Form 8332 releasing the claim to their child to the noncustodial parent for 2025. Which benefit moves to the noncustodial parent?
- A. Head of household filing status.
 - B. Earned income credit.
 - C. Child tax credit.
 - D. Child and dependent care credit.
8. A joint refund is applied to the husband's past-due child support from a prior relationship. Which form does the wife use to recover her share?
- A. Form 8857
 - B. Form 8379
 - C. Form 8862
 - D. Form 2120

Answers.

1. C. Wages of \$15,400 plus interest of \$500 equal \$15,900 of gross income, which is at least the \$15,750 threshold for a single filer under 65, so she must file. Her self-employment earnings (\$350) are below \$400, so B states the wrong reason even though its conclusion is right; on this exam the reason matters. Interest is included in gross income, so D is wrong.

2. B. A dependent parent is the only qualifying person who need not live with the taxpayer. Tom's wife lived in the home during the last six months, so he is not considered unmarried. Sam's girlfriend qualifies only under the member-of-household test, which does not support HOH. Kim files MFJ for 2025, the year of death.

3. C. The cousin is not on the relationship list but lived with Pat all year, had gross income under \$5,200, and Pat provided more than half the support. The son is a qualifying child, so he cannot be a qualifying relative. The mother's gross income is \$5,400, which fails the test. The niece did not live with Pat all year and is not a qualifying child because she did not live with Pat more than half the year.

- 4. B.** Weighted days: $150 + (60 \div 3 = 20) + (60 \div 6 = 10) = 180$, which is below 183. He meets the 31-day test but fails the 183-day test, so he is a nonresident alien. Work the arithmetic every time; D describes a test that does not exist.
- 5. B.** $\$3,900 - \$2,700 = \$1,200$ taxed at the parents' rate. The first \$1,350 is sheltered by the standard deduction and the next \$1,350 is taxed at Nina's rate.
- 6. C.** The standard deduction is an annual amount and never carries over.
- 7. C.** Form 8332 moves only the child tax credit and the credit for other dependents. Head of household status, the earned income credit, and the dependent care credit stay with the custodial parent.
- 8. B.** Form 8379, Injured Spouse Allocation. Form 8857 is innocent spouse relief; Form 8862 reclaims a disallowed EITC or other credit; Form 2120 is the multiple support declaration.

Chapter 2. Income and Assets

Domain 2 • 17 scored questions (20%)

What the outline tests, in four groups: **Income** (wages, interest, dividends, rentals, gambling, cancellation of debt, foreign income, other income, constructive receipt, passive and pass-through income, royalties, recoveries, information-return irregularities); **Retirement income** (IRA basis, traditional versus Roth, distributions, penalties and exceptions, conversions, RMDs, plan loans, Social Security, inherited accounts, foreign pensions); **Property** (sales and recapture, capital gains netting, basis, home sale exclusion, installment sales, options, like-kind exchanges, bad debts, investor versus trader); and **Adjustments to income** (self-employment tax, retirement contributions, HSAs, student loan interest, alimony, military moving expenses, self-employed health insurance).

This is the largest domain and the one where candidates lose the most points, usually on basis and on retirement distributions. The organizing idea is simple: **everything is income unless the Code says it is not**, and every asset has a **basis** that determines gain.

Part A: Income

2.1 Wages, salaries, and fringe benefits

The rule. All compensation for services is gross income when received, in whatever form: cash, property at fair market value, services, forgiven debts, or bonuses. Form W-2 box 1 reports taxable wages; boxes 3 and 5 report Social Security and Medicare wages, which can differ because pre-tax 401(k) deferrals reduce box 1 but not boxes 3 and 5.

Excluded fringe benefits (2025 amounts).

Benefit	Exclusion
Employer-paid health, dental, vision insurance; HSA contributions	Fully excluded
Group-term life insurance	Cost of first \$50,000 of coverage excluded; cost of excess coverage is taxable
Dependent care assistance	Up to \$5,000 (\$2,500 MFS)
Educational assistance (section 127), including student loan payments	Up to \$5,250
Adoption assistance	Up to \$17,280, subject to the same phaseout as the adoption credit

Benefit	Exclusion
Qualified transportation (transit pass or parking)	Up to \$325 per month for each
Employee achievement awards (tangible property, length of service or safety)	\$400 nonqualified plan; \$1,600 qualified plan
No-additional-cost services, qualified employee discounts, working condition fringes, de minimis fringes	Excluded under their own rules
Meals and lodging on the employer's premises for the employer's convenience	Excluded; lodging must also be a condition of employment

Tips. All tips are taxable income, including cash and noncash tips and tips shared through pools. An employee who receives \$20 or more in tips in a month must report them to the employer by the 10th of the next month; tips not reported to the employer are reported on **Form 4137**, which also computes the employee's Social Security and Medicare tax on them. Allocated tips (W-2 box 8) are included in income unless the employee has records showing lower actual tips.

New for 2025. The deduction for qualified tips (up to \$25,000) does not change what is income. Tips are still reported as wages. The deduction is taken separately on Schedule 1-A. See Chapter 3.

Worked example. Carlos received \$18,000 of wages and \$9,000 of tips in 2025. His gross income from the job is \$27,000; all tips are included. Separately, he may qualify for a Schedule 1-A deduction for the \$9,000 of qualified tips if his occupation is on the IRS tipped-occupation list.

2.2 Interest income

The rule. Interest is taxable when received or credited to the account, including interest on bank accounts, certificates of deposit, corporate and U.S. Treasury obligations, and tax refunds. Interest on state and local government bonds is excluded from federal income but still reported on the return (Form 1040, line 2a) because it affects the taxation of Social Security benefits and some phaseouts.

Type	Federal income tax	Note
Bank, CD, corporate bond interest	Taxable	Form 1099-INT if \$10 or more
U.S. Treasury bills, notes, bonds, savings bonds	Taxable federally	Exempt from state income tax
State and municipal bonds	Excluded	Reported as tax-exempt interest; private activity bond interest is an AMT preference
Series EE or I bonds used for higher education (Form 8815)	Excluded if requirements met	Bond owner at least 24 at issue; 2025 phaseout MAGI \$99,500–\$114,500 single, \$149,250–\$179,250 MFJ

Type	Federal income tax	Note
Original issue discount	Taxable as it accrues	Form 1099-OID
Interest on a federal or state tax refund	Taxable	Even if the refund itself is not
Dividends on deposits at credit unions	Taxable as interest	Despite the “dividend” label
Interest forfeited for early CD withdrawal	Deducted as an adjustment to income	Full interest reported; penalty on Schedule 1

Imputed interest on below-market loans. A gift loan over \$10,000 with no or low interest is treated as if the lender received interest at the applicable federal rate, then gave the money back to the borrower. For gift loans of \$100,000 or less, the imputed interest is limited to the borrower’s net investment income, and it is zero if that income is \$1,000 or less.

2.3 Dividends and distributions

The rule. Ordinary dividends are taxed at ordinary rates. **Qualified dividends** are taxed at the 0%, 15%, or 20% long-term capital gain rates if the stock was held more than 60 days during the 121-day period that begins 60 days before the ex-dividend date. Capital gain distributions from mutual funds are always long-term. Nondividend distributions (return of capital) are not taxed; they reduce basis, and any amount above basis is capital gain.

Form 1099-DIV box	Item	Treatment
1a	Total ordinary dividends	Ordinary income (line 3b)
1b	Qualified dividends (part of 1a)	Capital gain rates (line 3a)
2a	Capital gain distributions	Long-term capital gain on Schedule D (or line 7)
3	Nondividend distributions	Reduce basis; excess is capital gain
7	Foreign tax paid	Foreign tax credit or deduction

Dividends reinvested through a dividend reinvestment plan are still taxable in the year paid and add to basis. Dividends on a life insurance policy are a return of premium and not taxable until they exceed total premiums paid. Stock dividends and stock splits are generally not taxable; they spread the existing basis over more shares.

Worked example. Maria owns 100 shares bought for \$5,000. The company pays a \$300 nondividend distribution. Maria reports no income; her basis becomes \$4,700. If instead the company declares a 2-for-1 split, she holds 200 shares with basis of \$25 each.

Memory cue. “Sixty days around the ex-date makes a dividend qualified.” The full window is 121 days.

2.4 Rental income and personal property rental

The rule. Rental income from real estate is reported on Schedule E and includes advance rent in the year received, security deposits the landlord keeps, expenses paid by the tenant, and the fair market value of services received in lieu of rent. A refundable security deposit is not income while the landlord intends to return it. Rental of personal property (equipment, a vehicle) that is not a business is reported as other income on Schedule 1, with expenses as a write-in adjustment; if it is a business, it goes on Schedule C.

Vacation home rules (dwelling unit used personally).

Situation	Treatment
Rented fewer than 15 days during the year	Rental income is not reported; no rental expenses are deductible (mortgage interest and taxes may still be itemized)
Personal use not more than the greater of 14 days or 10% of rental days	Treated as rental property; expenses allocated between rental and personal days; rental loss allowed subject to passive loss rules
Personal use more than the greater of 14 days or 10% of rental days	Treated as a residence; rental deductions limited to rental income (no loss); excess carries forward

Personal use includes use by family members and use by anyone paying less than fair rent. Days spent repairing and maintaining the property do not count as personal days.

Depreciation. Residential rental property is depreciated straight-line over 27.5 years; nonresidential real property over 39 years; land is never depreciated. Depreciation allowed or allowable reduces basis even if the taxpayer failed to claim it.

Passive activity rules for rentals. Rental activities are passive by definition, so losses offset only passive income, with two exceptions. First, a taxpayer who **actively participates** (makes management decisions such as approving tenants and repairs) may deduct up to \$25,000 of rental real estate loss against nonpassive income; the allowance phases out by 50 cents per dollar of MAGI between \$100,000 and \$150,000 and is \$12,500 with a \$50,000–\$75,000 phaseout for MFS living apart, zero for MFS living together. Second, a **real estate professional**, who spends more than 750 hours and more than half of all personal service hours in real property trades or businesses in which he or she materially participates, treats rentals as nonpassive. Suspended losses are released in full when the entire interest is sold to an unrelated party in a taxable transaction (Form 8582).

Worked example. The Lopezes own a rental house. In 2025, rent received was \$18,000, expenses were \$14,000, and depreciation was \$9,000, producing a \$5,000 loss. David approves tenants and arranges repairs, so he actively participates. Their MAGI is \$120,000. The \$25,000 allowance is reduced by 50% of $(\$120,000 - \$100,000) = \$10,000$, leaving \$15,000, which is more than enough. They deduct the full \$5,000 loss. If their MAGI were \$150,000 or more, the allowance would be zero and the \$5,000 would be suspended.

Exam trap. The 14-day rule has two sides. Renting the home fewer than 15 days means no income and no expenses. Using it personally more than 14 days (or 10%) means income is reported but losses are capped. The exam tests which side applies.

2.5 Gambling income

All gambling winnings are gross income: lotteries, raffles, casinos, sports betting, and the fair market value of noncash prizes. Form W-2G reports winnings above thresholds (for example \$1,200 from bingo or slots, \$1,500 from keno, \$5,000 from poker tournaments, and \$600 or more if at least 300 times the wager for most other gambling), but income is taxable whether or not a W-2G is issued. For 2025, gambling **losses** are deductible only as an itemized deduction on Schedule A and only up to the amount of winnings reported; losses cannot create a net loss, and a taxpayer who takes the standard deduction gets no benefit from losses. Taxpayers should keep a diary of dates, locations, amounts won and lost, and names of others present, plus tickets and statements. A professional gambler reports on Schedule C, but losses and expenses are still limited to winnings.

Not on your exam. For tax years beginning after December 31, 2025, the deduction for gambling losses is limited to 90% of losses, still capped at winnings. For 2025, the limit is 100% of losses up to winnings.

2.6 Cancellation of debt

The rule. When a lender forgives debt, the forgiven amount is ordinary income to the borrower (Form 1099-C) unless an exclusion applies. Exclusions, claimed on **Form 982** in this order of priority, are: discharge in a title 11 bankruptcy case; discharge while **insolvent**, to the extent liabilities exceeded the fair market value of assets immediately before the discharge; qualified farm indebtedness; qualified real property business indebtedness; and **qualified principal residence indebtedness** of up to \$750,000 for discharges before January 1, 2026. Excluded amounts generally reduce tax attributes such as NOLs, credits, and basis.

Debt situation	Result
Credit card balance of \$12,000 settled for \$7,000	\$5,000 COD income unless an exclusion applies
Discharge in bankruptcy	Excluded in full
Insolvent by \$3,000 when \$5,000 is forgiven	\$3,000 excluded; \$2,000 taxable
Price reduction by the seller on purchased property	Not income; reduces basis of the property
Debt forgiven as a gift (for example, by a family member)	Not income; a gift
Student loan discharged for death or disability	Excluded (made permanent); other student loan discharges excluded through 2025 under the American Rescue Plan rule
Debt discharged that would have been deductible if paid (for example, business interest by a cash-basis taxpayer)	Not income

Foreclosures and repossessions (Form 1099-A and 1099-C). A foreclosure is treated as a sale. With **nonrecourse** debt, the amount realized is the full debt balance and there is no COD income. With **recourse** debt, the amount realized is the lesser of the debt or fair market value, producing gain or loss on the property, and any debt forgiven above fair market value is separate COD income.

Worked example. Carlos owed \$9,000 on a credit card. The bank accepted \$6,000 in full settlement and issued a 1099-C for \$3,000. Immediately before the settlement, Carlos had assets of \$20,000 and liabilities of \$22,000, so he was insolvent by \$2,000. He excludes \$2,000 and reports \$1,000 of COD income.

Memory cue. “Bankrupt beats insolvent beats the house.” That is the ordering of the exclusions, and insolvency is limited to the amount by which the taxpayer is underwater.

2.7 Foreign income of a U.S. citizen or resident

The rule. U.S. citizens and residents report worldwide income. To relieve double taxation, the taxpayer may (1) exclude foreign earned income on **Form 2555**, up to \$130,000 for 2025, plus a housing exclusion or deduction, or (2) claim a **foreign tax credit** on **Form 1116** for income taxes paid to a foreign country, or deduct those taxes on Schedule A. The exclusion and the credit cannot both be used on the same income.

Foreign earned income exclusion requirements. The taxpayer must have a **tax home** in a foreign country and meet either the **bona fide residence test** (resident of a foreign country for an uninterrupted period that includes an entire tax year, for U.S. citizens and treaty-country residents) or the **physical presence test** (present in a foreign country or countries for at least 330 full days during any 12 consecutive months). Earned income means wages and self-employment income for services; it excludes pensions, dividends, interest, and amounts paid by the U.S. government to its employees. The exclusion is prorated for a partial year, and income that is excluded still pushes the remaining income into higher brackets (the “stacking” rule).

Foreign tax credit. Limited to the U.S. tax attributable to foreign-source income, computed separately by income category. A taxpayer with \$300 or less of creditable foreign taxes (\$600 MFJ), all from passive income reported on payee statements, may claim the credit directly without Form 1116. Unused credit carries back one year and forward ten.

Information returns. Form 3520 reports transactions with foreign trusts and large foreign gifts; Form 5471 reports interests in foreign corporations; Form 8938 reports specified foreign financial assets. Chapter 6 covers these in depth. Tax treaties may reduce or exempt certain income; treaty positions are disclosed on Form 8833.

Worked example. Priya spent all of 2025 working in Singapore, meeting the physical presence test, and earned \$150,000 in salary plus \$4,000 of U.S. dividends. She may exclude \$130,000 of salary on Form 2555. The remaining \$20,000 of salary and the \$4,000 of dividends are taxable, with the tax computed as if the excluded income were still in the brackets. She cannot also claim a foreign tax credit for Singapore tax paid on the excluded \$130,000, but she may claim one for Singapore tax on the taxable \$20,000.

2.8 Other income: what is taxable and what is not

Item	Taxable?	Note
Scholarship used for tuition, required fees, books, supplies, and equipment by a degree candidate	No	Amounts for room, board, travel, or payment for teaching or research services are taxable
Barter	Yes	Fair market value of goods or services received; Form 1099-B from barter exchanges
Hobby income	Yes	Reported as other income; hobby expenses are not deductible for 2025
Alimony received under a divorce or separation instrument executed before 2019	Yes	Payer deducts; recipient includes. Instruments executed after 2018 (or modified to adopt the new rule): neither deductible nor includible
Child support	No	Never income, never deductible
Unemployment compensation	Yes	Form 1099-G
Jury duty pay	Yes	If turned over to employer, deduct as an adjustment
Prizes and awards	Yes	Fair market value; exception for certain employee achievement awards
Combat pay	No	Excluded, but may be elected into earned income for the EITC
Life insurance death benefits	No	Interest earned on proceeds left with the insurer is taxable
Gifts and inheritances	No	Income later earned on the property is taxable
Workers' compensation	No	For occupational sickness or injury
Damages for physical injury or sickness	No	Punitive damages, lost wages in non-physical cases, and interest are taxable
Social Security benefits	Up to 85%	See section 2.18
Recovery of an amount deducted in a prior year (for example, a state tax refund)	Yes, to the extent of the tax benefit	See section 2.11
Net operating loss carried in from a prior year	Reduces income	Negative other income, limited to 80% of taxable income
Illegal income	Yes	Embezzlement, drug sales, and bribes are gross income
Cash rebates on purchases	No	Reduce the cost basis of the item

Item	Taxable?	Note
Accident and health insurance benefits	Generally no	Taxable if the employer paid the premiums and the benefits replace wages

Exam trap. On alimony the date of the instrument controls, not the date of payment. A 2017 divorce decree paid in 2025 produces taxable alimony. A 2020 decree paid in 2025 does not.

2.9 Constructive receipt and constructive dividends

Constructive receipt. A cash-basis taxpayer has income when an amount is credited to the account, set apart, or made available without substantial restriction, even if not physically received. A paycheck available on December 31 is 2025 income even if picked up in January. Interest credited to a savings account in December is 2025 income. By contrast, a bonus the employer does not make available until January is not income until January, and a check received December 31 after the bank closed is still 2025 income because it was received.

Constructive dividends. When a corporation pays a shareholder's personal expenses, lets the shareholder use corporate property rent-free, sells property to the shareholder below market, or pays unreasonable compensation to a shareholder-employee, the benefit is a dividend to the shareholder (taxable to the extent of earnings and profits) and is not deductible by the corporation.

2.10 Passive income and pass-through income

Passive activities. A passive activity is a trade or business in which the taxpayer does not **materially participate**, and any rental activity (subject to the exceptions in section 2.4). Material participation is met under any of seven tests, the most common being more than 500 hours during the year, or substantially all participation in the activity, or more than 100 hours and not less than anyone else. Passive losses offset only passive income; the excess is suspended and carried forward on Form 8582, and released when the entire interest is disposed of in a fully taxable transaction. Portfolio income (interest, dividends, royalties, gains on investment property) is **not** passive income and cannot absorb passive losses.

Schedule K-1 income. Partners and S corporation shareholders report their share of income, deductions, and credits whether or not cash is distributed. Distributions themselves are generally tax-free up to basis. Losses are deductible only to the extent of (1) basis, then (2) amounts at risk (Form 6198), then (3) the passive activity rules, in that order. The K-1 also reports qualified business income items used in the 20% QBI deduction, section 179 deductions, and separately stated items such as charitable contributions and capital gains that keep their character on the owner's return.

Publicly traded partnerships. A loss from a PTP may offset only income from the same PTP. It cannot offset income from other passive activities, and it is suspended until that PTP generates income or the interest is sold.

Worked example. Priya invested in a limited partnership that reported a \$4,000 loss on her K-1. She did not participate. She also has \$1,500 of passive income from a different partnership and \$10,000 of interest income. She may deduct \$1,500 of the loss against the passive income. The remaining \$2,500 is suspended; the interest income is portfolio income and cannot absorb it.

2.11 Royalties and recoveries

Royalties from oil, gas, minerals, copyrights, and patents are reported on Schedule E, with related expenses, including the depletion deduction (15% percentage depletion for oil and gas royalty owners, limited to taxable income from the property). Royalties earned by a self-employed writer, inventor, or performer from his or her own work are business income on Schedule C and subject to self-employment tax.

Recoveries and the tax benefit rule. An amount recovered in 2025 that was deducted in a prior year is income only to the extent the earlier deduction reduced tax. The most tested example is a state income tax refund. If the taxpayer took the standard deduction in the prior year, the refund is not taxable. If the taxpayer itemized, the refund is taxable up to the amount by which the itemized deductions exceeded the standard deduction, and only to the extent the state tax deduction was not already limited by the SALT cap.

Worked example. In 2024, the Lopezes itemized with \$31,000 of deductions, including \$6,000 of state income taxes; the 2024 standard deduction for MFJ was \$29,200. In 2025 they received a \$2,500 state refund. Their itemized deductions exceeded the standard deduction by \$1,800, so only \$1,800 of the refund is taxable. The other \$700 produced no tax benefit and is excluded.

2.12 Information returns: 1099-NEC, 1099-MISC, 1099-K, and corrections

Form	Reports	2025 threshold
1099-NEC	Nonemployee compensation paid in a trade or business	\$600 or more
1099-MISC	Rents, royalties, prizes, other income, medical payments, attorney gross proceeds	Generally \$600 or more (\$10 for royalties)
1099-K	Payment card transactions and third-party network payments	Third-party networks must report only if gross payments exceed \$20,000 and transactions exceed 200; payment card transactions are reported with no threshold
1099-INT / 1099-DIV	Interest and dividends	\$10 or more
1099-R	Retirement distributions	\$10 or more
1099-G	Government payments (unemployment, state refunds)	\$10 or more
1099-B / 1099-DA	Broker proceeds; digital asset sales (new for 2025)	Any amount
W-2G	Gambling winnings	Varies by game

Irregularities. Income is taxable whether or not a form is issued. If a 1099 is wrong, the taxpayer should request a corrected form from the issuer; if the issuer refuses, report the correct amount and attach an explanation. A 1099-K may include personal reimbursements or sales of personal items at a loss; those are reported on

Schedule 1 as other income with an offsetting adjustment, so the taxpayer is not taxed on nontaxable amounts. A 1099-NEC received by someone who is really an employee may call for **Form 8919** (uncollected Social Security and Medicare tax on wages) and **Form SS-8** (worker status determination).

New for 2025. The One Big Beautiful Bill Act restored the \$20,000 / 200-transaction threshold for third-party network 1099-K reporting, reversing the phased-in \$600 threshold. The reporting threshold never changed what is taxable.

Part B: Retirement Income

2.13 Traditional and Roth IRAs compared

The rule. The 2025 contribution limit is \$7,000 across all traditional and Roth IRAs combined, plus a \$1,000 catch-up for taxpayers 50 or older, and never more than the taxpayer's **compensation** (wages, self-employment income, taxable alimony under pre-2019 instruments, and nontaxable combat pay; not interest, dividends, pensions, or rental income). A non-working spouse may contribute to a spousal IRA based on the working spouse's compensation on a joint return. Contributions for 2025 may be made until April 15, 2026, regardless of extensions.

Feature	Traditional IRA	Roth IRA
Contribution deductible?	Yes, unless covered by a workplace plan and MAGI is above the phaseout	Never
2025 phaseout for deduction/contribution (covered by plan)	Single/HOH \$79,000–\$89,000; MFJ \$126,000–\$146,000; MFS \$0–\$10,000	Single/HOH \$150,000–\$165,000; MFJ \$236,000–\$246,000; MFS \$0–\$10,000
Spouse not covered, other spouse covered	\$236,000–\$246,000	n/a
Age limit on contributions	None	None
Earnings	Tax-deferred; taxable on distribution	Tax-free if distribution is qualified
Required minimum distributions	Yes, beginning at age 73 (75 for those born 1960 or later)	None during the owner's lifetime
Qualified distribution	Any distribution after 59½ is penalty-free; all taxable except basis	After a 5-year period and age 59½, death, disability, or first-home purchase (\$10,000 lifetime)
Ordering of nonqualified distributions	Pro rata between basis and earnings	Contributions first (tax- and penalty-free), then conversions, then earnings

Nondeductible contributions and Form 8606. A taxpayer may make a nondeductible traditional IRA contribution regardless of income and must report it on Form 8606, which tracks basis. Later distributions are partly tax-free using the ratio of total basis to the total value of all traditional, SEP, and SIMPLE IRAs at year end plus distributions during the year.

Worked example. David has \$6,000 of basis (nondeductible contributions) in traditional IRAs worth \$60,000 at the end of 2025 after taking a \$10,000 distribution during the year. Tax-free portion: $\$6,000 \div (\$60,000 + \$10,000) = 8.57\%$, so \$857 of the distribution is tax-free and \$9,143 is taxable. His remaining basis is \$5,143.

Exam trap. The traditional IRA phaseout only matters if the taxpayer (or spouse) is **covered by a workplace plan**. A high-income taxpayer with no workplace plan deducts the full contribution. The Roth phaseout applies to everyone.

2.14 Conversions and recharacterizations

A **conversion** moves money from a traditional IRA (or pre-tax plan) to a Roth IRA. The converted amount is taxable in the year of conversion, except for the portion that represents basis, computed pro rata across all traditional IRAs. There is no income limit for conversions and no 10% penalty on the conversion itself, but a 10% penalty applies if converted amounts are withdrawn within five years by someone under 59½. Each conversion starts its own five-year clock for penalty purposes.

A **recharacterization** treats a contribution made to one type of IRA as if it had been made to the other type; it must be completed by the due date of the return including extensions. Since 2018, a conversion to a Roth IRA **cannot** be recharacterized, so a conversion cannot be undone.

2.15 Distributions, penalties, and exceptions

The rule. Distributions from traditional IRAs and pre-tax plan accounts are ordinary income, except for recovered basis. A distribution before age 59½ is also subject to a **10% additional tax** on the taxable amount unless an exception applies. Exceptions are reported on **Form 5329**.

Exception to the 10% penalty	IRA	Qualified plan (401(k), 403(b))
Death of the owner	Yes	Yes
Total and permanent disability	Yes	Yes
Series of substantially equal periodic payments (section 72(t))	Yes	Yes (after separation from service)
Unreimbursed medical expenses above 7.5% of AGI	Yes	Yes
Separation from service in or after the year the employee turns 55 (50 for public safety employees)	No	Yes
Qualified domestic relations order (QDRO)	No	Yes
Higher education expenses	Yes	No

Exception to the 10% penalty	IRA	Qualified plan (401(k), 403(b))
First-time home purchase, \$10,000 lifetime	Yes	No
Health insurance premiums while unemployed 12 consecutive weeks	Yes	No
IRS levy on the account	Yes	Yes
Qualified reservist called to active duty 180+ days	Yes	Yes
Birth or adoption, up to \$5,000 per child, within one year	Yes	Yes
Emergency personal expense, one per year, up to \$1,000	Yes	Yes
Domestic abuse victim, up to \$10,300 for 2025	Yes	Yes
Terminal illness	Yes	Yes
Federally declared disaster, up to \$22,000	Yes	Yes

Rollovers. A **direct rollover** (trustee to trustee) is never taxed and never subject to withholding. An **indirect rollover** must be completed within **60 days**; distributions from a qualified plan paid to the participant are subject to **20% mandatory withholding**, and the participant must come up with the withheld 20% from other funds to roll over the full amount or the shortfall is taxable. Only **one** indirect IRA-to-IRA rollover is allowed in any 12-month period across all of a taxpayer's IRAs; conversions and direct transfers do not count.

Excess contributions. A contribution above the limit incurs a **6% excise tax** every year it remains in the account. It is avoided by withdrawing the excess and its earnings before the due date of the return including extensions.

Prohibited transactions. Borrowing from an IRA, selling property to it, using it as security for a loan, or buying collectibles with it is prohibited. If the owner engages in a prohibited transaction, the account stops being an IRA as of the first day of the year and its entire fair market value is treated as distributed.

Plan loans. A loan from a qualified plan is not a distribution if it does not exceed the lesser of \$50,000 or 50% of the vested balance (a \$10,000 minimum is permitted), is repaid in level payments at least quarterly within five years (longer for a principal residence), and is enforceable. A loan that fails these rules, or that goes unpaid after separation, is a deemed distribution subject to tax and penalty. IRAs cannot make loans.

Worked example. Carlos, 40, withdrew \$8,000 from his traditional IRA in 2025 to pay \$8,000 of tuition for a graduate course. The \$8,000 is ordinary income, but the higher-education exception eliminates the 10% penalty. If he had taken the same \$8,000 from his 401(k), the penalty would apply, because the education exception is IRA-only.

Memory cue. “Plans get 55 and QDRO; IRAs get school, house, and health premiums.” Everything else overlaps.

2.16 Required minimum distributions

The rule. Owners of traditional IRAs, SEP and SIMPLE IRAs, and employer plans must begin RMDs for the year they reach age **73** (for those born 1951 through 1959) or **75** (for those born in 1960 or later). The first RMD may be delayed until **April 1** of the following year, but the second is due by December 31 of that same year, which doubles up income. Roth IRAs have no lifetime RMDs. The RMD equals the prior December 31 balance divided by the life expectancy factor from the Uniform Lifetime Table (or the Joint Life table if the sole beneficiary spouse is more than ten years younger).

Penalty for a missed RMD. 25% of the shortfall, reduced to **10%** if corrected within two years (generally by the end of the second year after the year the RMD was due), reported on Form 5329. The IRS may waive the penalty for reasonable error.

Qualified charitable distributions. An IRA owner who is at least **70½** may direct up to **\$108,000** (2025) per year from an IRA directly to a qualified charity. The QCD is excluded from income, is not deductible as a contribution, and counts toward the RMD. A one-time QCD of up to \$54,000 may fund a split-interest entity such as a charitable gift annuity.

Worked example. Rosa, 72 at the end of 2025 and born in 1953, turns 73 in 2026. Her first RMD is for 2026 and may be taken as late as April 1, 2027; her 2027 RMD is due December 31, 2027. If she takes both in 2027, both are 2027 income.

2.17 Inherited retirement accounts

Beneficiary	Rule for deaths after 2019
Surviving spouse	May treat the account as his or her own, roll it over, or remain a beneficiary and use life expectancy
Eligible designated beneficiary other than a spouse (minor child of the owner until age 21, disabled or chronically ill individual, or anyone not more than 10 years younger than the owner)	May stretch distributions over his or her own life expectancy
Other designated beneficiary (adult child, grandchild, friend)	10-year rule: the account must be fully distributed by December 31 of the tenth year after death; if the owner died on or after the required beginning date, annual RMDs are also required in years 1 through 9
No designated beneficiary (estate, charity, non-qualifying trust)	5-year rule if the owner died before the required beginning date; otherwise over the owner's remaining life expectancy

Inherited traditional IRA distributions are taxable to the beneficiary as ordinary income (income in respect of a decedent) and never subject to the 10% penalty, regardless of the beneficiary's age. Inherited Roth IRAs are also subject to the 10-year rule for non-spouse beneficiaries but distributions are generally tax-free. A non-spouse beneficiary cannot roll the account into his or her own IRA; the account must stay titled as an inherited IRA.

2.18 Social Security and Railroad Retirement benefits

The rule. Up to 85% of Social Security (and Tier 1 Railroad Retirement) benefits are taxable, depending on **provisional income**: AGI (before the Social Security inclusion) plus tax-exempt interest plus **half** of the benefits. Compare provisional income to the base amounts: \$25,000 single, HOH, QSS, or MFS living apart all year; \$32,000 MFJ; **\$0** for MFS who lived with the spouse at any time during the year.

Provisional income	Taxable portion of benefits
At or below the base amount (\$25,000 / \$32,000)	0%
Above the base but at or below the adjusted base (\$34,000 / \$44,000)	Lesser of 50% of benefits or 50% of the excess over the base
Above the adjusted base (\$34,000 / \$44,000)	Up to 85% of benefits

Worked example. Rosa, single, received \$14,000 of Social Security and \$20,000 of pension income, and no tax-exempt interest. Provisional income: $\$20,000 + \$7,000 = \$27,000$. That is \$2,000 over the \$25,000 base. Taxable benefits are the lesser of $50\% \times \$14,000 = \$7,000$ or $50\% \times \$2,000 = \$1,000$. She includes \$1,000.

Supplemental Security Income (SSI) is never taxable. Social Security disability benefits follow the same rules as retirement benefits. Lump-sum payments covering earlier years may be taxed using the earlier years' rules under the lump-sum election. Tier 2 Railroad Retirement benefits are taxed like a pension.

New for 2025. There is no "no tax on Social Security" provision. The new \$6,000 enhanced deduction for seniors reduces taxable income for taxpayers 65 and older, but the inclusion rules for benefits above are unchanged.

2.19 Annuities and nonqualified plans

For a purchased annuity, each payment is part return of after-tax investment and part taxable earnings, using the **exclusion ratio** (investment in the contract divided by expected return). For annuities from qualified plans with after-tax contributions, the **simplified method** divides the investment by a fixed number of anticipated payments based on age at the annuity starting date. Once the entire investment is recovered, all payments are taxable. Distributions from nonqualified deferred compensation plans are wages when paid, reported on Form W-2; early distributions from an annuity contract before 59½ are subject to a 10% penalty on the earnings portion.

2.20 Foreign pensions

Pensions from foreign employers and foreign government social insurance programs are generally taxable to a U.S. citizen or resident unless a tax treaty provides otherwise. Contributions to foreign plans are usually not excludable, so the recipient may have basis. Foreign pension accounts may also be reportable on the FBAR and Form 8938. Treaty-based positions are disclosed on Form 8833.

Part C: Property, Real and Personal

2.21 Basis: purchased, gifted, inherited

The rule. Basis is the starting point for gain or loss. Gain is amount realized minus adjusted basis. Adjusted basis is original basis plus capital improvements minus depreciation allowed or allowable, casualty losses deducted, and nondividend distributions.

How acquired	Basis	Holding period
Purchase	Cost, including sales tax, freight, installation, commissions, legal fees, title insurance, and recording fees	Starts the day after purchase
Gift, property has appreciated (FMV at gift $\geq$ donor's basis)	Donor's adjusted basis (carryover), plus any gift tax paid attributable to the appreciation	Includes the donor's holding period
Gift, property has declined (FMV at gift $<$ donor's basis)	Dual basis: use donor's basis to compute gain; use FMV at the date of gift to compute loss; if the sale price falls between, no gain or loss	Includes donor's period for gain; starts at gift for loss
Inheritance	Fair market value on the date of death (or on the alternate valuation date six months later if the executor elects it for the estate)	Automatically long-term
Inherited community property	Both halves receive a full basis step-up, even though the survivor already owned half	Long-term
Property converted from personal to business or rental use	Lesser of adjusted basis or FMV on the date of conversion, for computing depreciation and loss	Original holding period
Stock dividend or split	Original basis spread across the new total shares	Same as original shares
Dividend reinvestment	Each purchase has its own cost basis	Each lot separate

Worked example (gift, appreciated). Rosa gives Mateo stock she bought for \$2,000 that is worth \$5,000 on the date of the gift. Mateo's basis is \$2,000. If he sells for \$6,000, his gain is \$4,000, long-term if Rosa's holding period plus his exceeds one year.

Worked example (gift, declined). Rosa gives Sofia stock she bought for \$5,000 that is worth \$3,000 on the date of the gift. If Sofia sells for \$6,000, gain is \$1,000 (using \$5,000). If Sofia sells for \$2,000, loss is \$1,000 (using \$3,000). If Sofia sells for \$4,000, there is no gain or loss, because the price falls between the two bases.

Worked example (inheritance). Rosa dies holding stock she bought for \$2,000, worth \$5,000 at her death. Her heir's basis is \$5,000 and the holding period is long-term. A sale for \$5,200 one week later produces a \$200 long-term gain.

Memory cue. "Gift carries over; death steps up." And for a declined gift: "high basis for gain, low basis for loss, nothing in between."

2.22 Capital gains and losses

The rule. A capital asset is any property except inventory, depreciable business property, real property used in a business, accounts receivable, self-created copyrights and similar works, and supplies. Holding period of **more than one year** makes a gain or loss long-term. Report sales on Form 8949 and Schedule D. Net short-term against short-term, long-term against long-term, then net the two results. A net capital loss is deductible against ordinary income up to **\$3,000** per year (\$1,500 MFS); the excess carries forward indefinitely and keeps its character.

2025 long-term capital gain rates (also used for qualified dividends).

Filing status	0% rate applies to taxable income up to	15% rate applies up to	20% rate above
Single	\$48,350	\$533,400	\$533,400
Married filing jointly / QSS	\$96,700	\$600,050	\$600,050
Married filing separately	\$48,350	\$300,000	\$300,000
Head of household	\$64,750	\$566,700	\$566,700

Special rates: collectibles gain (art, antiques, coins, precious metals) is taxed at a maximum of **28%**; unrecaptured section 1250 gain (depreciation on real property) is taxed at a maximum of **25%**. Both are still long-term capital gains that can be offset by capital losses.

Netting procedure.

1. Net all short-term gains and losses, including the short-term carryover.
2. Net all long-term gains and losses, including the long-term carryover.
3. If one is a gain and the other a loss, net them against each other.
4. A net long-term gain is taxed at preferential rates; a net short-term gain is ordinary; a net loss is limited to \$3,000.

Worked example. In 2025 Maria has a \$9,000 short-term loss, a \$2,000 short-term gain, and a \$5,000 long-term gain. Step 1: net short-term loss \$7,000. Step 2: net long-term gain \$5,000. Step 3: net loss \$2,000. She deducts the full \$2,000 against ordinary income; nothing carries over. If her short-term loss had been \$12,000, the net loss would be \$5,000; she deducts \$3,000 and carries \$2,000 of short-term loss to 2026.

Wash sales. A loss on stock or securities is disallowed if the taxpayer buys substantially identical securities within **30 days before or after** the sale (a 61-day window). The disallowed loss is added to the basis of the replacement shares, and the holding period of the old shares tacks on. The rule applies to purchases in an IRA and by a spouse, and it never disallows gains.

Personal-use property. Gains on personal assets (a car, furniture, a boat) are taxable capital gains. Losses on personal-use property are **not** deductible, except casualty losses in a federally declared disaster.

Digital assets. Virtual currency is property, not currency. Selling it, exchanging it for another coin, or using it to buy goods is a taxable disposition with gain or loss measured against basis. Receiving it as payment or from mining or staking is ordinary income at fair market value. Brokers began issuing Form 1099-DA for 2025 sales.

Mark-to-market traders. A trader in securities who elects section 475(f) treats all gains and losses as ordinary, is exempt from the wash sale rule and the \$3,000 loss limit, and marks open positions to market at year end.

Exam trap. The holding period is “more than one year.” Stock bought on March 10, 2024 and sold on March 10, 2025 is short-term. Sold on March 11, 2025 it is long-term. Inherited property is always long-term, even if sold the next day.

2.23 Sale of a personal residence (section 121)

The rule. A taxpayer may exclude up to **\$250,000** of gain (\$500,000 on a joint return) on the sale of a main home if, during the five years ending on the sale date, the taxpayer **owned** the home for at least two years and **used** it as a main home for at least two years, and did not exclude gain on another home in the two years before the sale. The two years (730 days) need not be continuous. For \$500,000, either spouse may meet the ownership test, both must meet the use test, and neither may have used the exclusion in the prior two years.

Partial exclusion. A taxpayer who fails the two-year tests because of a change in place of employment (new job at least 50 miles farther), health, or unforeseen circumstances (death, divorce, multiple births, job loss, natural disaster) may exclude a prorated amount: the full exclusion multiplied by the fraction of two years met.

Reductions. Gain attributable to depreciation claimed after May 6, 1997 (for a home office or rental use) cannot be excluded and is taxed as unrecaptured section 1250 gain. Gain allocable to periods of **nonqualified use** after 2008 (for example, years as a rental before it became the main home) is also not excludable.

Special rules. A surviving spouse who sells within two years of the spouse's death may use the \$500,000 exclusion if the couple qualified at death. Members of the uniformed services and Foreign Service may suspend the five-year test period for up to ten years while on qualified official extended duty. A loss on a main home is never deductible. If the entire gain is excluded and no Form 1099-S was issued, the sale need not be reported.

Worked example. The Lopezes bought their home in 2015 for \$220,000, added a \$30,000 kitchen, and sold it in 2025 for \$560,000 with \$30,000 of selling costs. Amount realized \$530,000; adjusted basis \$250,000; gain \$280,000. They exclude all of it under the \$500,000 limit. If Maria had used a room as a home office and claimed \$8,000 of depreciation, \$8,000 of the gain would be taxable at up to 25% and the remaining \$272,000 excluded.

Worked example (partial). Carlos bought a condo and lived in it exactly one year before his employer transferred him 300 miles away. He sold it at a \$40,000 gain. He may exclude $12/24 \times \$250,000 = \$125,000$, so the entire \$40,000 gain is excluded.

Memory cue. "Two of five, once every two." Own two, use two, within the last five, no more often than every two years.

2.24 Installment sales

The rule. When at least one payment is received after the year of sale, gain is reported on **Form 6252** as payments are received, using the **gross profit percentage** (gross profit divided by contract price). Each payment of principal is multiplied by that percentage to find the gain recognized; interest is reported separately as ordinary income. The method is automatic unless the taxpayer elects out by reporting the full gain in the year of sale.

Limits. The installment method is **not** available for sales of inventory, publicly traded stock or securities, or dealer property, or for losses. **Depreciation recapture** (section 1245 or 1250 ordinary income) must be recognized in full in the year of sale regardless of payments. If a related party buys the property and resells it within two years, the original seller must recognize the remaining gain at that time. If the seller charges no or inadequate interest, part of each payment is recharacterized as imputed interest.

Worked example. Rosa sells land with a basis of \$40,000 for \$100,000, receiving \$20,000 down in 2025 and \$20,000 per year for four years, plus interest. Gross profit \$60,000; contract price \$100,000; gross profit percentage 60%. In 2025 she recognizes $60\% \times \$20,000 = \$12,000$ of gain plus the interest received. Each later year's \$20,000 payment produces another \$12,000 of gain.

2.25 Depreciation recapture and sales of business assets

Section 1245 property (equipment, furniture, vehicles, and other personal property used in business): gain is ordinary income to the extent of all depreciation taken, including section 179 and bonus depreciation; any gain above the original cost is section 1231 gain.

Section 1250 property (buildings): for individuals, gain attributable to straight-line depreciation is **unrecaptured section 1250 gain**, taxed at a maximum 25% rate; the rest is section 1231 gain.

Section 1231 netting: gains and losses on business property held more than one year are netted. A net gain is treated as long-term capital gain (subject to the five-year lookback for prior 1231 losses); a net loss is fully deductible as an ordinary loss.

Worked example. Priya bought a business computer for \$3,000, deducted \$2,200 of depreciation, and sold it for \$1,500. Adjusted basis \$800; gain \$700. All \$700 is ordinary income under section 1245 because it does not exceed the \$2,200 of depreciation taken. Had she sold it for \$3,400, \$2,200 would be ordinary recapture and \$400 would be section 1231 gain.

2.26 Like-kind exchanges (section 1031)

The rule. No gain or loss is recognized on an exchange of **real property** held for business or investment for other real property held for business or investment. Since 2018, personal property (vehicles, equipment, art) does not qualify. The replacement property must be **identified within 45 days** and **received within 180 days** of transferring the relinquished property (or by the return due date, if earlier). Reported on **Form 8824**.

Boot. Cash, debt relief, or other non-like-kind property received is boot, and gain is recognized to the extent of the **lesser** of realized gain or boot received. Loss is never recognized. **Basis of the property received** = basis of the property given up + boot paid + gain recognized – boot received. A quicker check: basis of the new property = its fair market value minus the gain deferred.

Worked example. David exchanges a rental lot with a basis of \$60,000 and a fair market value of \$100,000 for another rental lot worth \$90,000 plus \$10,000 cash. Realized gain \$40,000. Recognized gain is the lesser of \$40,000 or \$10,000 boot, so \$10,000. Deferred gain \$30,000. Basis in the new lot: \$60,000 + \$10,000 gain – \$10,000 cash = \$60,000, which equals \$90,000 FMV – \$30,000 deferred.

2.27 Stock options and employee stock purchase plans

Type	At grant	At exercise	At sale
Nonqualified stock option (NQSO)	No income (unless readily ascertainable value)	Ordinary income (W-2) equal to FMV minus exercise price; basis = FMV at exercise	Capital gain or loss measured from that basis

Type	At grant	At exercise	At sale
Incentive stock option (ISO)	No income	No regular income; the spread is an AMT adjustment	Qualifying disposition (held more than 2 years from grant and 1 year from exercise): entire gain is long-term capital gain. Disqualifying disposition: spread at exercise is ordinary income, the rest is capital gain
Employee stock purchase plan (ESPP, up to 15% discount)	No income	No income	Qualifying disposition (same 2-year/1-year holding): ordinary income equal to the lesser of the discount at grant or the actual gain; balance is capital gain. Disqualifying: discount at purchase is ordinary income
Restricted stock units (RSUs)	No income	Ordinary income at vesting equal to FMV; basis = FMV at vesting	Capital gain or loss from vesting-date basis

Worked example. Maria exercised an NQSO to buy 100 shares at \$20 when the stock was worth \$35. She has \$1,500 of W-2 income and a basis of \$35 per share. Selling at \$40 two years later produces a \$500 long-term capital gain. If instead the option had been an ISO, there would be no regular income at exercise, a \$1,500 AMT adjustment, and a \$2,000 long-term gain on the qualifying sale.

2.28 Nonbusiness bad debts

A loan made outside the taxpayer's trade or business that becomes **totally worthless** is deductible as a **short-term capital loss** in the year it becomes worthless, regardless of how long the debt was outstanding. There is no deduction for a partially worthless nonbusiness debt. The debt must be a bona fide loan with an expectation of repayment, so unpaid loans to family members are scrutinized and gifts never qualify. A guarantor who pays a debt may deduct the payment the same way if the guarantee was given for profit. Unpaid wages, rent, or fees that were never included in income cannot be deducted as bad debts by a cash-basis taxpayer.

2.29 Investor versus trader

An **investor** buys and holds for appreciation and income; gains and losses are capital, and investment expenses are not deductible for 2025 (miscellaneous itemized deductions are suspended), although investment interest expense is deductible on Schedule A to the extent of net investment income. A **trader** engages in substantial, frequent, and continuous trading to profit from short-term swings; trading expenses are deductible on Schedule C, but gains and losses remain capital on Schedule D unless the trader makes the mark-to-market election, and trading gains are not subject to self-employment tax either way. **Dealers** hold securities as inventory for sale to customers and report ordinary income.

Part D: Adjustments to Income

2.30 Self-employment tax and its deduction

The rule. Net earnings from self-employment of \$400 or more trigger self-employment tax on Schedule SE: multiply net profit by **92.35%**, then apply **15.3%** (12.4% Social Security up to the \$176,100 wage base for 2025, combined with any W-2 wages; 2.9% Medicare on everything). One-half of the SE tax is deducted as an adjustment to income on Schedule 1. Chapter 4 covers the computation in depth.

2.31 Retirement contributions for the self-employed

A self-employed taxpayer may deduct contributions to a **SEP-IRA** (up to 25% of net SE earnings after the SE tax deduction and the contribution itself, effectively 20% of net profit minus half SE tax, capped at \$70,000 for 2025), a **SIMPLE IRA** (\$16,500 deferral plus \$3,500 catch-up at 50, plus the employer match), or a **solo 401(k)** (\$23,500 deferral plus \$7,500 catch-up at 50 or \$11,250 at ages 60 to 63, plus an employer contribution, total \$70,000 before catch-up). The traditional IRA deduction (section 2.13) is separate and may be available in addition.

2.32 Health savings accounts

The rule. An individual covered on the first day of a month by a **high-deductible health plan (HDHP)**, with no other disqualifying coverage, not enrolled in Medicare, and not claimable as a dependent, may contribute to an HSA. The 2025 limits are **\$4,300** for self-only coverage and **\$8,550** for family coverage, plus a **\$1,000** catch-up at age 55 or older. Contributions are deductible as an adjustment (Form 8889) even for non-itemizers; employer contributions are excluded from wages and count toward the limit.

2025 HDHP definition	Self-only	Family
Minimum annual deductible	\$1,650	\$3,300
Maximum out-of-pocket (deductibles, copays, coinsurance; not premiums)	\$8,300	\$16,600

Distributions. Tax-free when used for qualified medical expenses of the owner, spouse, or dependents, including expenses incurred after the HSA was established even if the person is no longer eligible to contribute. Insurance premiums do not qualify except COBRA, coverage while receiving unemployment, Medicare premiums (not Medigap) after 65, and qualified long-term care premiums within age limits. Nonqualified distributions are taxable plus a **20%** penalty; the penalty does not apply after age 65, death, or disability. Unused balances roll over forever and the account belongs to the individual, not the employer.

Last-month rule. A person eligible on December 1 may contribute the full annual amount, but must stay eligible through the following December 31 or include the excess in income with a 10% penalty. A health FSA (2025 limit \$3,300) or general-purpose HRA is disqualifying coverage unless it is limited-purpose or post-deductible.

Worked example. David, 46, has family HDHP coverage all year. His employer contributed \$2,000 to his HSA. David may contribute up to $\$8,550 - \$2,000 = \$6,550$ and deduct that amount on Schedule 1, whether or not he itemizes. If he withdrew \$500 to pay a gym membership, the \$500 is income plus a \$100 penalty.

2.33 Other adjustments to income

Adjustment	2025 rule
Educator expenses	Up to \$300 per eligible K–12 educator working at least 900 hours (\$600 MFJ, both educators) for books, supplies, computer equipment, and professional development
Certain business expenses of reservists, performing artists, and fee-basis government officials	Form 2106; reservists' travel more than 100 miles from home
Moving expenses	Active-duty members of the Armed Forces only , for a permanent change of station (Form 3903); all other taxpayers get no deduction for 2025
Deductible part of self-employment tax	50% of SE tax
Self-employed SEP, SIMPLE, and qualified plans	See section 2.31
Self-employed health insurance	100% of premiums for medical, dental, and qualified long-term care (within age limits) for the taxpayer, spouse, dependents, and children under 27; limited to net SE income from the business; not allowed for any month the taxpayer or spouse was eligible for an employer-subsidized plan
Penalty on early withdrawal of savings	Amount forfeited on a CD, from Form 1099-INT box 2
Alimony paid	Only under instruments executed before 2019 and not modified to adopt the new rules; recipient's SSN required
IRA deduction	See section 2.13
Student loan interest	Up to \$2,500 of interest on a qualified loan for the taxpayer, spouse, or dependent (at the time of the loan); phaseout MAGI \$85,000–\$100,000 single/HOH/QSS, \$170,000–\$200,000 MFJ; not allowed for MFS or for a taxpayer claimed as a dependent; the taxpayer must be legally obligated on the loan
Archer MSA contributions	Form 8853
Jury duty pay given to employer	Write-in adjustment
Reforestation, repayment of supplemental unemployment benefits, attorney fees in discrimination and whistleblower cases	Write-in adjustments

Exam trap. When a parent pays interest on a loan for which only the child is legally liable, the **parent** gets no deduction, because the parent is not obligated on the loan. The payment is treated as a gift to the child, who is then treated as having paid the interest and may deduct it, but only if the child is not claimed as a dependent on anyone's return. If the parent cosigned, the parent is legally obligated and may deduct the interest the parent paid.

Quick Check: Chapter 2

1. Ben received stock from his aunt as a gift. She paid \$10,000 for it; it was worth \$7,000 on the date of the gift. Ben sells it for \$8,000. What is his recognized gain or loss?
 - A. \$2,000 loss
 - B. \$1,000 gain
 - C. \$0
 - D. \$3,000 loss
2. Which distribution from a 401(k) plan to a 52-year-old participant is exempt from the 10% additional tax?
 - A. \$10,000 used for a first-time home purchase.
 - B. \$6,000 used for the participant's daughter's college tuition.
 - C. \$15,000 paid to the participant's former spouse under a QDRO.
 - D. \$4,000 used to pay health insurance premiums while unemployed.
3. Dana, single, had \$30,000 of pension income, \$2,000 of tax-exempt interest, and \$12,000 of Social Security benefits. How much of her Social Security is taxable?
 - A. \$0
 - B. \$6,000
 - C. \$7,900
 - D. \$10,200
4. Which is **not** gross income?
 - A. A \$4,000 scholarship used by a degree candidate to pay room and board.
 - B. \$3,000 of unemployment compensation.
 - C. \$2,500 of court-awarded damages for a broken arm in a car accident.
 - D. \$800 of interest on a federal tax refund.
5. Lee rented his beach house for 12 days in 2025 for \$6,000 and used it personally for 60 days. How does he report the rental?
 - A. \$6,000 of Schedule E income with expenses allocated 12/72.
 - B. \$6,000 of income and no rental expense deduction.
 - C. No income and no rental expense deduction.
 - D. \$6,000 of Schedule C income.

- 6.** Grace sells a rental duplex with a \$100,000 adjusted basis for \$250,000, receiving \$50,000 in 2025 and the rest over three years. Ignoring interest and recapture, how much gain does she recognize in 2025?
- A. \$150,000
 - B. \$50,000
 - C. \$30,000
 - D. \$20,000
- 7.** Maya, 35, has traditional IRAs worth \$90,000 on December 31, 2025, including \$9,000 of nondeductible contributions reported on Form 8606. She withdrew \$10,000 during 2025. How much of the distribution is taxable?
- A. \$10,000
 - B. \$9,000
 - C. \$9,100
 - D. \$1,000
- 8.** Which statement about the Roth IRA is correct for 2025?
- A. Contributions are deductible if the taxpayer has no workplace plan.
 - B. The owner must begin required minimum distributions at 73.
 - C. A single taxpayer with MAGI of \$170,000 may not contribute.
 - D. Nonqualified distributions are treated as coming from earnings first.
- 9.** Omar exchanged an investment lot (basis \$50,000, FMV \$120,000) for another investment lot worth \$105,000 plus \$15,000 cash. What gain does he recognize and what is his basis in the new lot?
- A. \$70,000 gain; \$105,000 basis
 - B. \$15,000 gain; \$50,000 basis
 - C. \$15,000 gain; \$65,000 basis
 - D. \$0 gain; \$35,000 basis
- 10.** Tara, single with MAGI of \$92,000, paid \$3,100 of interest on her own qualified student loan in 2025. Her student loan interest deduction is:
- A. \$3,100
 - B. \$2,500
 - C. \$1,333
 - D. \$0

Answers.

1. C. For a gift of property that has declined in value, gain is measured from the donor's basis (\$10,000) and loss from FMV at the gift (\$7,000). A sale at \$8,000 is below \$10,000 (no gain) and above \$7,000 (no loss), so nothing is recognized.

2. C. QDRO payments are penalty-free from qualified plans. First-time home purchase, higher education, and health insurance premiums while unemployed are IRA-only exceptions.

- 3. C.** Provisional income: $\$30,000 + \$2,000 + \$6,000$ (half of benefits) = $\$38,000$, which exceeds the $\$34,000$ adjusted base for a single filer, so the 85% tier applies. The taxable amount is the lesser of (a) 85% of benefits, $\$10,200$, or (b) 85% of the excess over $\$34,000$ ($85\% \times \$4,000 = \$3,400$) plus the smaller of the 50%-tier amount ($\$6,000$) or $\$4,500$. That is $\$3,400 + \$4,500 = \$7,900$, which is less than $\$10,200$, so $\$7,900$ is taxable. D is the trap for anyone who assumes 85% of all benefits is taxable; 85% is a ceiling, not an automatic rate.
- 4. C.** Damages for physical injury are excluded. Scholarship amounts for room and board are taxable, unemployment compensation is taxable, and interest on a refund is taxable even though the refund is not.
- 5. C.** A dwelling rented fewer than 15 days is not treated as a rental: the income is excluded and rental expenses are not deductible. Mortgage interest and taxes may still be itemized.
- 6. C.** Gross profit $\$150,000 \div$ contract price $\$250,000 = 60\%$. $60\% \times \$50,000$ received = $\$30,000$ recognized in 2025.
- 7. C.** Basis fraction: $\$9,000 \div (\$90,000 + \$10,000) = 9\%$. Tax-free portion $\$900$; taxable $\$9,100$. Add the year-end balance and the distribution in the denominator.
- 8. C.** The 2025 single phaseout ends at $\$165,000$, so $\$170,000$ bars a contribution. Roth contributions are never deductible, there are no lifetime RMDs, and nonqualified distributions come from contributions first.
- 9. B.** Realized gain $\$70,000$; boot $\$15,000$; recognized gain is the lesser, $\$15,000$. Basis in the new lot: $\$50,000$ old basis + $\$15,000$ gain recognized – $\$15,000$ cash received = $\$50,000$. Check with the shortcut: FMV $\$105,000$ – deferred gain $\$55,000 = \$50,000$. C is the trap for adding the recognized gain without subtracting the boot.
- 10. C.** The phaseout range for single filers is $\$85,000$ to $\$100,000$, a $\$15,000$ range. Tara is $\$7,000$ into it, so $7/15$ of the $\$2,500$ maximum is lost: $\$2,500 \times (1 - 7/15) = \$2,500 \times 8/15 = \$1,333$. The deduction is also limited to interest paid, which is $\$3,100$, so the cap of $\$2,500$ applies first and then the phaseout.

Chapter 3. Deductions and Credits

Domain 3 • 17 scored questions (20%)

What the outline tests: **Itemized deductions and QBI** (medical, taxes, interest, charitable contributions, casualty and theft, other itemized deductions, Form 1040-NR deductions, the qualified business income deduction) and **Credits** (child and dependent care, child tax credit and credit for other dependents, education credits, foreign tax credit, earned income credit including preparer due diligence and disallowance, adoption credit, premium tax credit, and other refundable and nonrefundable credits such as energy credits and the saver's credit).

Two distinctions organize this entire chapter. A **deduction** reduces taxable income and is worth the taxpayer's marginal rate; a **credit** reduces tax dollar for dollar. A **nonrefundable** credit can bring tax to zero but no lower; a **refundable** credit can produce a refund. Every question in this domain is ultimately asking which of those you are looking at, how much it is, and when it phases out.

3.1 The standard deduction

The rule. For 2025 the standard deduction is **\$15,750** single or MFS, **\$31,500** MFJ or QSS, and **\$23,625** head of household. Add **\$1,600** for each instance of age 65 or blindness for a married taxpayer or QSS, or **\$2,000** for an unmarried taxpayer (single or HOH). A taxpayer who can be claimed as a dependent gets the greater of **\$1,350** or earned income plus **\$450**, capped at the regular amount.

Worked example. Rosa, 72, single, and legally blind, is not claimed as a dependent in 2025. Her standard deduction is $\$15,750 + \$2,000 \text{ (age)} + \$2,000 \text{ (blind)} = \$19,750$. If she were claimed as the Lopezes' dependent with \$1,900 of interest and no earned income, her standard deduction would be \$1,350 plus the additional amounts for age and blindness, \$5,350.

Who cannot use the standard deduction. A married person filing separately whose spouse itemizes; a nonresident alien or dual-status alien (with limited treaty exceptions); and a taxpayer filing a short-year return because of a change in accounting period.

New for 2025. The One Big Beautiful Bill Act raised the 2025 standard deduction from the previously announced \$15,000 / \$30,000 / \$22,500 to \$15,750 / \$31,500 / \$23,625 and made the larger standard deduction permanent. The additional amount for age or blindness is unchanged. The separate **\$6,000 enhanced deduction for seniors** is not part of the standard deduction and is covered in section 3.9.

3.2 Medical and dental expenses

The rule. Unreimbursed medical expenses paid during the year for the taxpayer, spouse, and dependents are deductible on Schedule A to the extent they exceed **7.5% of AGI**. Expenses are deductible when paid (including by credit card), not when the service is rendered.

Deductible	Not deductible
Health, dental, and vision insurance premiums paid with after-tax dollars; Medicare Part B, C, and D premiums	Premiums paid pre-tax through a cafeteria plan or already deducted as self-employed health insurance
Qualified long-term care premiums within age limits (2025: age 40 or less \$480; 41–50 \$900; 51–60 \$1,800; 61–70 \$4,810; over 70 \$6,020)	Life insurance, disability income insurance, loss-of-earnings policies
Doctors, dentists, hospitals, surgery, prescriptions, insulin, eyeglasses, contacts, hearing aids, guide dogs	Nonprescription drugs (other than insulin), vitamins, toiletries, cosmetic surgery unless correcting a deformity or injury
Medical mileage at 21 cents per mile for 2025, plus parking and tolls; lodging up to \$50 per night per person while away for care	Meals while traveling for care; trips for general health improvement
Capital improvements for medical reasons, to the extent cost exceeds the increase in home value (ramps, widened doorways: full cost)	Health club dues, weight-loss programs for general health, funeral expenses
Smoking-cessation programs, weight-loss programs for a diagnosed disease, fertility treatment	Illegal operations or drugs; expenses reimbursed by insurance
Nursing home costs when medical care is the principal reason; nursing services	Nursing home costs when custodial care is the principal reason (only the medical portion qualifies)

Whose expenses. The taxpayer may deduct expenses of a person who was a spouse or dependent either when the services were provided or when paid. A child of divorced parents is treated as the dependent of **both** parents for this purpose, so either parent may deduct medical expenses that parent actually paid. Expenses for a person who would be a dependent except for the gross income test, the joint return test, or the dependent taxpayer test also qualify. Medical expenses of a decedent paid within one year after death may be treated as paid when incurred and deducted on the decedent's final return.

Worked example. The Lopezes' AGI is \$100,000. They paid \$9,500 in medical expenses, of which \$1,500 was reimbursed by insurance. Unreimbursed expenses: \$8,000. Floor: $7.5\% \times \$100,000 = \$7,500$. Deduction: \$500.

3.3 Taxes paid

The rule. State and local **income** taxes (or, by election, general **sales** taxes), **real estate** taxes, and **personal property** taxes based on value are deductible on Schedule A, subject to the state and local tax (SALT) cap: **\$40,000** for 2025 (**\$20,000** MFS). The cap is reduced by 30% of MAGI above **\$500,000** (\$250,000 MFS), but never below **\$10,000** (\$5,000 MFS).

Deductible	Not deductible
State and local income tax withheld in 2025, estimated payments made in 2025, and a 2024 balance due paid in 2025	Federal income tax, Social Security and Medicare tax
General sales taxes (actual receipts or the IRS table plus tax on major purchases) instead of income taxes	Both income and sales taxes in the same year
Real estate taxes on any property owned (main home, vacation home, land), prorated between buyer and seller in the year of sale	Assessments for local benefits that increase property value (sidewalks, sewers); service charges for trash or water; transfer taxes; homeowner association dues
Personal property taxes based on value (ad valorem portion of a vehicle registration)	Flat-fee registration; license fees based on weight
Foreign income taxes (if not claimed as a credit)	Foreign real property taxes
Mandatory contributions to state disability or paid family leave funds	Gift, estate, and inheritance taxes

Worked example. The Lopezes paid \$6,000 of Texas property tax, \$9,000 of state income tax on Maria's remote work for a Louisiana employer, and \$1,200 of ad valorem vehicle tax. Total SALT \$16,200, below the \$40,000 cap, so all of it is deductible. A neighbor with \$55,000 of SALT and MAGI of \$450,000 deducts \$40,000. A neighbor with MAGI of \$560,000 has a cap of $\$40,000 - 30\% \times \$60,000 = \$22,000$.

New for 2025. The SALT cap rose from \$10,000 to \$40,000 and now phases down for MAGI above \$500,000. For 2025 the floor is \$10,000; a taxpayer with MAGI of \$600,000 or more is back to the \$10,000 cap. The cap increases 1% per year for 2026 through 2029 and returns to \$10,000 in 2030.

3.4 Interest expense

The rule. Deductible interest on Schedule A is **qualified residence interest** and **investment interest**. Personal interest (credit cards, car loans, personal loans) is not deductible on Schedule A. Interest is traced to the use of the loan proceeds, not the collateral.

Qualified residence interest. Interest on **acquisition indebtedness**, meaning debt used to buy, build, or substantially improve a main home or one second home and secured by that home. For debt incurred after December 15, 2017 the limit is **\$750,000** (\$375,000 MFS); for earlier debt, \$1,000,000 (\$500,000 MFS). Refinanced debt keeps the old limit up to the balance refinanced. Home equity loan interest is deductible only if the proceeds were used to buy, build, or improve the home that secures the loan. The \$750,000 limit is now permanent.

Points. Points paid to **buy or build** a main home are fully deductible in the year paid if paying points is an established practice in the area, the points are computed as a percentage of the loan, and the buyer provided funds at least equal to the points. Points on a **refinance** are amortized over the life of the loan; the unamortized balance is deductible when the loan is paid off (unless refinanced with the same lender). Points paid by the seller are treated as paid by the buyer and reduce the buyer's basis.

Investment interest. Interest on loans used to buy taxable investments (margin interest) is deductible up to **net investment income** (interest, dividends, royalties, short-term gains, minus investment expenses). Qualified dividends and long-term gains count only if the taxpayer elects to tax them at ordinary rates. Excess carries forward indefinitely (Form 4952). Interest to buy tax-exempt bonds is never deductible.

Worked example. In 2025 the Lopezes paid \$14,000 of interest on their \$400,000 home mortgage, \$1,800 of interest on a home equity loan used to pay off credit cards, and \$900 of interest on a car loan for a used vehicle. Only the \$14,000 is deductible on Schedule A. The home equity interest fails the tracing test because the proceeds did not improve the home, and the car loan is personal interest; because the vehicle was used, it also fails the new Schedule 1-A car loan interest deduction, which requires a new vehicle.

Not on your exam. Mortgage insurance premiums become deductible as qualified residence interest again for tax years beginning after December 31, 2025. For 2025, they are not deductible.

3.5 Charitable contributions

The rule. Contributions of cash or property to qualified organizations (religious, charitable, educational, scientific, literary, governments, and veterans' and fraternal organizations within limits) are deductible on Schedule A up to a percentage of AGI, with a **five-year carryover** of the excess. A 2025 taxpayer who takes the standard deduction gets **no** charitable deduction.

AGI limits.

Type of gift	Public charity	Private non-operating foundation
Cash	60% of AGI	30%
Ordinary income property, short-term capital gain property (deduct basis)	50%	30%

Type of gift	Public charity	Private non-operating foundation
Long-term capital gain property deducted at FMV	30% (50% if the taxpayer elects to deduct basis instead)	20%

Valuing property. Long-term appreciated property (stock held more than a year) is deductible at fair market value, which avoids tax on the appreciation. Property that would produce ordinary income or short-term gain is limited to basis. Tangible personal property put to an unrelated use by the charity (art donated to a hospital that sells it) is limited to basis. Clothing and household items must be in good used condition or better. Vehicles over \$500 are limited to the charity's gross sales price unless the charity uses or materially improves the vehicle (Form 1098-C).

Documentation.

Gift	Required record
Any cash gift	Bank record or written receipt from the charity
Any single gift of \$250 or more	Contemporaneous written acknowledgment stating whether goods or services were received (obtained before filing)
Noncash gifts totaling more than \$500	Form 8283, Section A
Noncash item or group over \$5,000	Qualified appraisal and Form 8283, Section B (publicly traded securities excepted)
Payroll deductions	Pay stub or W-2 plus pledge card

Not deductible. Gifts to individuals, political organizations and candidates, foreign organizations (treaty exceptions for Canada, Mexico, Israel), lobbying groups, homeowner associations, chambers of commerce, and social clubs; the value of the taxpayer's time or services; raffle, bingo, or lottery tickets; tuition; blood donations; and the portion of a payment for which the donor received a benefit (dinner, merchandise). Out-of-pocket costs of volunteering are deductible, including **14 cents** per mile.

Worked example. The Lopezes have AGI of \$100,000. They gave \$8,000 cash to their church and stock held three years with a basis of \$5,000 and FMV of \$20,000 to a university. Cash limit: $60\% \times \$100,000 = \$60,000$; the \$8,000 is fully deductible. Stock at FMV: 30% limit = \$30,000; the \$20,000 is fully deductible. Total \$28,000. They pay no tax on the \$15,000 of appreciation. Had they sold the stock and donated cash, they would have reported a \$15,000 gain.

Not on your exam. Beginning in 2026, non-itemizers may deduct up to \$1,000 (\$2,000 MFJ) of cash gifts, itemizers' contributions are subject to a 0.5%-of-AGI floor, and the 60% cash limit is permanent. For 2025, there is no non-itemizer charitable deduction and no floor.

3.6 Casualty and theft losses

The rule. For 2025, a **personal** casualty or theft loss is deductible only if it results from a **federally declared disaster**. The loss is the lesser of adjusted basis or the decline in fair market value, minus insurance reimbursement, minus **\$100 per event**, and the total for the year is deductible only to the extent it exceeds **10% of AGI**. Report on Form 4684 and Schedule A. Business and income-producing property losses are not subject to these limits.

Qualified disaster losses (losses from certain disasters specifically designated by Congress) use a **\$500** per-event floor, skip the 10% of AGI floor, and may be added to the standard deduction so non-itemizers can benefit. A taxpayer may elect to deduct a federally declared disaster loss on the **prior year's** return by filing an amended return, which produces a faster refund. Personal casualty **gains** (insurance exceeds basis) are taxable unless the taxpayer replaces the property within the replacement period (generally two years, four years for a main home in a federally declared disaster).

Worked example. A federally declared hurricane damaged the Lopezes' boat (basis \$12,000, FMV before \$10,000, FMV after \$2,000). Insurance paid \$3,000. Loss: lesser of \$12,000 or \$8,000 decline = \$8,000, minus \$3,000 insurance, minus \$100 = \$4,900. With AGI of \$100,000, the 10% floor is \$10,000, so the deduction is \$0. Had the loss been designated a qualified disaster loss, the floor would be \$500 and no AGI limit would apply: \$8,000 – \$3,000 – \$500 = \$4,500 deductible, even if they take the standard deduction.

3.7 Other itemized deductions

Still deductible on Schedule A, line 16, for 2025: gambling losses up to winnings; casualty and theft losses from income-producing property; federal estate tax paid on income in respect of a decedent; impairment-related work expenses of a disabled person; amortizable bond premium on taxable bonds; repayments of more than \$3,000 previously included in income under a claim of right (or a credit instead); unrecovered investment in an annuity on the decedent's final return; and the ordinary loss on certain fraudulent investment schemes.

No longer deductible (miscellaneous itemized deductions subject to the 2% floor, now permanently repealed): unreimbursed employee business expenses, tax preparation fees, investment advisory fees, safe deposit box rental, union dues, job-search costs, and hobby expenses.

3.8 Itemized deductions on Form 1040-NR

A nonresident alien cannot take the standard deduction (except certain students and business apprentices from India under the treaty) and may itemize only: state and local income taxes, charitable contributions to **U.S.** organizations, casualty and theft losses from federally declared disasters on property in the U.S., and certain other items connected with U.S. income. Medical expenses and mortgage interest on a foreign home are not deductible on Form 1040-NR.

3.9 The new Schedule 1-A deductions

New for 2025. Four deductions enacted by the One Big Beautiful Bill Act apply to 2025 through 2028. All four are claimed on Schedule 1-A, are available whether the taxpayer itemizes or takes the standard deduction, and require a valid Social Security number. Married taxpayers must file jointly to claim the tips, overtime, and senior deductions; the car loan interest deduction has no joint-filing requirement.

Deduction	2025 maximum	Phaseout begins at MAGI	Key requirements
Qualified tips	\$25,000	\$150,000 single; \$300,000 MFJ (reduced by \$100 per \$1,000 over)	Voluntary cash or charged tips in an occupation on the IRS list of occupations that customarily received tips before 2025; reported on W-2, 1099, or Form 4137; not available to employees or owners of a specified service trade or business; for the self-employed, limited to net income from the business
Qualified overtime	\$12,500; \$25,000 MFJ	\$150,000; \$300,000 (reduced by \$100 per \$1,000 over)	Only the premium portion required under the Fair Labor Standards Act, the “half” in time-and-a-half, reported by the employer
Qualified passenger vehicle loan interest	\$10,000	\$100,000; \$200,000 MFJ (reduced by \$200 per \$1,000 over)	Loan originated after December 31, 2024, secured by a new car, minivan, SUV, pickup, van, or motorcycle under 14,000 pounds with final assembly in the United States , for personal use; the VIN must be reported; leases do not qualify
Enhanced deduction for seniors	\$6,000 per spouse age 65 or older (\$12,000 if both)	\$75,000; \$150,000 MFJ (reduced by 6% of MAGI over the threshold)	Born before January 2, 1961; in addition to the regular additional standard deduction for age

Worked example. Carlos earned \$9,000 of reported tips as a bartender, an occupation on the IRS list. His MAGI is \$42,000. He deducts \$9,000 on Schedule 1-A even though he takes the standard deduction. His taxable income falls, but his AGI does not, so the deduction does not help him qualify for AGI-based benefits such as the saver’s credit.

Worked example. Rosa, 72, has MAGI of \$80,000 and files single. Her enhanced senior deduction is \$6,000 – $6\% \times (\$80,000 - \$75,000) = \$6,000 - \$300 = \$5,700$. She also receives the regular \$2,000 additional standard deduction for age.

Exam trap. The overtime deduction covers only the premium half, not the whole overtime paycheck. An employee paid \$30 per hour who works 10 overtime hours at \$45 per hour has \$450 of overtime pay but only \$150 of qualified overtime compensation.

3.10 The qualified business income deduction

The rule. A non-corporate taxpayer may deduct **20%** of qualified business income from a sole proprietorship, partnership, S corporation, or rental activity that rises to a trade or business, plus 20% of qualified REIT dividends and publicly traded partnership income. The deduction is taken from AGI, is available to itemizers and non-itemizers alike, and cannot exceed **20% of taxable income before the deduction minus net capital gain** (including qualified dividends).

Thresholds for 2025. Taxable income before the QBI deduction of **\$197,300** (single, HOH, MFS) or **\$394,600** (MFJ). Below the threshold, the deduction is simply 20% of QBI, using **Form 8995**, and it does not matter whether the business is a specified service trade or business (SSTB). Above the threshold, two limits phase in over the next **\$50,000** (\$100,000 MFJ) on **Form 8995-A**:

1. **W-2 wage and property limit.** The deduction for each business cannot exceed the greater of 50% of W-2 wages paid by the business, or 25% of W-2 wages plus 2.5% of the unadjusted basis of qualified property.
2. **SSTB limit.** Income from a specified service trade or business (health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage, investing, or any business whose principal asset is the reputation or skill of its owners) is phased out and fully disallowed once taxable income exceeds \$247,300 (\$494,600 MFJ). Architecture and engineering are not SSTBs.

What is not QBI. Wages, reasonable compensation paid to an S corporation shareholder, guaranteed payments to a partner, capital gains and losses, dividends, interest not allocable to the business, and income earned outside the United States. A **negative** QBI amount carries forward and reduces the next year's QBI.

Worked example. Priya's consulting business (an SSTB) earned \$80,000 of net profit. She deducted \$5,650 of SE tax, \$6,000 of self-employed health insurance, and \$10,000 of SEP contributions, so her QBI is \$58,350 (QBI is reduced by those business-related deductions). Her taxable income before QBI is \$60,000 and includes \$2,000 of qualified dividends. Tentative deduction: $20\% \times \$58,350 = \$11,670$. Limit: $20\% \times (\$60,000 - \$2,000) = \$11,600$. Her QBI deduction is \$11,600. Because she is below \$197,300, the SSTB label does not matter.

Not on your exam. The One Big Beautiful Bill Act made the QBI deduction permanent and, beginning in 2026, widens the phase-in range to \$75,000 (\$150,000 MFJ) and adds a \$400 minimum deduction for active businesses with at least \$1,000 of QBI. For 2025, use the \$50,000 / \$100,000 phase-in range and no minimum.

3.11 Child and dependent care credit

The rule. A **nonrefundable** credit of **20% to 35%** of employment-related expenses paid for the care of a **qualifying person** so the taxpayer (and spouse) can work or look for work. Expenses are capped at **\$3,000** for one qualifying person and **\$6,000** for two or more. The percentage is 35% at AGI of \$15,000 or less, falling by 1 point per \$2,000 of AGI to 20% at AGI above \$43,000. Form 2441.

Qualifying person. A dependent child under age 13 when the care was provided; a spouse or any dependent who is physically or mentally unable to care for himself or herself and lived with the taxpayer more than half the year. For divorced parents, only the **custodial** parent may claim the credit, even if Form 8332 was signed.

Earned income limit. Expenses cannot exceed the earned income of the lower-earning spouse. A spouse who is a full-time student or incapable of self-care is deemed to earn \$250 per month (\$500 with two or more qualifying persons). Married taxpayers must file jointly unless legally separated or living apart for the last six months.

Expenses that qualify. Day care, preschool, nanny, before- and after-school care, day camp (not overnight camp), and household services partly for the qualifying person's care. Payments to the taxpayer's spouse, to the parent of the qualifying child, to the taxpayer's own child under age 19, or to anyone the taxpayer claims as a dependent do not qualify. Kindergarten and higher grades are education, not care. The provider's name, address, and taxpayer identification number must be reported.

Dependent care benefits. Up to **\$5,000** of employer dependent care assistance is excluded from wages (W-2 box 10). The exclusion reduces the dollar limit for the credit dollar for dollar.

Worked example. The Lopezes paid \$7,000 of after-school care for Sofia (age 8). Both spouses work; AGI is \$100,000. The expense limit for one child is \$3,000; their percentage is 20%; the credit is \$600. If Maria's employer had provided \$3,000 of dependent care benefits excluded from her wages, the remaining limit would be \$0 and no credit would be allowed.

Not on your exam. For 2026 the maximum percentage rises to 50% and the dependent care assistance exclusion rises to \$7,500. For 2025, use 35% and \$5,000.

3.12 Child tax credit and credit for other dependents

The rule. The **child tax credit** is **\$2,200** per qualifying child under age **17** at the end of 2025 who has an SSN valid for employment issued before the return due date. Up to **\$1,700** per child is refundable as the **additional child tax credit**, equal to 15% of earned income above \$2,500 (or, for three or more children, the excess of Social Security taxes over the EITC if larger). The **credit for other dependents** is **\$500**, nonrefundable, for any dependent who is not a qualifying child for the CTC, including children 17 and older, parents, and dependents with ITINs. Both credits phase out by **\$50 for each \$1,000** (or part) of MAGI above **\$200,000** (**\$400,000** MFJ). Schedule 8812.

Worked example. The Lopezes have Sofia (8) and Mateo (16), both with SSNs, and claim Rosa as a dependent. MAGI \$100,000. Credits: $\$2,200 \times 2 = \$4,400$ child tax credit plus \$500 for Rosa, total \$4,900, all nonrefundable first. If their tax before credits were only \$3,000, the nonrefundable credits would be limited to \$3,000, leaving \$1,900 unused. The additional child tax credit is the smallest of that unused \$1,900, the per-child cap of $\$1,700 \times 2 = \$3,400$, and $15\% \times (\$100,000 \text{ wages} - \$2,500) = \$14,625$. Refundable amount: \$1,900.

Worked example (phaseout). A couple with MAGI of \$412,500 and one qualifying child: excess over \$400,000 is \$12,500, which rounds up to 13 increments of \$1,000; reduction \$650; credit $\$2,200 - \$650 = \$1,550$.

Exam trap. Mateo turns 17 in 2026. For 2025 he is a qualifying child for the \$2,200 credit because he was 16 at year end. For 2026 he will qualify only for the \$500 credit for other dependents. The age test is “under 17 at the end of the tax year.”

New for 2025. The CTC increased from \$2,000 to \$2,200 and the taxpayer (at least one spouse on a joint return) must now have an SSN. The \$1,700 refundable limit, the \$2,500 earned income threshold, and the \$200,000 / \$400,000 phaseouts are unchanged.

3.13 Education credits

	American opportunity credit (AOTC)	Lifetime learning credit (LLC)
Amount	100% of the first \$2,000 plus 25% of the next \$2,000 of qualified expenses: maximum \$2,500 per student	20% of up to \$10,000 of qualified expenses: maximum \$2,000 per return
Refundable?	40% (up to \$1,000) is refundable, unless the student is under 24 and subject to the kiddie tax rules	No

	American opportunity credit (AOTC)	Lifetime learning credit (LLC)
Years available	First four years of postsecondary education, and no more than four tax years per student	Unlimited
Enrollment	At least half-time in a degree or credential program for at least one academic period	Any course at an eligible institution, including a single course to acquire or improve job skills
Qualified expenses	Tuition, required fees, and course materials (books, supplies, equipment) even if not bought from the school	Tuition and fees required for enrollment; books only if paid to the institution as a condition of enrollment
Felony drug conviction	Disqualifies	No restriction
2025 phaseout (MAGI)	\$80,000–\$90,000 single/HOH; \$160,000–\$180,000 MFJ	Same
Filing status	Not MFS	Not MFS

Both credits require **Form 8863** and, generally, a **Form 1098-T** from the institution, and the student must be the taxpayer, spouse, or a dependent claimed on the return. Expenses paid with tax-free scholarships, employer assistance, or tax-free 529 earnings cannot also support a credit. A taxpayer cannot claim both credits for the **same student** in the same year but can claim the AOTC for one child and the LLC for another. Expenses paid in December 2025 for a term beginning in the first three months of 2026 count for 2025. If a dependent child pays the expenses, the parent who claims the child is treated as having paid them.

Worked example. Mateo’s cousin Lucia is a sophomore enrolled full time. Her parents paid \$3,500 of tuition and \$600 for required textbooks bought online. Qualified expenses \$4,100. AOTC: $\$2,000 + 25\% \times \$2,000 = \$2,500$ (the credit is capped at the first \$4,000 of expenses). Their MAGI is \$150,000, below the MFJ phaseout, so the full \$2,500 is allowed, of which up to \$1,000 is refundable.

Worked example (phaseout). If Lucia’s parents had MAGI of \$170,000, they would be halfway through the \$160,000–\$180,000 range and keep half the credit: \$1,250.

Memory cue. “AOTC: four years, half-time, books count, \$2,500, 40% back.” “LLC: any class, any year, 20% of \$10,000, nothing back.”

3.14 Foreign tax credit

A nonrefundable credit for income taxes paid or accrued to a foreign country or U.S. possession, limited to the U.S. tax on foreign-source taxable income (foreign-source taxable income $\div$ worldwide taxable income $\times$ U.S. tax), computed separately for passive and general category income on **Form 1116**. A taxpayer whose only foreign taxes are passive (dividends, interest) and total **\$300 or less** (\$600 MFJ), all reported on payee

statements, may claim the credit directly on Schedule 3 without Form 1116 and without the limitation. Unused credits carry back one year and forward ten. The taxpayer may instead deduct foreign taxes on Schedule A, but not both in the same year, and taxes on income excluded under Form 2555 cannot be credited.

3.15 Earned income tax credit

The rule. A **refundable** credit for low- and moderate-income workers, computed from **earned income** (wages, tips, net self-employment income, union strike benefits, and, by election, nontaxable combat pay; not pensions, unemployment, Social Security, alimony, child support, interest, or dividends). Schedule EIC lists the qualifying children.

2025 maximum credits and phaseout endpoints.

Qualifying children	Maximum credit	Credit fully phased out at earned income or AGI of (single, HOH, QSS)	(MFJ)
0	\$649	\$19,104	\$26,214
1	\$4,328	\$50,434	\$57,554
2	\$7,152	\$57,310	\$64,430
3 or more	\$8,046	\$61,555	\$68,675

Eligibility rules for everyone.

- Investment income (interest, dividends, capital gains, rents, royalties, passive income) must be **\$11,950** or less.
- Taxpayer, spouse, and each qualifying child must have an SSN valid for employment issued by the return due date. ITINs do not qualify.
- Cannot file **MFS**, unless the taxpayer lived apart from the spouse for the last six months of the year (or is legally separated) and has a qualifying child living with him or her more than half the year.
- Cannot file **Form 2555** (foreign earned income exclusion).
- Must be a U.S. citizen or resident alien all year (or a nonresident married to a citizen or resident filing jointly).
- Cannot be the qualifying child of another person.

Without a qualifying child, the taxpayer must be at least **25 and under 65** at year end, must have lived in the U.S. more than half the year, and cannot be claimed as a dependent.

With a qualifying child, the child must meet the relationship, age, residency (more than half the year **in the U.S.**), and joint return tests. The **support test does not apply** for the EITC, and a child's own income does not matter. Only one person may claim a given child; the tie-breaker rules apply. A noncustodial parent can never claim the EITC for the child, regardless of Form 8332.

Disallowance and Form 8862. If the IRS denies the credit for reckless or intentional disregard of the rules, the taxpayer is barred for **2 years**; for fraud, **10 years**. To claim the credit again after a disallowance for any reason other than a math or clerical error, the taxpayer must attach **Form 8862**.

Preparer due diligence (Form 8867). The preparer must complete the checklist, compute the credit on worksheets, ask reasonable questions when information seems incorrect or incomplete, document the questions and answers, and keep the records for three years. The penalty for returns filed in 2026 is **\$650 per failure**, per credit (and per head of household determination).

Worked example. Carlos, 34, single, earned \$14,000 in wages and tips and had \$200 of interest. He has no children. He meets the age test (25 to 64), his investment income is under \$11,950, and his income is below \$19,104, so he qualifies for a credit of up to \$649, computed from the EITC table.

Exam trap. A qualifying child for the EITC does not have to be a dependent. A custodial parent who released the exemption to the other parent on Form 8332 still claims the EITC for that child. Conversely, a dependent qualifying relative (a parent, a cousin) is never a qualifying child for the EITC.

3.16 Adoption credit

The rule. A credit of up to **\$17,280** per eligible child for qualified adoption expenses (adoption fees, court costs, attorney fees, travel), phased out for MAGI between **\$259,190 and \$299,190**. For 2025, up to **\$5,000** per child is **refundable**; the balance is nonrefundable with a **five-year** carryforward. A separate exclusion of up to \$17,280 applies to employer-provided adoption assistance, but the same expenses cannot support both. Form 8839.

Timing. For a **domestic** adoption, expenses paid before the year the adoption becomes final are claimed in the year after they were paid; expenses paid in the year it becomes final or later are claimed in the year paid. For a **foreign** adoption, no credit is allowed until the year the adoption becomes final. A **special-needs** child (a U.S. child a state has determined cannot be returned to the parents' home and is unlikely to be adopted without assistance) qualifies for the **full** \$17,280 credit in the year the adoption is final regardless of actual expenses. Adopting a spouse's child does not qualify. Expenses for a surrogate arrangement do not qualify.

New for 2025. The adoption credit was previously entirely nonrefundable. Beginning in 2025, up to \$5,000 per child is refundable. The nonrefundable portion still carries forward five years; the refundable portion does not carry forward.

3.17 Premium tax credit

A **refundable** credit (Form 8962) for taxpayers who enrolled in a qualified health plan through the Marketplace, cannot get affordable minimum essential coverage elsewhere (employer plan, Medicare, Medicaid), file a return, and are not claimed as a dependent. The credit equals the premium of the second-lowest-cost silver plan (the benchmark) minus the expected contribution, which is household income multiplied by the applicable percentage. For 2025, the applicable percentage is 0% for households up to 150% of the federal poverty line and rises to 8.5% for households at 400% and above; there is **no** upper income cap for 2025. Advance payments (APTC) made to the insurer must be reconciled: if APTC exceeds the allowed credit, the excess is repaid as additional tax, but repayment is capped for households below 400% of the poverty line, with the cap rising in tiers as income approaches 400%. Married taxpayers must file jointly except in cases of domestic abuse or abandonment.

3.18 Other credits

Credit	Refundable?	2025 rule
Retirement savings contributions credit (saver's credit, Form 8880)	No	50%, 20%, or 10% of up to \$2,000 of IRA, Roth, 401(k), 403(b), 457, SIMPLE, SEP, or ABLE contributions. 50% up to AGI of \$47,500 MFJ, \$35,625 HOH, \$23,750 other; 20% up to \$51,000 / \$38,250 / \$25,500; 10% up to \$79,000 / \$59,250 / \$39,500. Must be 18 or older, not a full-time student, not a dependent. Reduced by distributions taken in the testing period
Credit for the elderly or the disabled (Schedule R)	No	15% of a base amount (\$5,000 single or one qualifying spouse, \$7,500 both spouses, \$3,750 MFS) reduced by nontaxable Social Security and by half of AGI over \$7,500 / \$10,000 / \$5,000; rarely available in practice
Residential clean energy credit (Form 5695, Part I)	No, but carries forward	30% of solar electric, solar water heating, geothermal, wind, battery storage (3 kWh+) and fuel cell property placed in service in 2025; no dollar cap except fuel cells
Energy efficient home improvement credit (Form 5695, Part II)	No, no carryforward	30% of qualifying insulation, windows, doors, central air, water heaters, heat pumps, and home energy audits, up to \$1,200 per year (\$600 windows, \$500 doors, \$150 audit), with a separate \$2,000 limit for heat pumps and biomass stoves; existing home that is the taxpayer's residence

Credit	Refundable?	2025 rule
Clean vehicle credit (Form 8936)	No (unless transferred to the dealer)	Up to \$7,500 for a new clean vehicle and up to \$4,000 (30% of price) for a used one, subject to MSRP, income, and sourcing rules, for vehicles acquired on or before September 30, 2025
Credit for excess Social Security tax withheld	Yes	When two or more employers together withheld more than $6.2\% \times \$176,100 = \$10,918.20$ of Social Security tax; claimed on Schedule 3
Credit for federal tax paid on fuels (Form 4136)	Yes	Off-highway business use
Health coverage tax credit	—	Expired; no longer available

Ordering of nonrefundable credits. Nonrefundable personal credits are applied against regular tax plus AMT in a fixed sequence, and a credit that cannot be used in the current year is lost unless it specifically carries forward (adoption, residential clean energy, foreign tax, minimum tax credit). Refundable credits are then treated as payments.

Not on your exam. The One Big Beautiful Bill Act terminated the clean vehicle credits for vehicles acquired after September 30, 2025, the energy efficient home improvement credit for property placed in service after December 31, 2025, and the residential clean energy credit for expenditures made after December 31, 2025. For a 2025 question, these credits still exist; watch for a vehicle “purchased in November 2025,” which does not qualify.

Quick Check: Chapter 3

1. Hal, single, 67, and not blind, takes the standard deduction and has MAGI of \$70,000. What is the total of his standard deduction and enhanced senior deduction for 2025?

- A. \$15,750
- B. \$17,750
- C. \$21,750
- D. \$23,750

2. Vera’s AGI is \$80,000. She paid \$7,000 of medical expenses, \$2,000 of which her insurer reimbursed. Her Schedule A medical deduction is:

- A. \$0
- B. \$1,000
- C. \$5,000
- D. \$7,000

3. Noah, single, paid \$44,000 of state income and property taxes in 2025 and has MAGI of \$540,000. His SALT deduction is:
- A. \$10,000
 - B. \$28,000
 - C. \$40,000
 - D. \$44,000
4. The Rivera family paid \$8,000 of day care for their 4-year-old twins so both parents could work. Their AGI is \$50,000 and the lower-earning spouse earned \$20,000. Their child and dependent care credit is:
- A. \$1,200
 - B. \$1,600
 - C. \$2,100
 - D. \$2,800
5. Which taxpayer may claim the earned income tax credit for 2025?
- A. Alex, 23, single, no children, earned \$12,000, not a dependent.
 - B. Bea, married filing separately, lived with her husband all year, one child.
 - C. Cal, 45, single, no children, earned \$15,000, with \$12,500 of dividend income.
 - D. Dee, 30, head of household, one qualifying child, earned \$30,000.
6. Jin donated stock held for three years (basis \$2,000, FMV \$9,000) to a public charity. His AGI is \$20,000. What is his 2025 charitable deduction, and what carries over?
- A. \$9,000 deduction; \$0 carryover
 - B. \$6,000 deduction; \$3,000 carryover
 - C. \$2,000 deduction; \$0 carryover
 - D. \$12,000 deduction; \$0 carryover
7. Kim claims her 19-year-old son, a full-time college sophomore, and paid \$5,000 of his tuition and \$400 for required books from the campus store. Kim's MAGI is \$65,000 and she files head of household. Her American opportunity credit is:
- A. \$2,000
 - B. \$2,500
 - C. \$1,080
 - D. \$5,400
8. Which deduction is claimed on Schedule 1-A for 2025 and does **not** reduce AGI?
- A. Student loan interest
 - B. Health savings account contribution
 - C. Qualified overtime compensation
 - D. Educator expenses

9. A married couple filing jointly has MAGI of \$405,000 and two qualifying children under 17. Their child tax credit before any tax liability limit is:

- A. \$4,400
- B. \$4,150
- C. \$4,100
- D. \$3,900

10. Pam, single with taxable income of \$150,000 (none from capital gains) before the QBI deduction, earned \$60,000 of QBI from her law practice. Her QBI deduction is:

- A. \$0, because law is a specified service trade or business
- B. \$12,000
- C. \$30,000
- D. \$6,000

Answers.

1. D. Standard deduction \$15,750 + \$2,000 additional for age 65 = \$17,750. The enhanced senior deduction is a separate \$6,000, and his MAGI of \$70,000 is below the \$75,000 phaseout, so the total is \$23,750.

2. A. Unreimbursed expenses are \$5,000. The floor is $7.5\% \times \$80,000 = \$6,000$. Expenses do not exceed the floor, so the deduction is zero.

3. B. Cap is \$40,000 reduced by $30\% \times (\$540,000 - \$500,000) = \$12,000$, so \$28,000. The floor of \$10,000 is not reached until MAGI of \$600,000.

4. A. Two qualifying persons: expense limit \$6,000, which is below both the \$8,000 paid and the \$20,000 earned-income limit. At AGI of \$50,000 the percentage is 20%. Credit: \$1,200.

5. D. Alex is under 25 with no qualifying child. Bea is MFS and lived with her spouse. Cal's investment income exceeds \$11,950. Dee meets all tests and her income is below the \$50,434 limit for one child.

6. B. Long-term appreciated stock to a public charity is deductible at FMV, limited to 30% of AGI: \$6,000. The remaining \$3,000 carries forward for five years.

7. B. Qualified expenses \$5,400 (books count for the AOTC). Credit: $100\% \times \$2,000 + 25\% \times \$2,000 = \$2,500$. HOH phaseout begins at \$80,000, so no reduction. C would be the lifetime learning credit on \$5,400; A is the LLC maximum.

8. C. Qualified overtime is one of the four Schedule 1-A deductions, taken from AGI. The other three are Schedule 1 adjustments that reduce AGI.

9. B. Two children $\times \$2,200 = \$4,400$. MAGI exceeds \$400,000 by \$5,000, which is five \$1,000 increments, so the reduction is $\$50 \times 5 = \$250$. Credit: $\$4,400 - \$250 = \$4,150$.

10. B. Pam's taxable income of \$150,000 is below the \$197,300 threshold, so the SSTB rule and the wage limit do not apply. Deduction is $20\% \times \$60,000 = \$12,000$, which is less than 20% of taxable income (\$30,000).

Chapter 4. Taxation

Domain 4 • 15 scored questions (18%)

What the outline tests: alternative minimum tax and the credit for prior-year minimum tax; household employees; underpayment penalties and interest; self-employment tax; excess Social Security withholding; tax provisions for clergy; tax provisions for the military; income in respect of a decedent; net investment income tax; Additional Medicare Tax; uncollected Social Security and Medicare tax; and other taxes such as the first-time homebuyer credit repayment.

Domain 4 is about everything on Form 1040 **after** taxable income: the regular tax computation, the alternative minimum tax, and the parade of “other taxes” on Schedule 2. It also covers three groups of taxpayers with special rules: household employers, clergy, and the military. The questions here reward precise numbers.

4.1 The regular tax computation

The rule. Taxable income is AGI minus the standard or itemized deductions, minus the QBI deduction, minus the new Schedule 1-A deductions. Regular tax is computed from the tax tables (taxable income under \$100,000) or the tax rate schedules, with qualified dividends and net long-term capital gains taxed at 0%, 15%, or 20% using the worksheet.

2025 tax rate schedules.

Rate	Single	Married filing jointly / QSS	Married filing separately	Head of household
10%	\$0 – \$11,925	\$0 – \$23,850	\$0 – \$11,925	\$0 – \$17,000
12%	\$11,925 – \$48,475	\$23,850 – \$96,950	\$11,925 – \$48,475	\$17,000 – \$64,850
22%	\$48,475 – \$103,350	\$96,950 – \$206,700	\$48,475 – \$103,350	\$64,850 – \$103,350
24%	\$103,350 – \$197,300	\$206,700 – \$394,600	\$103,350 – \$197,300	\$103,350 – \$197,300
32%	\$197,300 – \$250,525	\$394,600 – \$501,050	\$197,300 – \$250,525	\$197,300 – \$250,500
35%	\$250,525 – \$626,350	\$501,050 – \$751,600	\$250,525 – \$375,800	\$250,500 – \$626,350
37%	Over \$626,350	Over \$751,600	Over \$375,800	Over \$626,350

Worked example. The Lopezes have taxable income of \$110,000, all ordinary. Tax: \$11,157 on the first \$96,950, plus $22\% \times (\$110,000 - \$96,950) = \$2,871$, total \$14,028. Their marginal rate is 22%; their effective rate on taxable income is about 12.8%. If \$10,000 of that income were qualified dividends, those dividends would be taxed at 15% (because taxable income exceeds \$96,700) instead of 22%, saving \$700.

4.2 Alternative minimum tax

The rule. The AMT is a parallel tax computed on **Form 6251**. Start with taxable income, add back **adjustments and preferences**, subtract the **AMT exemption**, and apply **26%** to the first **\$239,100** of the result (\$119,550 MFS) and **28%** above that. The taxpayer pays the regular tax plus the amount, if any, by which the tentative minimum tax exceeds the regular tax.

2025 exemption amounts and phaseouts.

Filing status	Exemption	Phaseout begins at AMTI of	Fully phased out at
Single / HOH	\$88,100	\$626,350	\$978,750
Married filing jointly / QSS	\$137,000	\$1,252,700	\$1,800,700
Married filing separately	\$68,500	\$626,350	\$900,350
Estates and trusts	\$30,700	\$102,500	\$225,300

The exemption is reduced by **25 cents** for every dollar of AMTI above the phaseout threshold.

Common adjustments and preferences.

Item	AMT treatment
State and local taxes deducted on Schedule A	Added back; not deductible for AMT
Standard deduction	Added back if taken (so AMT itemizers and non-itemizers start from the same point)
Incentive stock option exercise	Spread between FMV and exercise price is added, unless the stock is sold in the same year
Private activity bond interest (tax-exempt for regular tax)	Added back
Depreciation on property placed in service after 1986	Difference between regular and AMT depreciation (150% declining balance for personal property)
Percentage depletion in excess of basis, intangible drilling costs	Preferences added back
Medical expenses, mortgage interest on acquisition debt, charitable contributions, investment interest	Generally allowed for AMT (no adjustment)

Item	AMT treatment
Home equity interest not used to improve the home	Not deductible for either tax in 2025

Minimum tax credit (Form 8801). AMT paid because of **deferral** items (ISO exercise, depreciation differences) generates a credit that can be used in a later year when regular tax exceeds tentative minimum tax. AMT caused by **exclusion** items (SALT, standard deduction, private activity bond interest) does not generate a credit. The credit carries forward indefinitely.

Worked example. Maria exercised ISOs in 2025 with a \$60,000 spread and held the shares. The Lopeses' taxable income is \$110,000, and they deducted \$16,200 of state and local taxes. AMTI: $\$110,000 + \$60,000 + \$16,200 = \$186,200$. Exemption: \$137,000 (no phaseout). AMT base: \$49,200. Tentative minimum tax: $26\% \times \$49,200 = \$12,792$. Regular tax is \$14,028, which exceeds \$12,792, so no AMT is owed in 2025. Had the spread been \$100,000, AMTI would be \$226,200, the base \$89,200, the tentative minimum tax \$23,192, and the AMT \$9,164, of which the portion attributable to the ISO deferral item would generate a minimum tax credit.

Memory cue. "SALT and the standard deduction are gone; ISOs are in." Those three cause most individual AMT.

4.3 Household employment taxes

The rule. A taxpayer who pays a **household employee** (nanny, housekeeper, caregiver, gardener who works under the taxpayer's direction) cash wages of **\$2,800** or more in 2025 must withhold and pay Social Security and Medicare taxes (7.65% each for employer and employee, 15.3% total) on all of that employee's cash wages. Wages of **\$1,000** or more in any calendar quarter of 2025 or 2024 to all household employees combined trigger federal unemployment tax (FUTA, 6% on the first \$7,000 of wages, generally reduced to 0.6% by the state credit). Both are reported on **Schedule H** with the taxpayer's Form 1040, and the employer must issue a **Form W-2** to the employee and file Form W-3.

Not counted. Wages paid to the taxpayer's spouse, to the taxpayer's child under 21, to the taxpayer's parent (unless caring for the taxpayer's child under certain conditions), or to an employee under 18 whose principal occupation is being a student are exempt from Social Security and Medicare tax. Payments to an independent contractor (a lawn service that controls its own work and brings its own equipment) are not household employment. Federal income tax withholding is not required unless the employee asks and the employer agrees. The employer needs an EIN and may increase his or her own withholding or make estimated payments to cover the Schedule H liability.

Worked example. The Lopezes paid a part-time nanny \$9,000 in cash wages in 2025, including \$3,000 in the second quarter. Because \$9,000 exceeds \$2,800, they owe Social Security and Medicare tax of $15.3\% \times \$9,000 = \$1,377$ (half of which they may have withheld from her pay). Because wages in the second quarter were at least \$1,000, FUTA also applies: $0.6\% \times \$7,000 = \$42$ after the state credit. Total Schedule H tax: \$1,419. They also must give the nanny a W-2.

4.4 Estimated tax, underpayment penalties, and interest

The rule. Income tax is pay-as-you-go. A taxpayer who expects to owe **\$1,000 or more** after withholding and credits must make estimated payments (Form 1040-ES) due **April 15, June 15, September 15, and January 15** of the following year. No underpayment penalty applies if payments through withholding and estimates equal at least the smaller of **90% of the current-year tax** or **100% of the prior-year tax (110%** if the prior-year AGI exceeded **\$150,000**, or \$75,000 MFS), provided the prior year was a full 12-month year with a return filed.

Other safe harbors and exceptions. No penalty if the balance due after withholding is under \$1,000; if the taxpayer had no tax liability for the prior 12-month year and was a U.S. citizen or resident all year; or if the IRS waives the penalty because of a casualty, disaster, or other unusual circumstance, or because the taxpayer retired after age 62 or became disabled and the underpayment was due to reasonable cause. Farmers and fishermen (at least two-thirds of gross income from farming or fishing) need only pay 66⅔% of the current-year tax, may make one payment by January 15, or may skip estimates entirely by filing and paying by March 2. **Withholding** is treated as paid evenly through the year regardless of when it was withheld, which makes a late-year withholding increase the best cure for an underpayment. The **annualized income installment method** on Form 2210 reduces or eliminates the penalty for taxpayers whose income arrived unevenly.

Penalty rates for 2025 returns.

Penalty	Rate	Limit
Underpayment of estimated tax (Form 2210)	Interest-like charge at the federal short-term rate plus 3 percentage points, computed from each installment due date	Until paid or April 15, 2026
Failure to file	5% of the unpaid tax per month or part of a month	25% of unpaid tax; minimum penalty \$525 (or 100% of the tax if less) when the return is more than 60 days late
Failure to pay	0.5% of the unpaid tax per month or part of a month (0.25% while an installment agreement is in effect; 1% after a notice of intent to levy)	25% of unpaid tax
Both failure to file and failure to pay in the same month	Combined 5% (the failure-to-file penalty is reduced by the failure-to-pay penalty)	Combined maximum 47.5%

Penalty	Rate	Limit
Accuracy-related	20% of the underpayment attributable to negligence or a substantial understatement (more than the greater of 10% of the correct tax or \$5,000)	—
Civil fraud	75% of the underpayment attributable to fraud	—
Frivolous return	\$5,000	—
Interest on underpayments	Federal short-term rate plus 3%, compounded daily, from the original due date	Interest cannot be abated for reasonable cause

Worked example. Priya's 2024 tax was \$20,000 with AGI of \$130,000. Her 2025 tax turns out to be \$32,000. She avoids the underpayment penalty if her 2025 withholding and estimates total at least the smaller of $90\% \times \$32,000 = \$28,800$ or $100\% \times \$20,000 = \$20,000$. Paying four installments of \$5,000 protects her even though she will owe \$12,000 on April 15, 2026. If her 2024 AGI had been \$160,000, the prior-year safe harbor would be $110\% \times \$20,000 = \$22,000$.

Worked example. Carlos filed his 2025 return on August 20, 2026, with no extension, owing \$2,000. He is five months late (April 16 through August 20 spans five months or parts of months). Step 1, failure to pay: $0.5\% \times 5 = 2.5\% \times \$2,000 = \$50$. Step 2, failure to file: $5\% \times 5 = 25\% \times \$2,000 = \$500$, reduced by the \$50 failure-to-pay penalty for the same months, leaving \$450. Step 3, minimum penalty: because the return is more than 60 days late, the failure-to-file penalty cannot be less than the smaller of \$525 or the tax due (\$2,000), so it is raised from \$450 to \$525. Total penalties: $\$525 + \$50 = \$575$, plus interest on the \$2,000 from April 15.

Memory cue. "Ninety now or a hundred then; one-ten if you made one-fifty." And "file five, pay half, cap twenty-five."

4.5 Self-employment tax

The rule. Net earnings from self-employment of **\$400** or more (or church employee income of \$108.28 or more) are subject to self-employment tax on **Schedule SE**. Multiply net profit from Schedule C, Schedule F, and general partnership K-1 income by **92.35%** to get net earnings. Apply **12.4%** Social Security tax to net earnings up to the **\$176,100** wage base (reduced by any W-2 Social Security wages already earned) and **2.9%** Medicare tax to all net earnings. Half of the SE tax is an adjustment to income.

What is subject to SE tax. Sole proprietorship profit, general partner distributive shares and guaranteed payments, independent contractor income reported on 1099-NEC, director fees, clergy earnings including housing allowance, and the net profit of a professional gambler or trader only if the activity is a trade or business (trading gains are not SE income). **Not subject:** wages, S corporation distributive shares, limited partner shares (other than guaranteed payments for services), rental real estate income unless substantial services are provided, interest and dividends, capital gains, notary public fees, and the income of a statutory employee.

Optional methods. Farmers and taxpayers with low net earnings may elect the optional methods to report a minimum amount of SE earnings (so they earn Social Security credits), even in a loss year.

Worked example. Priya's Schedule C profit is \$80,000 and she has no W-2 wages. Net earnings: $\$80,000 \times 92.35\% = \$73,880$. SE tax: $15.3\% \times \$73,880 = \$11,304$. She deducts \$5,652 as an adjustment to income. Had she also earned \$150,000 of W-2 wages, the Social Security portion would apply only to $\$176,100 - \$150,000 = \$26,100$ of her net earnings ($12.4\% \times \$26,100 = \$3,236$), while the 2.9% Medicare tax would apply to all \$73,880 (\$2,143), for SE tax of \$5,379.

Exam trap. The 92.35% step is not optional, and the question will usually give the net profit, not net earnings. Multiply before applying 15.3%. A \$10,000 Schedule C profit produces \$1,413 of SE tax, not \$1,530.

4.6 Excess Social Security withholding

Each employer must withhold 6.2% Social Security tax on wages up to the wage base, **\$176,100** for 2025, a maximum of **\$10,918.20** per employer. A taxpayer with **two or more employers** whose combined Social Security withholding exceeds \$10,918.20 claims the excess as a refundable credit on Schedule 3. If a **single** employer over-withheld, the taxpayer cannot claim the credit and must ask the employer for a refund. On a joint return, the limit applies to each spouse separately. Tier 1 Railroad Retirement tax is combined with Social Security tax for this purpose. There is no wage cap on Medicare tax, so there is never "excess Medicare withholding."

Worked example. In 2025 David earned \$120,000 from Employer A and \$90,000 from Employer B, each of which withheld 6.2%: \$7,440 and \$5,580, total \$13,020. Excess: $\$13,020 - \$10,918.20 = \$2,101.80$, claimed as a credit. Maria's withholding from her single employer is tested separately.

4.7 Members of the clergy

Ministers, priests, rabbis, imams, and other duly ordained, commissioned, or licensed ministers have a **dual tax status**: for income tax they are usually **employees** of the congregation (Form W-2, but exempt from mandatory income tax withholding), while for Social Security and Medicare they are always treated as **self-employed** and pay SE tax on Schedule SE.

Housing (parsonage) allowance. The rental value of a home provided, or a housing allowance designated in advance by the church, is **excluded from income tax** to the extent it is used for housing costs (rent, mortgage, utilities, furnishings, repairs) and does not exceed the fair rental value of the home plus utilities. The allowance is **included** in net earnings for SE tax. Unreimbursed business expenses allocable to the excluded allowance are not deductible.

Exemption from SE tax (Form 4361). A minister who is conscientiously opposed to public insurance on religious grounds may apply for exemption by the due date of the return for the second year with at least \$400 of ministerial earnings. The election is irrevocable. Members of certain religious orders who have taken a vow of poverty are not subject to SE tax on earnings from duties required by the order.

Worked example. Pastor Reed receives a \$50,000 salary and a \$20,000 housing allowance designated in advance. He spends \$18,000 on housing and the fair rental value of the home is \$24,000. For income tax, he excludes \$18,000 (the amount actually spent, which is below both the designated allowance and the fair rental value) and reports \$52,000 (\$50,000 + \$2,000 unused allowance). For SE tax, his net earnings include the full \$70,000.

4.8 Members of the Armed Forces

Provision	Rule
Combat zone pay	Excluded from gross income for enlisted members and warrant officers for every month served in a combat zone; for commissioned officers, excluded up to the highest enlisted pay plus imminent danger pay. May be elected into earned income for the EITC and counts as compensation for IRA contributions
Allowances	Basic allowance for housing (BAH), basic allowance for subsistence (BAS), uniform allowances, family separation allowance, and moving allowances are excluded; basic pay, bonuses, and most special pays are taxable
Moving expenses	Deductible as an adjustment (Form 3903) for a permanent change of station; reimbursements under the Joint Travel Regulations are excluded
Filing deadlines	Automatic extension of at least 180 days after leaving a combat zone (plus the number of days left in the filing period when the member entered the zone) to file, pay, make IRA contributions, and respond to the IRS; interest and penalties are suspended. Members stationed abroad on April 15 get the automatic two-month extension to June 15
Home sale exclusion	The five-year ownership and use test period may be suspended for up to 10 years while on qualified official extended duty (at least 90 days, more than 50 miles from the home)

Provision	Rule
Reservists	Travel more than 100 miles from home for reserve duty is an adjustment to income (Form 2106); a qualified reservist distribution from a retirement plan during active duty of 180 days or more is exempt from the 10% penalty and may be recontributed within two years
Death benefits	The \$100,000 military death gratuity and SGLI proceeds are excluded; tax liability is forgiven for the year of death and any earlier year from the first day served in a combat zone for a member who dies in a combat zone or from wounds received there
State taxes	Military pay is taxed only by the state of legal residence; under the Military Spouses Residency Relief Act a spouse may keep the same state of residence as the service member
Uniforms	The cost of uniforms that may not be worn off duty was a miscellaneous itemized deduction and is not deductible for 2025

Worked example. Sergeant Diaz served in a combat zone from February through November 2025 and received \$36,000 of basic pay for those months plus \$8,000 for December and January. Her W-2 box 1 shows \$8,000; the \$36,000 is excluded and reported in box 12 with code Q. She may elect to treat the \$36,000 as earned income for the EITC if that increases her credit, and she may base an IRA contribution on it.

4.9 Income in respect of a decedent

The rule. Income the decedent earned or had a right to receive before death, but that was not includible on the final Form 1040 (because the decedent used the cash method and had not received it), is **income in respect of a decedent (IRD)**. It is taxed to whoever receives it, the estate (Form 1041) or the beneficiary, with the **same character** it would have had for the decedent, and it does **not** receive a basis step-up.

Common IRD items. Traditional IRA and pre-tax retirement plan balances; the final paycheck and accrued vacation pay received after death; accrued but unpaid interest and dividends declared before death; installment sale payments received after death; unpaid rents and royalties; a deceased partner's share of partnership income; and the gain on a sale completed before death with payment after death. Deductions the decedent incurred but did not pay (business expenses, interest, taxes) are "deductions in respect of a decedent," deductible by the estate or beneficiary who pays them.

Estate tax deduction. If the decedent's estate paid federal estate tax, the recipient of IRD may deduct the portion of the estate tax attributable to including the IRD in the gross estate, as an itemized deduction not subject to any floor.

Worked example. Rosa dies in 2025 holding a traditional IRA worth \$200,000 and stock worth \$200,000 that she bought for \$50,000. Her daughter Maria inherits both. The stock's basis steps up to \$200,000, so Maria can sell it with no gain. The IRA is IRD: every dollar Maria withdraws is ordinary income to her, exactly as it would have been to Rosa, with no step-up.

Memory cue. “Things she owned step up; things she was owed are IRD.”

4.10 Net investment income tax

The rule. A **3.8%** tax (Form 8960) on the **lesser** of (1) net investment income or (2) the excess of MAGI over **\$200,000** (single, HOH), **\$250,000** (MFJ, QSS), or **\$125,000** (MFS). These thresholds are not indexed for inflation.

Net investment income includes	Not net investment income
Taxable interest, dividends, annuities, royalties, rents	Wages, self-employment income, unemployment
Capital gains, including gain on a home sale above the section 121 exclusion	Tax-exempt interest, excluded home sale gain
Income from a passive activity or a trade or business of trading financial instruments	Income from an active trade or business
Net gain from the disposition of property not held in an active trade or business	Distributions from IRAs and qualified retirement plans; Social Security benefits
Less: allocable deductions (investment interest, state taxes on investment income, advisory fees)	Alaska Permanent Fund dividends; veterans' benefits

Worked example. The Lopezes have MAGI of \$270,000 including \$30,000 of dividends and capital gains. Excess over \$250,000: \$20,000. Net investment income: \$30,000. NIIT: $3.8\% \times \text{the lesser, } \$20,000 = \$760$. If their MAGI were \$240,000, no NIIT would apply regardless of how much investment income they had.

4.11 Additional Medicare Tax

The rule. A **0.9%** tax (Form 8959) on wages, Railroad Retirement compensation, and self-employment income above **\$200,000** (single, HOH, QSS), **\$250,000** (MFJ), or **\$125,000** (MFS). Employers must withhold the 0.9% on an employee's wages above \$200,000 in the calendar year **regardless of filing status**, which can produce over- or under-withholding that is reconciled on the return. The thresholds are reduced by wages when applying them to SE income, and there is no employer match and no deduction for the tax.

Worked example. David earned \$210,000 in wages and Maria earned \$60,000. David's employer withheld $0.9\% \times \$10,000 = \$90$ of Additional Medicare Tax. Their combined wages are \$270,000, so they owe $0.9\% \times (\$270,000 - \$250,000) = \$180$. They report \$180 on Form 8959, credit the \$90 withheld, and owe an additional \$90. Had Maria earned nothing, David's \$210,000 would be below the \$250,000 joint threshold and the \$90 withheld would be refunded through the return.

Exam trap. The NIIT and the Additional Medicare Tax use the same dollar thresholds but tax different things. NIIT hits investment income; Additional Medicare Tax hits earned income. A taxpayer with \$300,000 of wages and \$50,000 of dividends (MFJ) owes both: 0.9% on \$50,000 of wages and 3.8% on \$50,000 (the lesser of NII and the \$100,000 excess of MAGI over \$250,000).

4.12 Uncollected Social Security and Medicare tax

Tips. An employee who did not have enough wages for the employer to withhold Social Security and Medicare tax on reported tips sees codes **A** and **B** in W-2 box 12 and pays the uncollected amounts on Schedule 2. Tips the employee failed to report to the employer are reported on **Form 4137**, which computes the employee's share of Social Security and Medicare tax on them (and may trigger a 50% penalty on that tax for failure to report).

Misclassified workers. A worker who was treated as an independent contractor (Form 1099-NEC) but believes he or she was an employee may file **Form SS-8** asking the IRS to determine worker status, and uses **Form 8919** to pay only the **employee** share (7.65%) of Social Security and Medicare tax instead of the full 15.3% SE tax. Form 8919 requires a reason code, such as an SS-8 determination or a W-2 and 1099 from the same firm for similar work.

Group-term life insurance over \$50,000. Former employees see code **M** and **N** for uncollected Social Security and Medicare tax on the taxable cost, also paid on Schedule 2.

4.13 Other taxes on Schedule 2

Item	Rule
First-time homebuyer credit repayment (Form 5405)	Buyers who claimed the 2008 credit (up to \$7,500) repaid it in 15 annual installments of up to \$500, from the 2010 return through the 2024 return. For 2025 the issue arises only if installments were missed or if the home is sold or stops being the main home while a balance remains; the remaining balance is then due in that year, limited to the gain on a sale to an unrelated party
Additional tax on IRAs and other tax-favored accounts (Form 5329)	10% early distribution penalty; 6% excess contribution excise; 25%/10% missed RMD penalty; 20% HSA nonqualified distribution penalty; 10% on Coverdell and 529 nonqualified earnings

Item	Rule
Repayment of excess advance premium tax credit (Form 8962)	Added to tax, subject to the repayment caps for households below 400% of the poverty line
Recapture of credits	Education credit recapture when expenses are refunded in a later year; recapture of the low-income housing or investment credit; recapture of the new clean vehicle credit transferred to a dealer when the buyer turns out to be ineligible
Section 72(m)(5) excess benefits tax; section 453A interest on large installment sales; section 1260 interest; tax on accumulation distributions from trusts (Form 4970)	Specialized items that may appear as answer choices but are rarely tested in depth
Household employment taxes (Schedule H)	See section 4.3
Unreported tip income and uncollected taxes (Forms 4137, 8919)	See section 4.12

Quick Check: Chapter 4

1. Omar's Schedule C shows a net profit of \$50,000. He has no other earned income. His 2025 self-employment tax is closest to:

- A. \$7,650
- B. \$7,065
- C. \$3,825
- D. \$6,120

2. A single taxpayer has MAGI of \$230,000, including \$45,000 of interest and dividends. Her net investment income tax is:

- A. \$1,710
- B. \$1,140
- C. \$0
- D. \$8,740

3. Which taxpayer must file Schedule H for 2025?

- A. Rena, who paid a lawn care company \$3,600 for weekly mowing with its own equipment.
- B. Sol, who paid his 17-year-old daughter \$3,000 to babysit his younger children.
- C. Tia, who paid a housekeeper \$2,900 in cash wages.
- D. Uri, who paid a babysitter \$900 in total for the year.

4. Pastor Lee's church pays him \$45,000 and a properly designated \$15,000 housing allowance. He spent \$13,000 on housing; the home's fair rental value is \$16,000. For income tax and SE tax, respectively, his includible earnings are:
- A. \$45,000 and \$45,000
 - B. \$47,000 and \$60,000
 - C. \$45,000 and \$60,000
 - D. \$60,000 and \$60,000
5. Which item is income in respect of a decedent?
- A. Stock the decedent purchased for \$10,000 that was worth \$50,000 at death.
 - B. The decedent's final paycheck, received by the estate two weeks after death.
 - C. A personal residence owned by the decedent.
 - D. Life insurance proceeds paid to the decedent's spouse.
6. Kai's 2024 AGI was \$200,000 and his 2024 tax was \$40,000. To avoid the 2025 underpayment penalty using the prior-year safe harbor, his 2025 withholding and estimated payments must total at least:
- A. \$36,000
 - B. \$40,000
 - C. \$44,000
 - D. \$45,000
7. Ivy had two employers in 2025. Employer 1 withheld \$8,000 of Social Security tax and Employer 2 withheld \$4,500. Her credit for excess Social Security tax withheld is:
- A. \$0
 - B. \$1,581.80
 - C. \$12,500
 - D. \$4,500
8. A married couple filing jointly has AMTI of \$1,300,000. Their 2025 AMT exemption is:
- A. \$137,000
 - B. \$125,175
 - C. \$0
 - D. \$88,100

Answers.

1. **B.** $\$50,000 \times 92.35\% = \$46,175 \times 15.3\% = \$7,065$. A is the trap for skipping the 92.35% step.
2. **B.** Excess of MAGI over \$200,000 is \$30,000. Net investment income is \$45,000. $3.8\% \times$ the lesser, \$30,000 = \$1,140.
3. **C.** Tia paid a household employee \$2,800 or more in cash wages. The lawn company is an independent contractor. Wages to the taxpayer's child under 21 are exempt. Uri's \$900 is below both the \$2,800 annual and the \$1,000 quarterly thresholds.

4. B. For income tax he excludes the smallest of the designated allowance (\$15,000), the amount spent (\$13,000), or the fair rental value (\$16,000), which is \$13,000; includible income is $\$60,000 - \$13,000 = \$47,000$. For SE tax the entire \$60,000 is included.

5. B. Wages earned before death but received afterward are IRD, taxed to the recipient as ordinary income. Appreciated stock and a residence receive a stepped-up basis. Life insurance proceeds are excluded from income.

6. C. Because his prior-year AGI exceeded \$150,000, the prior-year safe harbor is $110\% \times \$40,000 = \$44,000$. The 90%-of-current-year alternative may be lower, but the question asks about the prior-year safe harbor.

7. B. Maximum Social Security tax for 2025 is $6.2\% \times \$176,100 = \$10,918.20$. Total withheld \$12,500. Excess \$1,581.80, refundable because two employers were involved.

8. B. The MFJ exemption of \$137,000 phases out by 25 cents per dollar of AMTI over \$1,252,700. Excess: $\$47,300 \times 25\% = \$11,825$. Exemption: $\$137,000 - \$11,825 = \$125,175$.

Chapter 5. Advising the Individual Taxpayer

Domain 5 • 11 scored questions (13%)

What the outline tests: reporting obligations (1099s, bartering, cash); planning for property sales; education planning (lifetime learning credit, 529 plans); estate planning (gift versus inheritance, trusts, family partnerships, charitable giving, long-term care, life insurance); retirement planning (annuities, IRAs, employer plans, early retirement, RMDs, beneficiaries, charitable IRA distributions); marriage and divorce (settlements, common-law marriage, community property, alimony); items that affect future or past returns (carryovers, NOLs, Form 8801, negative QBI); injured spouse; innocent spouse; estimated tax and penalty avoidance; timing of income and deductions; character of transactions; MFJ versus MFS versus HOH; claims for refund; and the penalty of perjury.

Domain 5 asks the preparer to look forward. The tax rules are the same ones you learned in Chapters 1 through 4; what changes is the question. Instead of “what is the tax?” the exam asks “what should the client do, and what happens next year?” Most answer choices will be true statements; the skill is picking the one that fits the client’s facts.

5.1 Reporting obligations the client may not know about

Situation	Obligation
Paying an independent contractor \$600 or more in a trade or business	Issue Form 1099-NEC by January 31; obtain a Form W-9 first; backup withholding at 24% if no TIN is provided
Paying rent, prizes, or other income of \$600 or more in a business; royalties of \$10 or more	Form 1099-MISC
Receiving more than \$10,000 in cash in a trade or business in one transaction or related transactions	Form 8300 within 15 days
Bartering	Report the fair market value of goods or services received as income; barter exchanges issue Form 1099-B
Selling goods or services through payment apps	Income is taxable whether or not a 1099-K is issued; the 2025 1099-K threshold for third-party networks is more than \$20,000 and more than 200 transactions
Digital assets	Answer the digital asset question on Form 1040; report every sale, exchange, or use as a disposition
Hiring a household employee	Schedule H, W-2, and possibly state unemployment registration (Chapter 4)
Foreign accounts or assets	FBAR and Form 8938 (Chapter 6)

Situation	Obligation
Gifts above \$19,000 to any one person	Form 709 (Chapter 6)

5.2 Advising on property sales

Holding period planning. Waiting until the asset has been held **more than one year** converts ordinary-rate gain into 0%, 15%, or 20% gain. For a taxpayer in the 24% bracket, that is a 9-point saving on each dollar of gain. Inherited property is long-term immediately.

Collectibles and antiques. Gains on art, antiques, stamps, coins, precious metals, and wine are taxed at a maximum **28%** rate, so holding them for the long-term rate does not help as much; losses on personal-use collectibles are not deductible at all.

Home sales. Confirm the two-of-five-year tests; consider waiting to sell until the two-year mark is passed; be alert to nonqualified use and home office depreciation; document improvements to raise basis; remind a surviving spouse of the two-year window for the \$500,000 exclusion.

Business sales. The sale of a sole proprietorship is treated as a sale of each asset. Buyer and seller allocate the price on **Form 8594** among asset classes; inventory and receivables produce ordinary income, equipment produces section 1245 recapture, buildings produce unrecaptured section 1250 gain, and goodwill produces capital gain. Using the installment method for the goodwill and real estate can spread the gain, but recapture is recognized in full in the year of sale.

Harvesting losses. Selling losing positions before year end offsets gains and up to \$3,000 of ordinary income, but the wash sale rule bars repurchasing substantially identical securities within 30 days. Gifting appreciated property to charity avoids the gain entirely; gifting loss property to anyone wastes the loss because the donee's loss basis is FMV.

Worked example. David bought stock for \$20,000 on April 3, 2025. On March 20, 2026 it is worth \$32,000 and he wants to sell. If he sells immediately the \$12,000 gain is short-term, taxed at 22% (\$2,640). If he waits until April 4, 2026, the gain is long-term, taxed at 15% (\$1,800). Two weeks of patience saves \$840, assuming the price holds.

5.3 Education planning

Vehicle	2025 rule	Interaction with credits
Section 529 qualified tuition program	No federal deduction for contributions; earnings grow tax-free; distributions are tax-free for tuition, fees, books, supplies, computers, room and board for at least half-time students, up to \$10,000 per year of K–12 tuition, up to \$10,000 lifetime of student loan repayment, and registered apprenticeship costs. Nonqualified earnings are taxable plus a 10% penalty. Contributions are gifts eligible for the \$19,000 annual exclusion, and a donor may elect to spread a lump sum over five years (\$95,000 single, \$190,000 split) on Form 709. Up to \$35,000 lifetime may be rolled to the beneficiary's Roth IRA if the account is at least 15 years old, subject to annual IRA limits	Expenses paid with tax-free 529 earnings cannot also support the AOTC or LLC; coordinate by paying \$4,000 of tuition from other funds to claim the full AOTC
Coverdell education savings account	Up to \$2,000 per beneficiary per year until age 18 (unless special needs); contributor phaseout MAGI \$95,000–\$110,000 single, \$190,000–\$220,000 MFJ; tax-free for elementary, secondary, and higher education expenses; must be used by age 30	Same no-double-benefit rule
Series EE and I savings bonds (Form 8815)	Interest excluded when redeemed for tuition and fees (not room and board) of the taxpayer, spouse, or dependent; bond owner must have been at least 24 when the bond was issued; 2025 phaseout MAGI \$99,500–\$114,500 single, \$149,250–\$179,250 MFJ	Expenses reduced by tax-free scholarships and amounts used for credits
Employer educational assistance	Up to \$5,250 per year excluded, including employer payments of student loan principal and interest	Expenses paid by the employer cannot support a credit
Scholarships	Tax-free for tuition, fees, and required books and supplies of a degree candidate; taxable for room and board	A student may elect to treat part of a scholarship as taxable (if its terms allow) to free up tuition for the AOTC, which is often worthwhile for a low-bracket student
Student loan interest deduction	Up to \$2,500 (Chapter 2)	Independent of the credits

Choosing between the credits. For a dependent in the first four years of college, at least half-time, the AOTC (\$2,500, 40% refundable) nearly always beats the LLC (\$2,000, nonrefundable). The LLC is the choice for graduate students, part-time students, a fifth year of undergraduate study, or a single job-skills course. A parent whose MAGI exceeds the phaseout may consider **not** claiming the child as a dependent so the child can claim the credit on the child's own return (the child still cannot claim the refundable part of the AOTC if subject to the kiddie tax rules, and the parent loses the \$500 credit for other dependents).

Worked example. Mateo will start college in 2027. The Lopezes contribute \$12,000 to a Texas 529 plan in 2025. There is no federal deduction, but the gift is under the \$19,000 annual exclusion and no Form 709 is needed. When Mateo is in school, they should pay the first \$4,000 of tuition from their checking account to claim the \$2,500 AOTC and use 529 money for the rest, so no dollar of expense is used twice.

Not on your exam. Beginning in 2026, the annual K–12 limit for 529 distributions rises to \$20,000 and qualified expenses expand to include additional K–12 costs and postsecondary credentialing expenses. For 2025, the K–12 limit is \$10,000 for tuition only.

5.4 Estate planning essentials for Part 1

The detailed estate and gift computations are in Chapter 6. The advising questions in Domain 5 test the **decisions**:

- **Gift versus inheritance.** A gift carries the donor's basis; an inheritance takes a stepped-up (or stepped-down) basis to date-of-death value. Advice: give appreciated property **by bequest** and give **cash or high-basis property** during life. Never give loss property; sell it, take the loss, and give the cash.
- **Annual exclusion gifts.** \$19,000 per donee per year (2025), doubled with gift-splitting, removes assets and their future growth from the estate without using the lifetime exemption. Direct payments of **tuition** to the school and **medical expenses** to the provider are unlimited and do not count against the exclusion.
- **Unlimited marital deduction** for transfers to a U.S. citizen spouse, during life or at death; a qualified domestic trust (QDOT) is needed for a noncitizen spouse at death, and lifetime gifts to a noncitizen spouse are limited to \$190,000 in 2025.
- **Portability.** A surviving spouse may use the deceased spouse's unused exclusion (DSUE) if the executor files a timely Form 706 to elect it, even when no estate tax is due.
- **Life insurance.** Proceeds are income-tax-free to the beneficiary but are included in the insured's gross estate if the insured owned the policy or any incidents of ownership at death, or transferred it within three years of death. An irrevocable life insurance trust keeps the proceeds out of the estate.
- **Trusts.** A revocable living trust avoids probate but does not save income or estate tax; it is a grantor trust and the grantor reports everything. An irrevocable trust removes assets from the estate if the grantor keeps no strings. Trust income retained is taxed to the trust at compressed brackets (37% above \$15,650 in 2025), so distributing income to lower-bracket beneficiaries often saves tax.

- **Family limited partnerships** shift future appreciation to the next generation while the senior generation keeps management control; valuation discounts for lack of control and marketability are common but must be supported.
- **Charitable giving.** Appreciated long-term property to a public charity avoids capital gain and is deductible at FMV; qualified charitable distributions after age 70½ reduce AGI; charitable remainder trusts pay the donor an income stream and defer gain; bequests are fully deductible from the gross estate.
- **Long-term care.** Premiums within the age limits are medical expenses; benefits from a qualified contract are generally tax-free; Medicaid planning has a five-year lookback on gifts.

5.5 Retirement planning

Decision	Guidance
Traditional versus Roth contributions	Traditional (deduct now, taxed later) favors a taxpayer who expects a lower bracket in retirement; Roth favors a lower bracket today, a long horizon, or a desire to avoid RMDs. A backdoor Roth (nondeductible contribution followed by conversion) works best when the taxpayer has no other pre-tax IRA balances, because of the pro rata rule
Roth conversions	Convert in low-income years (early retirement before Social Security and RMDs begin, a year with a large deduction or loss); each conversion starts a separate five-year clock for penalty purposes; conversions cannot be undone
Employer plan contributions	Contribute at least enough to capture the full employer match; 2025 limits are \$23,500 plus \$7,500 catch-up at 50, or \$11,250 for ages 60 to 63; a SIMPLE IRA allows \$16,500 plus \$3,500 (or \$5,250 at ages 60 to 63)
Early retirement before 59½	Use the age 55 rule by leaving the employer plan balance in the plan (not rolling it to an IRA) when separating in or after the year of turning 55; or set up substantially equal periodic payments under section 72(t), which must continue for the longer of five years or until 59½
Required minimum distributions	First RMD for the year of turning 73 (75 if born after 1959); delaying the first RMD to April 1 doubles income the following year; a QCD of up to \$108,000 after 70½ satisfies the RMD without raising AGI, protecting Social Security taxation, Medicare premium surcharges, and the medical deduction floor
Beneficiary designations	Override the will; name contingent beneficiaries; a spouse can roll over or stretch, most other beneficiaries have ten years; naming the estate forces the five-year rule or the decedent's life expectancy; charities as IRA beneficiaries pay no tax on IRD, so leave the IRA to charity and the appreciated stock to the children

Decision	Guidance
Annuities	Payments are taxed under the exclusion ratio; deferred annuities grow tax-deferred but gains come out first and are ordinary income, with a 10% penalty before 59½; immediate annuities convert a lump sum into lifetime income
Social Security claiming	Benefits may begin at 62 (reduced), full retirement age (66–67), or 70 (increased); up to 85% is taxable depending on provisional income; delaying benefits while drawing down traditional IRAs can reduce lifetime tax
Saver's credit	Remind lower-income clients that IRA or 401(k) contributions can earn a credit of up to \$1,000 (\$2,000 MFJ) on top of the deduction

Worked example. Rosa, 72, has a \$300,000 traditional IRA, takes the standard deduction, and gives \$8,000 a year to her church. Beginning in 2026 she must take RMDs. If she takes the RMD in cash and writes a check to the church, the full RMD is in AGI and the gift produces no deduction because she does not itemize. If instead she directs \$8,000 of the RMD to the church as a qualified charitable distribution, that \$8,000 never enters AGI, which lowers the taxable portion of her Social Security and may keep her below the Medicare premium surcharge thresholds.

5.6 Marriage and divorce

Issue	Rule
Common-law marriage	Recognized for federal tax purposes if valid under the law of the state where it began (Texas recognizes it); the couple is married for filing status until divorced
Marital status at year end	Determines filing status for the whole year; a decree of divorce or separate maintenance by December 31 makes the taxpayer unmarried; a decree of legal separation also qualifies, but living apart without a decree does not
Property settlements (section 1041)	Transfers of property between spouses, or incident to divorce (within one year of the divorce or related to its cessation), are not taxable ; the recipient takes the transferor's basis , so a spouse who receives appreciated stock receives the built-in gain. Advice: compare after-tax values, not face values
Alimony	Instruments executed before 2019: deductible by payer, income to recipient, must be in cash, cannot continue after death, parties cannot live in the same household or file jointly. Instruments executed after 2018 or modified to adopt the new rule: no deduction, no income

Issue	Rule
Child support	Never deductible, never income; if a payment is reduced upon a contingency related to a child (age 18, graduation), it is child support regardless of its label
Retirement accounts in divorce	A QDRO divides an employer plan without tax to the participant; distributions to the alternate payee are taxed to that spouse and are penalty-free. An IRA may be transferred incident to divorce tax-free, but a later withdrawal by a recipient under 59½ is penalized because QDRO treatment does not apply to IRAs
Dependents after divorce	Custodial parent controls; Form 8332 releases the CTC and ODC only (Chapter 1)
Home sale after divorce	A spouse who receives the home in the divorce counts the ex-spouse's ownership period; a spouse who moves out but whose ex still lives in the home under the decree is treated as still using it
Community property	In Texas, Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Washington, and Wisconsin, income earned during marriage generally belongs half to each spouse. Married couples filing separately must each report half of community income (Form 8958), which usually removes the benefit of MFS; Publication 555 relief exists for spouses who did not know of the income
Filing status in the year of divorce	Unmarried on December 31: single or HOH; the former spouses cannot file jointly for that year

Worked example. In their 2025 divorce, Ana receives the house (basis \$200,000, FMV \$400,000) and her ex-husband receives the brokerage account (basis \$380,000, FMV \$400,000). The split looks equal. Ana's built-in gain is \$200,000, though up to \$250,000 could be excluded if she keeps the home as her main residence for two of the five years before selling. Her ex-husband's built-in gain is only \$20,000. If Ana will not live in the house, she has received the far worse asset after tax.

5.7 Items that affect future and past returns

Item	What to track and tell the client
Capital loss carryover	Unlimited life; \$3,000 per year against ordinary income; dies with the taxpayer (a surviving spouse keeps only his or her share)
Net operating loss	Post-2017 NOLs carry forward indefinitely, no carryback (except farming), and offset at most 80% of taxable income in the carryover year; keep Form 1045 Schedule A computations

Item	What to track and tell the client
Charitable contribution carryover	5 years, in order, after current-year gifts
Minimum tax credit (Form 8801)	Indefinite; used when regular tax exceeds tentative minimum tax
Negative QBI carryover	Reduces next year's QBI; a client with a loss business this year will have a smaller deduction next year even if next year is profitable
Passive loss carryforward (Form 8582)	Released when the activity is fully disposed of; selling at a loss can unlock years of suspended losses
Investment interest carryover (Form 4952)	Indefinite
Adoption credit carryforward	5 years (nonrefundable portion)
Foreign tax credit	Back 1, forward 10
Nondeductible IRA basis (Form 8606)	Permanent; losing track of it means paying tax twice
Installment sale (Form 6252)	Report each year's payments; a related-party resale within two years accelerates gain
Section 121 exclusion used	No second exclusion within two years
Depreciation taken on a home office or rental	Reduces basis and is recaptured on sale even if never claimed ("allowed or allowable")
Prior-year AGI and tax	Needed for the estimated tax safe harbor and for e-file identity verification

5.8 Injured spouse and innocent spouse

	Injured spouse (Form 8379)	Innocent spouse (Form 8857)
Problem	A joint refund was or will be applied to the other spouse's past-due federal tax, state tax, child or spousal support, or federal nontax debt (student loans)	The IRS asserts additional tax on a joint return because of the other spouse's erroneous items (unreported income, improper deductions)
What the taxpayer gets	His or her share of the refund, based on his or her own income, withholding, and payments (community property rules modify the allocation)	Relief from joint and several liability for the deficiency, interest, and penalties

	Injured spouse (Form 8379)	Innocent spouse (Form 8857)
Requirements	Not legally obligated on the debt; reported income or made payments on the joint return	Three types: innocent spouse relief (understatement attributable to the other spouse, taxpayer did not know and had no reason to know, inequitable to hold liable); separation of liability (divorced, legally separated, widowed, or living apart for 12 months; allocates the deficiency); equitable relief (for underpayments or when the other types fail)
Deadline	Within the refund statute (generally 3 years from the return due date or 2 years from payment)	Innocent spouse and separation of liability: within 2 years after the IRS first begins collection against the requesting spouse; equitable relief: within the collection statute or refund statute
Filed	With the original return or afterward by itself	Separately; the IRS must notify the other spouse, who may participate

Memory cue. “Injured: my refund was taken. Innocent: they say I owe.” 8379 keeps money; 8857 removes liability.

5.9 Estimated tax planning and penalty avoidance

The mechanics are in Chapter 4. The advising points:

- **Mid-year check.** Project the full-year tax after a job change, a business start, a large capital gain, a Roth conversion, or the loss of a dependent, and adjust the remaining installments or Form W-4 withholding. A client who sells property in October still has the January 15 installment and, better, year-end withholding to cure the shortfall.
- **Withholding is retroactive.** Because withholding is treated as paid evenly through the year, a large December withholding from a bonus, an IRA distribution (with voluntary withholding up to 100%), or a final paycheck eliminates earlier-quarter penalties. Estimated payments do not have that effect.
- **Choose the cheaper safe harbor.** In a rising-income year, pay 100% (or 110%) of last year’s tax and keep the difference until April. In a falling-income year, pay 90% of the current year’s projected tax and use the annualized method if income arrives late in the year.
- **Avoid the \$1,000 problem.** If the projected balance due is under \$1,000, no estimates are needed.
- **Form W-4.** A two-earner couple should use the multiple jobs worksheet or check the box in Step 2(c) so each employer withholds at the higher combined rate.

5.10 Timing, character, and filing-status choices

Timing. A cash-basis taxpayer controls many dates: pay January's mortgage interest and property tax in December to **bunch** itemized deductions into alternate years and take the standard deduction in the other years; make charitable gifts through a donor-advised fund in the high-income year; defer a bonus or billings into January when next year's bracket will be lower; accelerate income into a low-bracket year (Roth conversion, capital gain harvesting at the 0% rate); pay medical bills in a single year to clear the 7.5% floor. Income cannot be deferred by simply refusing to cash a check (constructive receipt).

Character. Ordinary income is taxed up to 37%; long-term gains and qualified dividends up to 20%; collectibles 28%; unrecaptured section 1250 gain 25%. Converting ordinary income to capital gain (hold more than one year, structure a business sale toward goodwill) or converting a nondeductible personal loss into a deductible one (convert a personal residence to a rental before selling at a loss, with basis limited to the lower of FMV or adjusted basis at conversion) are classic planning moves. Section 1231 gives the best of both: net gains are capital, net losses are ordinary.

MFJ versus MFS.

Consideration	Married filing jointly	Married filing separately
Liability	Joint and several: each spouse is liable for the entire tax, even after divorce	Each spouse liable only for own return
Standard deduction	\$31,500	\$15,750; if one itemizes, both must
Tax brackets	Widest	Half of MFJ brackets; 37% begins at \$375,800
Credits lost under MFS	—	EITC (unless separated-spouse rule), child and dependent care credit (generally), education credits, adoption credit (generally), premium tax credit (generally), student loan interest deduction, savings bond education exclusion, new tips, overtime, and senior deductions
Phaseouts	Normal	Social Security base amount \$0 if living together; IRA deduction and Roth phaseout \$0–\$10,000; capital loss limit \$1,500; rental loss allowance \$0 if living together
When MFS can help	—	One spouse has large medical expenses relative to a lower AGI; one spouse has income-driven student loan payments based on separate AGI; the spouses want to separate liability for a spouse with questionable items or past-due debts; state tax savings in some states

Consideration	Married filing jointly	Married filing separately
Community property	Each spouse reports half of community income under MFS, which often eliminates the benefit	

A joint return can be filed after separate returns (by amending within three years of the due date), but separate returns **cannot** be filed after a joint return once the due date has passed, except by a personal representative for a decedent. Head of household is better than MFS whenever the “considered unmarried” tests are met.

Worked example. Maria had \$40,000 of unreimbursed medical expenses in 2025. Joint AGI is \$200,000, so the floor is \$15,000 and the deduction is \$25,000. If Maria earned \$60,000 and filed separately, her floor would be \$4,500 and her deduction \$35,500, but the couple would lose the child and dependent care credit, face the \$0 Social Security base if applicable, split Texas community income, and give up the wider joint brackets. The preparer must compute both ways; MFS is rarely better, but medical expenses are the leading case where it can be.

5.11 Claims for refund and amended returns

The rule. A claim for refund (Form 1040-X for individuals, now e-fileable) must be filed within **3 years** from the date the original return was filed, or **2 years** from the date the tax was paid, whichever is later. A return filed before the due date is treated as filed on the due date. If the claim is filed within the 3-year window, the refund is limited to tax paid within the 3 years (plus extensions) before the claim; if only the 2-year rule applies, the refund is limited to tax paid within those 2 years.

Special periods. 7 years for a bad debt or worthless securities deduction. Carrybacks (foreign tax credit): within 3 years of the due date of the return for the year the carryback arose. A disaster loss election to deduct on the prior year is made by the due date of the current-year return (without extension), by amending the prior year. Financially disabled taxpayers have the limitation period suspended. Withholding and estimated payments are deemed paid on the April 15 due date, so a refund claim on an unfiled 2025 return must be made by April 15, 2029 or the withholding is lost.

When to amend. Correct filing status (including electing joint after separate), add or remove dependents, report omitted income, claim missed deductions or credits, or carry back a credit. Math errors need not be amended; the IRS corrects them. An amended return cannot change an irrevocable election after the due date (for example, switching from the standard deduction to itemizing **can** be done; electing out of the installment method generally cannot be undone). Interest is paid on refunds issued more than 45 days after the later of the return due date or filing date.

Worked example. The Lopezes filed their 2022 return on March 1, 2023 and later discovered they missed a \$1,500 education credit. The return is treated as filed April 18, 2023 (the 2022 due date), so the claim must be filed by April 18, 2026. A claim filed in May 2026 is too late, no matter how clear the error.

5.12 The penalty of perjury

Every Form 1040 is signed “under penalties of perjury,” which means the taxpayer declares that he or she has examined the return and that to the best of his or her knowledge it is true, correct, and complete. The declaration applies even when a paid preparer prepared the return; the **taxpayer** remains responsible for the accuracy of the information provided. The paid preparer signs a separate declaration that the return is based on all information of which the preparer has any knowledge. Willfully making a false return is a felony under section 7206(1), punishable by up to three years in prison and fines; willfully aiding or assisting in a false return (section 7206(2)) exposes the preparer to the same sanctions. Both spouses must sign a joint return; a spouse who signs under duress may seek relief, and a forged signature means there is no valid joint return. A taxpayer who cannot sign because of illness or absence may have a spouse or agent sign with a valid power of attorney (Form 2848) attached.

Quick Check: Chapter 5

1. Elena, 68, wants to leave her estate to her two children. She owns a traditional IRA worth \$400,000 and a brokerage account worth \$400,000 with a basis of \$100,000. She also wants to leave \$100,000 to her church. Which plan is most tax-efficient?
 - A. Leave the IRA to the children and the brokerage account to the church and children.
 - B. Leave \$100,000 of the IRA to the church and the rest of the IRA plus the brokerage account to the children.
 - C. Sell the stock now, pay the tax, and leave cash to everyone.
 - D. Convert the IRA to a Roth before death so the children receive it tax-free regardless of timing.
2. Under a 2025 divorce decree, Victor pays his former spouse \$2,000 per month, which drops to \$1,200 when their daughter turns 18. For 2025 Victor may deduct:
 - A. \$24,000
 - B. \$14,400
 - C. \$9,600
 - D. \$0
3. Which taxpayer’s refund claim is timely?
 - A. Fay filed her 2021 return on April 15, 2022 and files Form 1040-X on June 1, 2025.
 - B. Gus never filed a 2021 return; his only payments were withholding; he files the return claiming a refund on May 1, 2025.
 - C. Hana filed her 2022 return on October 10, 2023 under extension and files Form 1040-X on October 1, 2026.
 - D. Ivan paid a 2019 deficiency on March 1, 2023 and files a claim for that payment on June 1, 2025.
4. Which statement about married filing separately is correct for 2025?
 - A. Each spouse may choose independently whether to itemize.
 - B. The Social Security base amount is \$0 for spouses who lived together at any time during the year.
 - C. Spouses in a community property state each report only their own wages.
 - D. The earned income credit is available to any MFS filer with a qualifying child.

5. Sam's 2025 income arrived almost entirely from a \$90,000 capital gain in December. He made no estimated payments. What is the best advice to avoid or minimize the underpayment penalty?
- A. Make a single estimated payment on January 15, 2026 and use the annualized income installment method on Form 2210.
 - B. Nothing can be done; the penalty applies to all four quarters.
 - C. File the return early to stop the penalty.
 - D. Request a six-month extension so the payment is not late.
6. Which form does a taxpayer file to recover her share of a joint refund that the IRS applied to her husband's defaulted federal student loan?
- A. Form 8857
 - B. Form 8379
 - C. Form 8862
 - D. Form 1040-X
7. Which item carries forward indefinitely?
- A. Charitable contribution carryover
 - B. Adoption credit carryforward
 - C. Capital loss carryover
 - D. Foreign tax credit carryover
8. A parent with MAGI of \$195,000 (MFJ) has a 19-year-old full-time college sophomore with \$6,000 of tuition. Which choice produces the largest American opportunity credit for the family?
- A. The parents claim the student and the \$2,500 AOTC.
 - B. The parents do not claim the student; the student claims the AOTC on his own return.
 - C. The parents claim the lifetime learning credit instead.
 - D. No one can claim a credit because the parents' income is too high.

Answers.

- 1. B.** The church pays no income tax on the IRA (IRD), while the children would. The children receive the brokerage account with a stepped-up basis, eliminating the \$300,000 of built-in gain. Plan A wastes the step-up on the church and burdens the children with IRD; Plan C triggers tax unnecessarily; Plan D accelerates tax without need.
- 2. D.** The decree was executed after 2018, so no alimony is deductible regardless of label. Even under a pre-2019 instrument, the \$800 that drops off when the child turns 18 would be child support.
- 3. C.** Hana's claim is within 3 years of her October 10, 2023 filing date. Fay's return is treated as filed April 15, 2022, so her window closed April 15, 2025. Gus's withholding is deemed paid April 15, 2022, so his refund window also closed April 15, 2025. Ivan's 2-year window from the March 1, 2023 payment closed March 1, 2025.

- 4. B.** When MFS spouses lived together at any time during the year, the base amount for taxing Social Security is \$0. If one MFS spouse itemizes, the other must also. Community property spouses split community income. The EITC is available to an MFS filer only under the separated-spouse rules.
- 5. A.** The annualized income installment method matches required installments to when the income was actually earned, so a December gain creates a required payment only for the fourth installment. Paying it by January 15 eliminates the penalty. Filing early does not stop a penalty already accrued, and an extension does not extend the time to pay.
- 6. B.** Injured spouse allocation. Form 8857 is innocent spouse relief, Form 8862 reclaims a disallowed credit, and Form 1040-X amends the return.
- 7. C.** Capital losses carry forward indefinitely. Charitable and adoption carryovers last five years; the foreign tax credit carries forward ten.
- 8. B.** The parents are in the \$160,000–\$180,000 phaseout range and beyond it, so their AOTC is zero. If they forgo claiming the student, the student may claim the nonrefundable portion of the AOTC against his own tax (he cannot claim the refundable 40% because he is under 24 with a living parent and is subject to the kiddie tax rules unless his earned income exceeds half his support). The family trades the \$500 credit for other dependents for whatever AOTC the student can use.

Chapter 6. Specialized Returns for Individuals

Domain 6 · 11 scored questions (13%)

What the outline tests, in three groups: **Estate tax** (gross estate and taxable estate, unified credit, jointly held property, marital deduction and portability, life insurance and retirement accounts, Form 706 and Form 1041 filing requirements and due dates); **Gift tax** (gift-splitting, annual exclusion, unified credit, the generation-skipping transfer tax, Form 709); and **International information reporting** (FBAR, Form 8938, Forms 8865, 5471, and 3520; covered accounts; penalties; and the distinctions between FBAR and Form 8938).

Part 1 does not expect you to prepare a Form 706 from scratch. It expects you to know **when** each return is required, **what** goes into the gross estate or a taxable gift, the key **2025 numbers**, and the **penalties** for missing an international information return. Eleven questions on these three topics is a generous share for a small body of rules, which makes this chapter a high-return investment.

Part A: Estate Tax

6.1 The gross estate

The rule. The gross estate is the fair market value, on the date of death (or on the **alternate valuation date** six months later, if the executor elects it and it lowers both the gross estate and the estate tax), of everything the decedent owned or controlled at death, wherever located.

Included in the gross estate	Common exam detail
Cash, securities, real estate, business interests, personal property, digital assets	At FMV, not basis
Life insurance on the decedent's life	Included if the proceeds are payable to the estate or the decedent held any incident of ownership (right to change the beneficiary, borrow against the policy, surrender it); also included if the decedent transferred the policy within three years of death
Jointly held property with a spouse (tenants by the entirety or joint tenants with right of survivorship)	One-half included, regardless of who paid

Included in the gross estate	Common exam detail
Jointly held property with a non-spouse	Full value included, except to the extent the executor proves the survivor contributed to the purchase; property acquired by gift or inheritance as joint tenants is included proportionately
Revocable trust assets	Fully included; the decedent retained the power to revoke
Retirement accounts (IRAs, 401(k)s), annuities with survivor benefits	Included at FMV; also IRD for the beneficiary
Property subject to a general power of appointment	Included
Gifts made within three years of death	Not included (the gift itself), except life insurance; but the gift tax paid on gifts within three years is added back
Transfers with a retained life estate or retained income	Included at full value
Dower, curtesy, community property	The decedent's one-half of community property is included; the surviving spouse's half is not

Worked example. Rosa dies in 2025 owning a home worth \$400,000 (titled jointly with her daughter Maria, who paid nothing toward it), a \$300,000 IRA, a \$200,000 life insurance policy she owned naming Maria as beneficiary, and \$50,000 of cash. Gross estate: \$400,000 (full value of the non-spouse joint property because Maria contributed nothing) + \$300,000 + \$200,000 + \$50,000 = \$950,000. Maria receives the insurance income-tax-free, but it is still in Rosa's gross estate because Rosa owned the policy.

6.2 From gross estate to tax

The rule. Taxable estate = gross estate – deductions. Deductions include funeral expenses, administration expenses (executor and attorney fees, appraisal and court costs, either on Form 706 or on the estate's Form 1041 but not both), debts of the decedent and mortgages, casualty losses during administration, the **unlimited marital deduction** for property passing outright to a U.S. citizen spouse (or in a qualifying trust such as a QTIP), the **charitable deduction** for bequests to qualified organizations, and state death taxes paid. Add **adjusted taxable gifts** made after 1976 to reach the tax base, compute the tentative tax, subtract gift taxes paid on those gifts, and subtract the **unified credit**.

2025 numbers.

Item	2025 amount
Basic exclusion amount (estate and gift, unified)	\$13,990,000
Unified credit (tax on the basic exclusion)	\$5,541,800
Top estate and gift tax rate	40% (reached at \$1,000,000 of cumulative taxable transfers)
GST exemption	\$13,990,000

Item	2025 amount
Annual gift exclusion	\$19,000 per donee
Annual exclusion for gifts to a noncitizen spouse	\$190,000

Marital deduction details. Unlimited for a U.S. citizen spouse. For a noncitizen surviving spouse, the deduction is allowed only if the property passes to a **qualified domestic trust (QDOT)**. A terminable interest (a life estate that ends at the survivor's death) does not qualify unless the executor makes a **QTIP election**, which then includes the property in the survivor's estate.

Portability. The **deceased spousal unused exclusion (DSUE)** amount may be transferred to the surviving spouse only if the executor files a Form 706 and makes the election, even if the estate is otherwise below the filing threshold. The IRS allows a late portability-only election up to **five years** after death under Revenue Procedure 2022-32 for estates not otherwise required to file. The surviving spouse may then shelter his or her own \$13,990,000 plus the DSUE. The DSUE from the most recently deceased spouse is the one that counts.

Worked example. Hank dies in 2025 with a \$6,000,000 estate, all left to his wife Joan. The marital deduction reduces the taxable estate to zero and no tax is due. If Joan's executor later files a Form 706 electing portability, Joan carries Hank's unused \$13,990,000 forward. When Joan dies, she can shelter her own exclusion plus Hank's DSUE, nearly \$28 million at 2025 values. If no Form 706 is filed for Hank, his exclusion is lost.

6.3 Estate filing requirements and the decedent's returns

Return	Who files	When required	Due date
Form 706 , United States Estate (and Generation-Skipping Transfer) Tax Return	Executor or personal representative	Gross estate plus adjusted taxable gifts exceeds \$13,990,000 for a 2025 decedent, or to elect portability	9 months after death; automatic 6-month extension on Form 4768 (extends time to file, not to pay)
Form 1041 , U.S. Income Tax Return for Estates and Trusts	Fiduciary	Estate has gross income of \$600 or more for the year, or any beneficiary is a nonresident alien; a trust must file with any taxable income, gross income of \$600 or more, or a nonresident alien beneficiary	15th day of the 4th month after the end of the estate's tax year (April 15 for a calendar year); an estate may elect a fiscal year ; 5½-month extension on Form 7004
Final Form 1040 of the decedent	Personal representative or surviving spouse	Same filing thresholds as any individual, for income through the date of death	April 15 of the year after death; a surviving spouse may file jointly for the year of death if not remarried by year end

Return	Who files	When required	Due date
Form 1310 , Statement of Person Claiming Refund Due a Deceased Taxpayer	Person claiming a refund on the final return	Not required for a surviving spouse filing a joint return or for a court-appointed representative who attaches the court certificate	With the final return
Form 8971 , Information Regarding Beneficiaries Acquiring Property from a Decedent	Executor of an estate required to file Form 706	Basis consistency reporting to the IRS and beneficiaries	30 days after Form 706 is due or filed
Form 56 , Notice Concerning Fiduciary Relationship	Fiduciary	Notifies the IRS of the fiduciary's appointment	When the relationship begins and ends
Form 709 for the decedent's final year	Executor	Gifts above the annual exclusion in the year of death	April 15 of the following year, or the Form 706 due date if earlier

The final Form 1040. Report income actually or constructively received through the date of death (cash basis). Deductions include medical expenses paid before death and, by election, medical expenses paid by the estate within **one year** after death. The full standard deduction is allowed, with no proration. Write “Deceased,” the decedent’s name, and the date of death at the top. Any income received **after** death belongs to the estate (Form 1041) or to the beneficiary, generally as IRD.

Form 1041 basics. The estate’s income (post-death interest, dividends, rents, gain on sales, IRD) is taxed either to the estate or to the beneficiaries through the **distribution deduction**, limited to **distributable net income (DNI)**. Beneficiaries receive a Schedule K-1 and report their shares. The estate’s personal exemption is **\$600**; a simple trust (required to distribute all income) gets \$300; a complex trust gets \$100. Trusts reach the 37% bracket at only \$15,650 of taxable income in 2025. A **section 645 election** lets a qualified revocable trust be taxed as part of the estate, gaining the estate’s fiscal-year and \$600-exemption advantages.

Worked example. Rosa dies on June 10, 2025. Her final Form 1040 reports her pension and Social Security through June 10 and is due April 15, 2026, signed by Maria as executor; Maria claims any refund with the court certificate attached, so no Form 1310 is needed. The bank interest Rosa’s accounts earn after June 10 (\$1,200) and the IRA distributions the estate receives are reported on Form 1041, because the estate’s gross income exceeds \$600. No Form 706 is required: the estate is far below the \$13,990,000 threshold and, because Rosa was unmarried, there is no portability election to make.

Memory cue. “706 in nine, 1041 at six hundred, final 1040 as usual.”

Part B: Gift Tax

6.4 What is a gift and what is excluded

The rule. A gift is any transfer of property for less than full and adequate consideration. The **donor** pays any gift tax and files Form 709. Gifts are valued at FMV on the date of the gift. The **annual exclusion** is **\$19,000 per donee** for 2025, available only for gifts of a **present interest** (the donee can use the property now). Gifts of a future interest (a remainder interest, most trust interests without Crummey withdrawal rights) get no annual exclusion and must be reported.

Excluded or deductible transfers	Rule
Annual exclusion gifts	\$19,000 per donee per year, unlimited donees
Gift-splitting	Spouses may elect to treat a gift by one as made half by each, doubling the exclusion to \$38,000 per donee; requires both spouses' consent on Form 709, even if the split gift is under the exclusion for each; both must be U.S. citizens or residents and married at the time of the gift
Tuition paid directly to the educational institution	Unlimited; tuition only, not books or room and board
Medical expenses paid directly to the provider	Unlimited; includes medical insurance
Gifts to a U.S. citizen spouse	Unlimited marital deduction
Gifts to a noncitizen spouse	\$190,000 annual exclusion for 2025; no unlimited deduction
Gifts to qualified charities	Unlimited charitable deduction
Gifts to political organizations	Not gifts
Transfers in a divorce settlement under a written agreement	Not gifts
Contributions to a 529 plan	Present-interest gifts; donor may elect to treat up to \$95,000 (\$190,000 split) as made ratably over five years
Support of a dependent, payments of a legal obligation	Not gifts
Below-market or interest-free loans	The forgone interest is a gift each year
Adding a child as joint owner of a bank account	Not a gift until the child withdraws funds; adding a joint owner to real estate or securities is a completed gift of one-half

Worked example. In 2025 David and Maria give Mateo \$50,000 for a car and a college fund, pay \$12,000 of Sofia's private school tuition directly to the school, and pay \$8,000 of Rosa's hospital bill directly to the hospital. The tuition and medical payments are fully excluded and need no return. With gift-splitting, \$38,000 of the gift to Mateo is excluded and \$12,000 is a taxable gift that uses \$12,000 of their lifetime exclusions (\$6,000 each). They must file Form 709 (one from each spouse, each consenting to the split) but owe no tax.

6.5 Computing the gift tax and the unified credit

Gift tax is **cumulative**. Each year's Form 709 adds the current year's taxable gifts (after exclusions and deductions) to all prior taxable gifts, computes the tentative tax on the total, subtracts the tax on prior gifts, and applies the remaining unified credit. Tax is actually paid only when cumulative taxable gifts exceed the **\$13,990,000** basic exclusion (2025). Every dollar of exclusion used during life reduces the amount available at death, which is why adjusted taxable gifts are added back on Form 706.

Basis to the donee. Carryover basis, increased by the portion of any gift tax paid that is attributable to net appreciation (Chapter 2). The donee's holding period includes the donor's.

Form 709 filing requirements and due date. Required when the donor gives more than \$19,000 to any one donee (other than a citizen spouse or a charity receiving the donor's entire interest), gives any future interest, or elects gift-splitting or the five-year 529 election. Due **April 15** following the year of the gift; an extension of the income tax return (Form 4868) automatically extends Form 709, or Form 8892 may be used to extend Form 709 alone. Married couples file **separate** Forms 709; there is no joint gift tax return.

Exam trap. Gift-splitting requires a Form 709 from the donor spouse, with the other spouse's consent, even when the split gift (\$30,000 to one child, for example) ends up fully excluded. The exam likes to say "no return is required because each half is under \$19,000." A return is required to make the election.

6.6 Generation-skipping transfer tax

The GST tax is a separate, **flat 40%** tax on transfers to a **skip person**: a grandchild or more remote descendant, or an unrelated person more than **37½ years younger** than the transferor, or a trust whose beneficiaries are all skip persons. Each transferor has a GST exemption equal to the basic exclusion amount (\$13,990,000 for 2025), allocated on Form 709 or Form 706. Three events trigger the tax: a **direct skip** (an outright gift or bequest to a grandchild), a **taxable termination** (a trust interest ends and skip persons take), and a **taxable distribution** (a trust distributes to a skip person). Under the **predeceased parent rule**, a grandchild whose parent (the transferor's child) is already dead moves up a generation and is not a skip person. Annual exclusion gifts to a grandchild are generally exempt from GST tax as well.

Worked example. Rosa gives \$19,000 to each of her grandchildren, Sofia and Mateo, in 2025. The gifts are within the annual exclusion and are direct skips that qualify for the GST annual exclusion, so no gift or GST tax applies and no Form 709 is required. If Rosa left \$2,000,000 to Sofia at death, it would be a direct skip subject to GST tax unless Rosa's executor allocates GST exemption to it on Form 706.

Part C: International Information Reporting

6.7 FBAR: FinCEN Form 114

The rule. A **U.S. person** (citizen, resident, or domestic entity) who had a **financial interest in or signature authority over** one or more **foreign financial accounts** whose **aggregate** value exceeded **\$10,000 at any time** during the calendar year must file FinCEN Form 114 electronically through the Treasury's BSA E-Filing System. It is filed with **FinCEN**, not the IRS, and is **not** attached to the tax return. It is due **April 15** with an **automatic extension to October 15**; no extension request is needed.

Covered accounts. Bank accounts, securities and brokerage accounts, mutual funds, certain foreign pension and retirement accounts, foreign-issued life insurance or annuities with cash value, and accounts at foreign branches of U.S. banks. **Not covered:** accounts at U.S. branches of foreign banks, directly held foreign real estate, directly held stock or bonds (not in an account), precious metals held directly, and accounts in a U.S. military banking facility. Signature authority over an employer's account can require filing even with no financial interest. A child who owns a foreign account must file; a parent may sign for the child.

Penalties. Non-willful failure: up to **\$10,000** per report (inflation-adjusted, about \$16,500 for penalties assessed in 2025), with the Supreme Court's Bittner decision confirming the penalty applies **per report**, not per account. Willful failure: the greater of **\$100,000** (inflation-adjusted) or **50% of the account balance** at the time of the violation, per violation, plus possible criminal penalties. The statute of limitations is **6 years** from the due date. Delinquent filers with reasonable cause may use the delinquent FBAR submission procedures or, for unreported income, the Streamlined Filing Compliance Procedures.

Worked example. Priya kept a Singapore bank account that peaked at \$7,000 in March 2025 and a Singapore brokerage account that peaked at \$5,000 in September 2025. On no single day did the two balances together exceed \$10,000. She must still file the FBAR for 2025, because the FBAR test adds together each account's **maximum** value during the year: $\$7,000 + \$5,000 = \$12,000$, which exceeds \$10,000.

6.8 Form 8938: Statement of Specified Foreign Financial Assets

The rule. A **specified individual** (U.S. citizen, resident alien, or certain nonresident aliens) with an interest in **specified foreign financial assets** above the applicable threshold must attach Form 8938 to the income tax return. It is filed with the **IRS**, is due with the return including extensions, and is **in addition to**, not instead of, the FBAR.

Thresholds.

Taxpayer	Value on the last day of the year	Or value at any time during the year
Unmarried or MFS, living in the U.S.	More than \$50,000	More than \$75,000

Taxpayer	Value on the last day of the year	Or value at any time during the year
Married filing jointly, living in the U.S.	More than \$100,000	More than \$150,000
Unmarried or MFS, living abroad	More than \$200,000	More than \$300,000
Married filing jointly, living abroad	More than \$400,000	More than \$600,000

Covered assets. Foreign financial accounts; foreign stock or securities held directly (not in an account); interests in foreign partnerships, trusts, and estates; foreign-issued life insurance or annuities with cash value; notes or bonds issued by foreign persons; and foreign deferred compensation and pension interests. **Not covered:** directly held foreign real estate, directly held precious metals and art, and foreign currency held directly. Assets reported on Forms 3520, 5471, 8621, or 8865 need not be re-detailed but must be identified on Form 8938. No Form 8938 is required if no income tax return is required.

Penalties. **\$10,000** for failure to file, plus **\$10,000 for each 30 days** after IRS notice, up to a maximum of **\$50,000** additional; a **40%** accuracy-related penalty on understatements attributable to undisclosed foreign assets; and the statute of limitations on the **entire return** stays open until three years after Form 8938 is filed (and six years if more than \$5,000 of income from specified foreign assets was omitted).

6.9 FBAR versus Form 8938 side by side

	FBAR (FinCEN 114)	Form 8938
Authority	Bank Secrecy Act (Title 31)	Internal Revenue Code section 6038D (FATCA)
Filed with	FinCEN, electronically through BSA E-Filing	IRS, attached to Form 1040
Who files	U.S. persons, including entities, children, and those with mere signature authority	Specified individuals (and certain specified domestic entities) with an interest in the assets
Threshold	Aggregate of maximum account values exceeds \$10,000 at any time	\$50,000 / \$75,000 and up, depending on filing status and residence
What is reported	Foreign financial accounts	Foreign financial accounts plus other foreign financial assets (stock held directly, partnership interests, foreign pensions)
Foreign real estate held directly	Not reported	Not reported
Account at a foreign branch of a U.S. bank	Reported	Not reported
Account at a U.S. branch of a foreign bank	Not reported	Not reported
Signature authority only	Must report	Not required

	FBAR (FinCEN 114)	Form 8938
Due date	April 15, automatic extension to October 15	With the return, including extensions
Required if no tax return is required?	Yes	No
Penalties	Non-willful up to \$10,000 (indexed) per report; willful greater of \$100,000 (indexed) or 50% of balance	\$10,000, plus up to \$50,000 for continued failure; 40% accuracy penalty
Statute of limitations	6 years	Return stays open until filed

Memory cue. “FBAR is the Treasury’s form about accounts; 8938 is the IRS’s form about assets.” Many taxpayers must file both.

6.10 Forms 3520, 5471, 8865, and 8621

Form	Who must file	Trigger	Penalty
3520 , Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts	U.S. person	Receives gifts or bequests of more than \$100,000 in the year from a nonresident alien individual or foreign estate (aggregating gifts from related persons), or more than \$19,570 (2025) from foreign corporations or partnerships; or creates, transfers property to, is treated as owner of, or receives a distribution from a foreign trust	Gifts: 5% per month of the gift, up to 25%; trust transactions: greater of \$10,000 or 35% of the amount transferred or distributed; owner’s failure: 5% of the trust assets
3520-A , Annual Information Return of Foreign Trust With a U.S. Owner	Foreign trust with a U.S. owner (the owner must ensure it is filed)	Each year the trust has a U.S. owner	Greater of \$10,000 or 5% of trust assets treated as owned
5471 , Information Return of U.S. Persons With Respect to Certain Foreign Corporations	U.S. citizens and residents who are officers, directors, or shareholders in certain foreign corporations	Acquiring or disposing of 10% ownership; being a 10% shareholder of a controlled foreign corporation; control of a foreign corporation	\$10,000 per form per year, plus \$10,000 per 30 days after notice up to \$50,000; reduction of foreign tax credits; return stays open
8865 , Return of U.S. Persons With Respect to Certain Foreign Partnerships	U.S. persons who control (more than 50%) or own at least 10% of a foreign partnership, or contribute property to one	Control, 10% interest in a U.S.-controlled partnership, contributions, acquisitions and dispositions	\$10,000 per year plus continuation penalties, as for Form 5471

Form	Who must file	Trigger	Penalty
8621 , Information Return by a Shareholder of a Passive Foreign Investment Company	Shareholders of a PFIC (most foreign mutual funds)	Owning PFIC stock, receiving distributions, disposing of shares, or making a QEF or mark-to-market election	Punitive interest-charge regime on excess distributions; return stays open

Receiving a **foreign gift** is not income to the recipient; Form 3520 is information-only. Receiving a distribution from a **foreign trust**, however, can be taxable and can carry a throwback interest charge. A **foreign inheritance** of over \$100,000 is also reported on Form 3520 even though no tax applies.

Worked example. In 2025 Priya's mother, a citizen and resident of India, gives Priya \$150,000 to help buy a house in Houston. The gift is not income to Priya and the U.S. gift tax does not apply to Priya's mother (a nonresident giving intangible property). Because the gift exceeds \$100,000, Priya must file Form 3520 by the due date of her 2025 return including extensions. If she forgets and files it 10 months late, the penalty is $5\% \times 5 \text{ months (capped at 25\%)} \times \$150,000 = \$37,500$, absent reasonable cause.

Exam trap. The \$100,000 Form 3520 threshold is for gifts from nonresident alien **individuals** or foreign **estates**. Gifts from foreign **corporations or partnerships** have a much lower threshold (\$19,570 for 2025). And a gift of \$120,000 split as \$60,000 from a mother and \$60,000 from a father must be aggregated because they are related.

Quick Check: Chapter 6

1. Lars died in 2025 owning a \$9,000,000 brokerage account, a home worth \$800,000 titled jointly with his wife, and a \$1,000,000 life insurance policy he owned naming his son as beneficiary. His gross estate is:

- A. \$9,000,000
- B. \$9,400,000
- C. \$10,400,000
- D. \$10,800,000

2. Which estate must file Form 706 for a 2025 decedent?

- A. A \$5,000,000 estate left entirely to the surviving spouse, where the executor wants to preserve the unused exclusion.
- B. A \$12,000,000 estate left to the children, with no lifetime taxable gifts.
- C. A \$900,000 estate with \$600 of post-death interest income.
- D. A \$4,000,000 estate left entirely to charity.

3. Nora, unmarried, gave her nephew \$30,000 cash, paid \$25,000 of his tuition directly to his university, and paid \$7,000 of his medical bills directly to the hospital in 2025. Her taxable gifts for 2025 are:
- A. \$0
 - B. \$11,000
 - C. \$43,000
 - D. \$62,000
4. Which asset is reported on Form 8938 but **not** on the FBAR?
- A. A checking account at a bank in Germany.
 - B. Shares of a French corporation held directly in certificate form, not in a brokerage account.
 - C. A vacation condo in Mexico owned directly.
 - D. A savings account at a U.S. branch of a Canadian bank.
5. Oscar, a U.S. citizen living in Houston and filing single, had a foreign brokerage account worth \$40,000 on December 31, 2025 that reached \$80,000 in July. Which is true?
- A. He must file the FBAR but not Form 8938.
 - B. He must file Form 8938 but not the FBAR.
 - C. He must file both.
 - D. He must file neither.
6. Tess and her husband (both U.S. citizens) want to give their daughter \$38,000 in 2025 using gift-splitting. Which is correct?
- A. No gift tax return is required because each spouse's half is within the \$19,000 exclusion.
 - B. Form 709 must be filed to make the gift-splitting election, but no tax is due and no lifetime exclusion is used.
 - C. One joint Form 709 is filed by the couple.
 - D. The gift uses \$38,000 of their combined lifetime exclusion.
7. The estate of a decedent who died on March 10, 2025 must file Form 706 (if required) by:
- A. April 15, 2026
 - B. December 10, 2025
 - C. March 10, 2026
 - D. September 10, 2025
8. Which statement about income in respect of a decedent and estate income tax is correct?
- A. An estate must file Form 1041 only if its gross income is \$5,000 or more.
 - B. A simple trust receives a \$600 personal exemption.
 - C. An estate may elect a fiscal year for Form 1041.
 - D. Income the decedent earned but received after death is reported on the decedent's final Form 1040.

Answers.

- 1. C.** \$9,000,000 + one-half of the jointly held spousal property (\$400,000) + the full \$1,000,000 of life insurance he owned = \$10,400,000. Insurance owned by the decedent is included regardless of the beneficiary.
- 2. A.** A portability election requires a Form 706 even when the estate is below the filing threshold. B is below \$13,990,000; C's \$600 of income triggers Form 1041, not Form 706; D is below the threshold and fully deductible in any case.
- 3. B.** Direct tuition and medical payments are unlimited exclusions. Of the \$30,000 cash gift, \$19,000 is excluded, leaving \$11,000 of taxable gifts that use lifetime exclusion. No tax is due, but Form 709 is required.
- 4. B.** Directly held foreign stock is a specified foreign financial asset for Form 8938 but is not a financial account for the FBAR. The German account is on both. Foreign real estate held directly is on neither. An account at a U.S. branch of a foreign bank is on neither.
- 5. C.** FBAR: the account exceeded \$10,000 at some point. Form 8938 for an unmarried U.S. resident: more than \$50,000 at year end **or** more than \$75,000 at any time; \$80,000 in July meets the second test.
- 6. B.** Gift-splitting requires each spouse's consent on a Form 709 filed by the donor spouse, even when the result is fully excluded. There is no joint Form 709, and a fully excluded gift uses no lifetime exclusion.
- 7. B.** Form 706 is due nine months after the date of death. Form 4768 provides an automatic six-month extension to file.
- 8. C.** An estate (but not a trust, with limited exceptions) may choose a fiscal year. The Form 1041 threshold is \$600 of gross income; the \$600 exemption belongs to estates, while simple trusts get \$300; income received after death is IRD reported by the estate or beneficiary, not on the final Form 1040.

Part III. Practice Exam

50 questions • 105 minutes • 2025 tax law

This practice exam mirrors the domain weighting of the real Part 1 exam: 8 questions on Preliminary Work, 10 on Income and Assets, 10 on Deductions and Credits, 9 on Taxation, 7 on Advising, and 6 on Specialized Returns. Set a timer for 105 minutes, which matches the pace of 100 questions in 3.5 hours. Mark each question you are unsure of and come back to it. Unless a question says otherwise, all facts relate to calendar year 2025. The answer key with explanations follows the last question. All questions are original study questions and are not actual exam items.

Questions

1. Marco's wife died in February 2025. He did not remarry and has no children. His filing status for 2025 is:
 - A. Single
 - B. Married filing jointly
 - C. Qualifying surviving spouse
 - D. Head of household
2. Lily turned 24 in November 2025. She was a full-time student all year, lived with her parents, earned \$4,000 from a part-time job, and her parents provided more than half of her support. For 2025, Lily is her parents':
 - A. Qualifying child, entitling them to the \$2,200 child tax credit.
 - B. Qualifying relative, entitling them to the \$500 credit for other dependents.
 - C. Not a dependent, because she is 24.
 - D. Not a dependent, because her gross income exceeds \$1,350.
3. A married couple, both age 66, file jointly and had \$34,000 of gross income in 2025, none from self-employment. Are they required to file?
 - A. Yes, because their income exceeds \$31,500.
 - B. No, because their income is below \$34,700.
 - C. Yes, because their income exceeds \$33,100.
 - D. Only if they intend to itemize deductions.
4. Which expense counts toward the cost of keeping up a home for head of household purposes?
 - A. Clothing for the qualifying child
 - B. Food eaten in the home
 - C. The qualifying child's medical insurance
 - D. The rental value of the home the taxpayer owns

5. Chen arrived in the United States on an F-1 student visa in January 2025 and was present 300 days during the year. He had never been in the U.S. before. For 2025, Chen is:

- A. A resident alien under the substantial presence test.
- B. A nonresident alien, because days as an exempt student do not count.
- C. A dual-status alien.
- D. A resident alien under the green card test.

6. Amir, age 15, has \$5,000 of interest income and no earned income. His parents are in the 24% bracket. The portion of Amir's tax computed at his parents' rate is:

- A. \$0
- B. \$552
- C. \$876
- D. \$1,200

7. Dana and Eli are not married. Their son lived with Dana for seven months and with Eli for five months in 2025. Both want to claim him. Dana's AGI is \$40,000 and Eli's is \$90,000. Under the tie-breaker rules, the child is the qualifying child of:

- A. Eli, because he has the higher AGI.
- B. Dana, because the child lived with her longer.
- C. Both; they may each claim half the benefits.
- D. Neither, until a court decides.

8. Fiona's 2025 gross income was \$9,000, and she received advance payments of the premium tax credit for Marketplace coverage. Which is correct?

- A. She need not file because her income is below \$15,750.
- B. She must file a return to reconcile the advance payments on Form 8962.
- C. She must file only if she owes repayment.
- D. She should file Form 1095-A instead of a return.

9. Which interest is taxable on a 2025 federal return?

- A. Interest on a City of Houston general obligation bond
- B. Interest on a U.S. Treasury note
- C. Series EE bond interest redeemed for tuition by a qualifying taxpayer under the phaseout
- D. Interest credited inside a traditional IRA that was not withdrawn

10. Gail bought stock 30 days before the ex-dividend date and sold it 20 days after. The \$500 dividend she received is:

- A. A qualified dividend taxed at capital gain rates.
- B. An ordinary dividend taxed at ordinary rates, because she held the stock only 50 days during the 121-day window.
- C. A nondividend distribution that reduces basis.
- D. Excluded from income.

11. Hugo's credit card issuer forgave \$10,000 of debt in 2025. Immediately before the forgiveness, his assets were worth \$30,000 and his liabilities were \$36,000. How much cancellation of debt income does he report?

- A. \$0
- B. \$4,000
- C. \$6,000
- D. \$10,000

12. Which distribution is subject to the 10% additional tax on early distributions?

- A. A \$20,000 401(k) distribution to a 48-year-old who quit her job in 2025.
- B. A \$20,000 401(k) distribution to a 56-year-old who retired in 2025.
- C. A \$10,000 IRA distribution to a 50-year-old used for a first-time home purchase.
- D. A \$20,000 distribution from an inherited IRA to a 30-year-old beneficiary.

13. Ira was born on May 3, 1952. He has a traditional IRA. By what date must he take his first required minimum distribution?

- A. December 31, 2025
- B. April 1, 2026
- C. April 1, 2027
- D. December 31, 2027

14. Jade owned 100 shares bought for \$5,000. The stock split 2-for-1. She then sold 50 shares for \$2,000. Her gain is:

- A. \$0
- B. \$750
- C. \$1,250
- D. \$2,000

15. In 2025 Kurt had a \$4,000 short-term capital gain and a \$10,000 long-term capital loss. He reports:

- A. A \$6,000 capital loss deduction.
- B. A \$3,000 capital loss deduction and a \$3,000 long-term loss carryover.
- C. A \$3,000 capital loss deduction and a \$3,000 short-term loss carryover.
- D. A \$4,000 gain and a \$10,000 loss carryover.

16. Lana, single, sold her main home in 2025 for a \$300,000 gain. She owned and lived in it for the three years before the sale and had not sold another home. Her taxable gain is:

- A. \$0
- B. \$50,000
- C. \$250,000
- D. \$300,000

17. Max, age 58, had self-only HDHP coverage for all of 2025 and no other coverage. His maximum HSA contribution is:

- A. \$4,300
- B. \$5,300
- C. \$8,550
- D. \$9,550

18. A married couple filing jointly received \$16,000 of Social Security benefits and had \$22,000 of other income, with no tax-exempt interest. The taxable portion of their benefits is:

- A. \$0
- B. \$8,000
- C. \$13,600
- D. \$16,000

19. A married couple filing jointly, both age 67 and neither blind, take the standard deduction. Their 2025 standard deduction (before any Schedule 1-A deduction) is:

- A. \$31,500
- B. \$33,100
- C. \$34,700
- D. \$35,500

20. Nia's AGI is \$60,000 and she paid \$6,000 of unreimbursed medical expenses. Her Schedule A medical deduction is:

- A. \$0
- B. \$1,500
- C. \$4,500
- D. \$6,000

21. For 2025, the state and local tax deduction cap for a married individual filing separately with MAGI under \$250,000 is:

- A. \$5,000
- B. \$10,000
- C. \$20,000
- D. \$40,000

22. Owen took out a \$900,000 mortgage in 2024 to buy his main home and paid \$45,000 of interest in 2025. The deductible portion of his mortgage interest is:

- A. \$45,000
- B. \$37,500
- C. \$25,000
- D. \$0

23. Pia's AGI is \$50,000. She gave \$35,000 cash to her church in 2025. Her 2025 charitable deduction and carryover are:

- A. \$35,000; \$0
- B. \$30,000; \$5,000
- C. \$25,000; \$10,000
- D. \$15,000; \$20,000

24. Quinn worked all year and earned \$70,000; his wife was a full-time student for nine months and had no earned income. They paid \$5,000 of day care for their one child, age 3, and their AGI is \$70,000. Their child and dependent care credit is:

- A. \$600
- B. \$450
- C. \$1,000
- D. \$0

25. The Ruiz family's son turned 17 on December 30, 2025, and is their dependent with a valid SSN. For 2025 they may claim:

- A. The \$2,200 child tax credit.
- B. The \$500 credit for other dependents.
- C. Both credits.
- D. Neither credit.

26. Sara is a full-time graduate student. Her parents claim her and paid \$8,000 of her tuition in 2025. Their MAGI is \$120,000. The education credit available to them is:

- A. \$2,500 American opportunity credit
- B. \$2,000 lifetime learning credit
- C. \$1,600 lifetime learning credit
- D. \$0

27. Which fact disqualifies a taxpayer from the earned income tax credit for 2025?

- A. Investment income of \$12,500
- B. Head of household filing status
- C. Net self-employment income as the only earned income
- D. A qualifying child who is a 22-year-old full-time student

28. The Tran family finalized the adoption of a child with special needs in 2025 and paid \$3,000 of adoption expenses. Their MAGI is \$150,000. Their 2025 adoption credit is:

- A. \$3,000, all nonrefundable
- B. \$17,280, of which up to \$5,000 is refundable
- C. \$5,000, all refundable
- D. \$3,000, all refundable

29. Uma's Schedule C net profit is \$30,000; she has no wages. Her deduction for one-half of self-employment tax is closest to:

- A. \$4,239
- B. \$2,119
- C. \$2,295
- D. \$1,500

30. A married couple filing jointly has MAGI of \$300,000, including \$80,000 of net investment income. Their net investment income tax is:

- A. \$3,040
- B. \$1,900
- C. \$11,400
- D. \$0

31. Vic, single, earned \$230,000 of wages and had no other income. His Additional Medicare Tax is:

- A. \$0
- B. \$270
- C. \$2,070
- D. \$3,335

32. Wes paid a babysitter \$2,500 in cash wages during 2025, including \$1,200 in the third quarter. Which household employment tax applies?

- A. Social Security and Medicare tax only
- B. Federal unemployment tax only
- C. Both Social Security/Medicare and federal unemployment tax
- D. Neither

33. Xena's 2024 AGI was \$140,000 and her 2024 tax was \$18,000. Her 2025 tax is \$30,000. The minimum amount of 2025 withholding and estimated payments that avoids an underpayment penalty is:

- A. \$18,000
- B. \$19,800
- C. \$27,000
- D. \$30,000

34. The failure-to-file penalty is generally:

- A. 0.5% of unpaid tax per month, up to 25%.
- B. 5% of unpaid tax per month, up to 25%.
- C. 20% of the underpayment.
- D. 5% of unpaid tax per month, with no maximum.

35. Reverend Young receives a \$12,000 housing allowance that is fully excluded from income tax. For self-employment tax purposes, the allowance is:

- A. Excluded, the same as for income tax.
- B. Included in net earnings from self-employment.
- C. Included only if he did not file Form 4361.
- D. Included at 50%.

36. An enlisted service member's pay for months served in a combat zone is:

- A. Fully taxable.
- B. Excluded from gross income, but may be elected into earned income for the EITC.
- C. Excluded only up to \$10,000.
- D. Taxable, but exempt from Social Security tax.

37. Which asset inherited from a decedent does **not** receive a stepped-up basis?

- A. Publicly traded stock
- B. The decedent's personal residence
- C. A traditional IRA
- D. Artwork

38. Under a 2025 divorce decree, Zoe transferred stock with a basis of \$20,000 and a value of \$50,000 to her former husband. Which is correct?

- A. Zoe recognizes a \$30,000 gain.
- B. Her former husband's basis in the stock is \$20,000.
- C. Her former husband's basis in the stock is \$50,000.
- D. Zoe may deduct the transfer as alimony.

39. For 2025, tax-free distributions from a section 529 plan for elementary and secondary school tuition are limited to:

- A. \$2,000 per beneficiary
- B. \$10,000 per beneficiary per year
- C. \$20,000 per beneficiary per year
- D. There is no limit

40. Abe filed his 2022 Form 1040 on February 1, 2023 and now wants to claim a missed credit. His claim for refund is timely if filed by:

- A. February 1, 2026
- B. April 18, 2026
- C. February 1, 2025
- D. April 15, 2027

- 41.** A request for innocent spouse relief or separation of liability must generally be filed within:
- A. 3 years from the date the joint return was filed.
 - B. 2 years after the IRS first begins collection activity against the requesting spouse.
 - C. 6 months after the divorce is final.
 - D. 1 year after the IRS issues the notice of deficiency.
- 42.** The principal legal disadvantage of filing a joint return is:
- A. The loss of the earned income credit.
 - B. Joint and several liability for the entire tax.
 - C. A smaller standard deduction.
 - D. The \$1,500 capital loss limitation.
- 43.** Bo, a cash-basis taxpayer who itemizes, received his 2025 property tax bill in October 2025, with payment due January 31, 2026. He paid it on December 28, 2025. The tax is deductible:
- A. In 2025, subject to the SALT cap.
 - B. In 2026, when it was due.
 - C. Half in each year.
 - D. Never, because it was prepaid.
- 44.** Cy, age 74, takes the standard deduction and makes large annual gifts to charity. Which strategy reduces his adjusted gross income?
- A. Taking his RMD and donating the cash to charity
 - B. Directing his RMD to charity as a qualified charitable distribution
 - C. Donating appreciated stock from his brokerage account
 - D. Bunching his gifts into alternate years
- 45.** In 2025 Dee gave \$25,000 cash to a friend and nothing to anyone else. Dee is unmarried. Which is correct?
- A. No Form 709 is required because no tax is due.
 - B. Form 709 is required and \$6,000 of taxable gifts reduces her lifetime exclusion.
 - C. Form 709 is required and \$25,000 of gift tax is due.
 - D. The friend must report \$25,000 of income.
- 46.** Ed died in 2025 owning real estate worth \$500,000 as a joint tenant with right of survivorship with his nephew. The executor can prove the nephew paid 40% of the purchase price. The amount included in Ed's gross estate is:
- A. \$0
 - B. \$200,000
 - C. \$250,000
 - D. \$300,000

- 47.** Which statement about the FBAR for calendar year 2025 is correct?
- A. It is attached to Form 1040 and due with the return.
 - B. It is filed with FinCEN, due April 15, 2026, with an automatic extension to October 15, 2026.
 - C. It is required only if a foreign account exceeded \$50,000.
 - D. It is filed only by taxpayers who live abroad.
- 48.** Fay, a U.S. citizen, inherited \$120,000 from her uncle, a citizen and resident of Nigeria, in 2025. Which is correct?
- A. The inheritance is taxable income to Fay.
 - B. Fay must report the inheritance on Form 3520; it is not taxable income.
 - C. Fay must file Form 709.
 - D. No reporting is required because inheritances are tax-free.
- 49.** To allow a surviving spouse to use the deceased spouse's unused exclusion amount, the executor must:
- A. File Form 709 for the decedent's final year.
 - B. File Form 706 and elect portability, even if no estate tax is due.
 - C. Do nothing; portability is automatic.
 - D. File Form 1041 electing a fiscal year.
- 50.** A calendar-year estate had \$2,000 of interest income in 2025. Its Form 1041 is:
- A. Not required, because income is below \$5,000.
 - B. Required, and due April 15, 2026.
 - C. Required, and due nine months after death.
 - D. Required only if a beneficiary received a distribution.

Answer Key and Explanations

- 1. B.** A surviving spouse may file jointly for the year of death if not remarried by year end. Qualifying surviving spouse status requires a dependent child and applies to the two following years.
- 2. B.** Lily fails the age test for a qualifying child because she was not under 24 at the end of 2025. She passes the qualifying relative tests: not anyone's qualifying child, member of the household all year, gross income of \$4,000 is under \$5,200, and her parents provided more than half of her support. She qualifies them for the \$500 credit for other dependents.
- 3. B.** For MFJ with both spouses 65 or older, the 2025 filing threshold is \$34,700. Their \$34,000 is below it, and they have no self-employment income.
- 4. B.** Food eaten in the home counts. Clothing, medical care, and the rental value of a home the taxpayer owns do not.
- 5. B.** A student on an F-1 visa is an exempt individual for his first five calendar years, so his days of presence do not count toward the substantial presence test. He is a nonresident alien for 2025.

- 6. B.** Unearned income above \$2,700 is taxed at the parents' rate: $(\$5,000 - \$2,700) \times 24\% = \$552$. The first \$1,350 is sheltered by the standard deduction and the next \$1,350 is taxed at Amir's rate.
- 7. B.** When both parents claim the child and they do not file jointly, the child is the qualifying child of the parent with whom the child lived longer. AGI matters only if the time is equal or if no parent claims the child.
- 8. B.** Anyone who received advance premium tax credit payments must file a return to reconcile them, regardless of income.
- 9. B.** Treasury interest is taxable federally (exempt from state tax). Municipal bond interest is excluded, qualified EE bond interest for education is excluded, and interest earned inside an IRA is not taxed until distributed.
- 10. B.** To be qualified, the stock must be held more than 60 days during the 121-day period beginning 60 days before the ex-dividend date. Fifty days falls short.
- 11. B.** Insolvency immediately before the discharge was $\$36,000 - \$30,000 = \$6,000$, so \$6,000 is excluded and \$4,000 is income.
- 12. A.** Separation from service avoids the penalty only if it occurs in or after the year the employee turns 55. The first-time homebuyer exception applies to IRAs, and distributions to a beneficiary after the owner's death are never penalized.
- 13. B.** Born in 1952, Ira reaches age 73 in 2025, so 2025 is his first distribution year, and the first RMD may be delayed until April 1, 2026. His 2026 RMD is then due by December 31, 2026.
- 14. B.** After the split, each of the 200 shares has a basis of \$25. Fifty shares have a basis of \$1,250; sale proceeds of \$2,000 produce a \$750 gain.
- 15. B.** Net the \$4,000 short-term gain against the \$10,000 long-term loss for a \$6,000 net long-term loss. Deduct \$3,000 against ordinary income; the \$3,000 remainder carries forward as a long-term loss.
- 16. B.** She excludes \$250,000 under section 121 and reports the remaining \$50,000 as long-term capital gain.
- 17. B.** The 2025 self-only limit is \$4,300 plus the \$1,000 catch-up for taxpayers 55 or older.
- 18. A.** Provisional income is $\$22,000 + \text{half of } \$16,000 = \$30,000$, which is below the \$32,000 base amount for joint filers, so no benefits are taxable.
- 19. C.** \$31,500 plus \$1,600 for each spouse who is 65 or older: $\$31,500 + \$3,200 = \$34,700$.
- 20. B.** The floor is $7.5\% \times \$60,000 = \$4,500$. Deduction: $\$6,000 - \$4,500 = \$1,500$.
- 21. C.** The 2025 SALT cap is \$40,000, or \$20,000 for married filing separately, before any phase-down for MAGI above \$500,000 (\$250,000 MFS).
- 22. B.** Acquisition debt after December 15, 2017 is limited to \$750,000. Deductible interest: $\$750,000 \div \$900,000 \times \$45,000 = \$37,500$.
- 23. B.** Cash gifts to a public charity are limited to 60% of AGI: \$30,000. The \$5,000 excess carries forward for up to five years.

- 24. B.** A spouse who is a full-time student is deemed to earn \$250 per month with one qualifying person: $9 \times \$250 = \$2,250$, which becomes the expense limit (lower than \$3,000 and \$5,000). At AGI above \$43,000 the rate is 20%: \$450.
- 25. B.** The child tax credit requires the child to be under 17 at the end of the year. A child who turned 17 on December 30 is 17 at year end and qualifies only for the \$500 credit for other dependents.
- 26. C.** A graduate student is beyond the first four years of postsecondary education, so only the lifetime learning credit is available: $20\% \times \$8,000 = \$1,600$. The MFJ phaseout begins at \$160,000, so there is no reduction.
- 27. A.** Investment income above \$11,950 disqualifies the taxpayer. Head of household status, self-employment income, and a student qualifying child under 24 are all permitted.
- 28. B.** A special-needs adoption qualifies for the full \$17,280 credit in the year it becomes final regardless of expenses. Beginning in 2025, up to \$5,000 of the credit is refundable. Their MAGI is below the \$259,190 phaseout.
- 29. B.** Net earnings: $\$30,000 \times 92.35\% = \$27,705$. SE tax: $15.3\% \times \$27,705 = \$4,239$. One-half: \$2,119.
- 30. B.** The excess of MAGI over \$250,000 is \$50,000, which is less than net investment income of \$80,000. $3.8\% \times \$50,000 = \$1,900$.
- 31. B.** $0.9\% \times (\$230,000 - \$200,000) = \$270$.
- 32. B.** Cash wages of \$2,500 are below the \$2,800 Social Security and Medicare threshold, but wages of \$1,000 or more in a calendar quarter trigger federal unemployment tax.
- 33. A.** The safe harbor is the smaller of 90% of the current-year tax (\$27,000) or 100% of the prior-year tax (\$18,000, since prior-year AGI did not exceed \$150,000).
- 34. B.** Failure to file: 5% per month or part of a month, up to 25%. Failure to pay is 0.5% per month, and the accuracy-related penalty is 20%.
- 35. B.** A minister's housing allowance is excluded from income tax but included in net earnings for self-employment tax, unless the minister has an approved Form 4361 exemption.
- 36. B.** Combat pay is excluded for enlisted members and warrant officers (and for officers up to the highest enlisted pay plus imminent danger pay), and the taxpayer may elect to include it as earned income for the EITC.
- 37. C.** A traditional IRA is income in respect of a decedent and is taxed to the beneficiary as ordinary income without a basis adjustment. Stock, a residence, and artwork receive a stepped-up basis.
- 38. B.** Transfers incident to divorce are not taxable under section 1041, and the recipient takes a carryover basis of \$20,000.
- 39. B.** For 2025, up to \$10,000 per beneficiary per year may be used for K–12 tuition. The increase to \$20,000 applies beginning in 2026.
- 40. B.** A return filed early is treated as filed on the due date, April 18, 2023, so the three-year period ends April 18, 2026.

- 41. B.** Innocent spouse relief and separation of liability must be requested within two years after the IRS first attempts to collect from the requesting spouse. Equitable relief has a longer period.
- 42. B.** Each spouse is liable for the full tax, interest, and penalties on a joint return, even after divorce, unless innocent spouse relief is granted.
- 43. A.** A cash-basis taxpayer deducts taxes in the year paid. The tax had been assessed, so the December payment is deductible in 2025, within the SALT cap.
- 44. B.** A qualified charitable distribution (available at 70½ and older, up to \$108,000 for 2025) is excluded from income and satisfies the RMD, lowering AGI. Donating cash or stock produces an itemized deduction, which does not lower AGI and does not help a taxpayer who takes the standard deduction.
- 45. B.** The gift exceeds the \$19,000 annual exclusion by \$6,000, so Form 709 is required and \$6,000 of lifetime exclusion is used. No tax is due until cumulative taxable gifts exceed \$13,990,000, and gifts are never income to the recipient.
- 46. D.** For joint property with a non-spouse, the full value is included except to the extent the survivor's contribution is proven. The nephew contributed 40%, so $60\% \times \$500,000 = \$300,000$ is included.
- 47. B.** The FBAR is filed electronically with FinCEN, not the IRS. The threshold is an aggregate of more than \$10,000, and it applies to U.S. persons wherever they live.
- 48. B.** Inheritances and gifts from foreign persons are not income, but amounts over \$100,000 from a nonresident alien individual or foreign estate must be reported on Form 3520. Form 709 is filed by donors, not recipients.
- 49. B.** Portability requires an election on a timely filed Form 706 (or a late portability-only return under the five-year relief procedure). It is never automatic.
- 50. B.** An estate must file Form 1041 if its gross income is \$600 or more. A calendar-year estate's return is due April 15 of the following year. The nine-month deadline applies to Form 706.

Scoring Your Practice Exam

Correct answers	Reading
43–50	You are performing above the level the passing standard requires. Spend your remaining time on the domains where you missed questions and on Appendix A.
36–42	You are on track. Re-read the chapters for the domains with two or more misses, then retake the Quick Checks for those chapters.
28–35	Solid foundation with gaps. Work through each missed question's explanation, find the rule in the chapter, and write the rule in your own words.
Under 28	Take a second full pass through Chapters 1 to 6 before scheduling the exam. Focus on the comparison tables, which carry most of the testable distinctions.

Because the real exam reports a scaled score rather than a percentage, no practice score converts exactly to a 500. As a planning guide, candidates who consistently answer about 70% or more of well-constructed practice questions correctly are usually prepared.

APPENDICES

Reference

2025 numbers at a glance, a forms directory, a glossary, sources, and the 2026 changes that are not on your exam.

Appendix A. 2025 Numbers at a Glance

Print this appendix and review it in the final week. Every figure applies to tax year 2025, the year tested in the July 1, 2026 – February 28, 2027 window.

Filing and standard deduction

Item	2025
Standard deduction: single / MFS	\$15,750
Standard deduction: MFJ / QSS	\$31,500
Standard deduction: head of household	\$23,625
Additional standard deduction, age 65 or blind: married or QSS	\$1,600 each
Additional standard deduction, age 65 or blind: single or HOH	\$2,000 each
Dependent's standard deduction	Greater of \$1,350 or earned income + \$450
Enhanced deduction for seniors (Schedule 1-A)	\$6,000 per spouse 65+; phaseout MAGI \$75,000 / \$150,000 MFJ
Qualified tips deduction	\$25,000; phaseout MAGI \$150,000 / \$300,000 MFJ
Qualified overtime deduction	\$12,500 / \$25,000 MFJ; phaseout MAGI \$150,000 / \$300,000
Car loan interest deduction	\$10,000; phaseout MAGI \$100,000 / \$200,000 MFJ
Qualifying relative gross income test	Less than \$5,200
Self-employment filing threshold	\$400 net earnings
Form 1040 due date	April 15, 2026; extension to October 15, 2026

Tax rates and thresholds

Item	2025
Ordinary brackets	10%, 12%, 22%, 24%, 32%, 35%, 37% (37% begins at \$626,350 single; \$751,600 MFJ; \$375,800 MFS)
Long-term capital gain 0% rate up to taxable income of	\$48,350 single and MFS; \$96,700 MFJ; \$64,750 HOH
Long-term capital gain 20% rate begins above	\$533,400 single; \$600,050 MFJ; \$300,000 MFS; \$566,700 HOH

Item	2025
Collectibles maximum rate / unrecaptured section 1250 maximum rate	28% / 25%
Capital loss deduction limit	\$3,000 (\$1,500 MFS)
Kiddie tax: unearned income taxed at parents' rate above	\$2,700 (first \$1,350 sheltered; next \$1,350 at child's rate)
Form 8814 parent election: child's gross income	More than \$1,350 and less than \$13,500
AMT exemption	\$88,100 single/HOH; \$137,000 MFJ; \$68,500 MFS; \$30,700 estates and trusts
AMT exemption phaseout begins	\$626,350 single/HOH/MFS; \$1,252,700 MFJ
AMT 28% rate begins at AMT base of	\$239,100 (\$119,550 MFS)
Net investment income tax 3.8% threshold (MAGI)	\$200,000 single/HOH; \$250,000 MFJ; \$125,000 MFS
Additional Medicare Tax 0.9% threshold	\$200,000 single/HOH/QSS; \$250,000 MFJ; \$125,000 MFS
Social Security wage base	\$176,100 (maximum employee tax \$10,918.20)
Self-employment tax	15.3% of 92.35% of net profit; 12.4% portion stops at the wage base
Social Security benefits base amounts	\$25,000 single; \$32,000 MFJ; \$0 MFS living together; 85% tier at \$34,000 / \$44,000
Household employee threshold	\$2,800 cash wages (FICA); \$1,000 in a quarter (FUTA)
Estimated tax safe harbor	90% current year or 100% prior year (110% if prior AGI over \$150,000); no penalty if balance under \$1,000
Failure to file / failure to pay	5% per month to 25% / 0.5% per month to 25%; minimum FTF \$525 after 60 days
Accuracy-related / fraud penalties	20% / 75%
Estates and trusts 37% bracket begins	\$15,650
Trust and estate exemptions	\$600 estate; \$300 simple trust; \$100 complex trust

Retirement and savings

Item	2025
IRA contribution limit	\$7,000; \$8,000 at age 50+
Traditional IRA deduction phaseout (covered by plan)	\$79,000–\$89,000 single/HOH; \$126,000–\$146,000 MFJ; \$0–\$10,000 MFS
Traditional IRA deduction phaseout (spouse covered, taxpayer not)	\$236,000–\$246,000

Item	2025
Roth IRA contribution phaseout	\$150,000–\$165,000 single/HOH; \$236,000–\$246,000 MFJ; \$0–\$10,000 MFS
401(k), 403(b), 457 deferral	\$23,500; catch-up \$7,500 at 50+; \$11,250 at ages 60–63
SIMPLE IRA deferral	\$16,500; catch-up \$3,500 (or \$5,250 at ages 60–63)
SEP and defined contribution annual additions limit	\$70,000
RMD starting age	73 (born 1951–1959); 75 (born 1960 or later)
Missed RMD penalty	25%, reduced to 10% if corrected within two years
Qualified charitable distribution	\$108,000 (age 70½+)
Early distribution penalty	10%; emergency \$1,000; domestic abuse \$10,300; birth/adoption \$5,000; disaster \$22,000; first home (IRA) \$10,000
Saver's credit 50% AGI ceiling	\$47,500 MFJ; \$35,625 HOH; \$23,750 other (credit ends at \$79,000 / \$59,250 / \$39,500)
HSA contribution	\$4,300 self-only; \$8,550 family; catch-up \$1,000 at 55+
HDHP minimum deductible / out-of-pocket maximum	\$1,650 / \$8,300 self-only; \$3,300 / \$16,600 family
Health FSA	\$3,300
Dependent care assistance exclusion	\$5,000 (\$2,500 MFS)
Qualified transportation fringe	\$325 per month
Educational assistance exclusion	\$5,250
Group-term life insurance exclusion	First \$50,000 of coverage

Credits

Item	2025
Child tax credit	\$2,200 per child under 17; refundable ACTC up to \$1,700; 15% of earned income over \$2,500
Credit for other dependents	\$500
CTC/ODC phaseout	\$50 per \$1,000 of MAGI over \$200,000 (\$400,000 MFJ)
Child and dependent care credit	20%–35% of up to \$3,000 / \$6,000 of expenses; 35% at AGI \$15,000 or less; 20% above \$43,000
American opportunity credit	\$2,500 per student (100% of \$2,000 + 25% of next \$2,000); 40% refundable; phaseout \$80,000–\$90,000 / \$160,000–\$180,000 MFJ
Lifetime learning credit	20% of up to \$10,000 = \$2,000 per return; same phaseout

Item	2025
Student loan interest deduction	\$2,500; phaseout \$85,000–\$100,000 / \$170,000–\$200,000 MFJ
Savings bond education exclusion phaseout	\$99,500–\$114,500 / \$149,250–\$179,250 MFJ
Coverdell ESA	\$2,000 per beneficiary; phaseout \$95,000–\$110,000 / \$190,000–\$220,000
EITC maximum credits	\$649 (0 children); \$4,328 (1); \$7,152 (2); \$8,046 (3+)
EITC income limits (single/HOH)	\$19,104; \$50,434; \$57,310; \$61,555
EITC income limits (MFJ)	\$26,214; \$57,554; \$64,430; \$68,675
EITC investment income limit	\$11,950
EITC age without a qualifying child	25 through 64
Adoption credit	\$17,280; refundable up to \$5,000; phaseout \$259,190–\$299,190
Foreign tax credit without Form 1116	\$300 (\$600 MFJ) of passive foreign taxes
Clean vehicle credit	\$7,500 new / \$4,000 used, vehicles acquired by September 30, 2025
Energy efficient home improvement credit	30%, up to \$1,200 (\$2,000 heat pumps), property placed in service by December 31, 2025
Residential clean energy credit	30%, expenditures through December 31, 2025
Preparer due diligence penalty (Form 8867)	\$650 per failure, returns filed in 2026

Itemized deductions and QBI

Item	2025
Medical expense floor	7.5% of AGI
Medical mileage / charitable mileage / business mileage	21¢ / 14¢ / 70¢ per mile
Long-term care premium limits	\$480 (40 or under); \$900 (41–50); \$1,800 (51–60); \$4,810 (61–70); \$6,020 (over 70)
SALT cap	\$40,000 (\$20,000 MFS); phase-down 30% of MAGI over \$500,000 (\$250,000 MFS); floor \$10,000 (\$5,000)
Acquisition debt limit	\$750,000 (\$375,000 MFS) for debt after December 15, 2017; \$1,000,000 for earlier debt
Charitable AGI limits	60% cash to public charities; 30% appreciated property; 20% to private foundations for appreciated property
Charitable documentation	Written acknowledgment at \$250; Form 8283 over \$500; appraisal over \$5,000

Item	2025
Personal casualty losses	Federally declared disasters only; \$100 per event; 10% of AGI floor (qualified disaster: \$500 floor, no AGI floor)
QBI deduction	20%; taxable income threshold \$197,300 / \$394,600 MFJ; phase-in range \$50,000 / \$100,000
Excess business loss limit	\$313,000 / \$626,000 MFJ
Section 179 limit	\$2,500,000; phaseout begins \$4,000,000
Bonus depreciation	100% for property acquired and placed in service after January 19, 2025
Foreign earned income exclusion	\$130,000

Estate, gift, and international

Item	2025
Basic exclusion amount (estate and gift)	\$13,990,000
Unified credit	\$5,541,800
Top estate, gift, and GST rate	40%
Annual gift exclusion	\$19,000 per donee (\$38,000 with gift-splitting)
Annual exclusion, gifts to noncitizen spouse	\$190,000
529 five-year election	\$95,000 (\$190,000 split)
Form 706 due	9 months after death; 6-month extension on Form 4768
Form 1041 filing threshold	\$600 of gross income or a nonresident alien beneficiary
Form 709 due	April 15, 2026
FBAR threshold / due date	Aggregate over \$10,000 at any time / April 15, automatic extension to October 15
Form 8938 thresholds (U.S. residents)	\$50,000 / \$75,000 unmarried; \$100,000 / \$150,000 MFJ
Form 8938 thresholds (living abroad)	\$200,000 / \$300,000 unmarried; \$400,000 / \$600,000 MFJ
Form 3520 foreign gift thresholds	More than \$100,000 from individuals or estates; more than \$19,570 from foreign corporations or partnerships
Form 8938 / Form 5471 / Form 8865 penalty	\$10,000, plus \$10,000 per 30 days after notice up to \$50,000
Form 3520 penalty for unreported gifts	5% per month, up to 25%
Form 1099-K third-party network threshold	More than \$20,000 and more than 200 transactions
Form 1099-NEC threshold	\$600

Item	2025
Form 8300 cash reporting	More than \$10,000
Backup withholding rate	24%

Appendix B. Forms Directory

Form or schedule	Purpose	Chapter
Form 1040 / 1040-SR	Individual income tax return (1040-SR for taxpayers 65 and older)	1
Form 1040-NR	Nonresident alien income tax return	1, 3
Form 1040-X	Amended return and claim for refund	5
Form 1040-ES	Estimated tax vouchers	4
Schedule 1	Additional income and adjustments to income	1, 2
Schedule 1-A	Tips, overtime, car loan interest, and senior deductions (new for 2025)	3
Schedule 2	Additional taxes (AMT, SE tax, NIIT, Additional Medicare Tax, Form 5329, Schedule H)	4
Schedule 3	Additional credits and payments	3
Schedule A	Itemized deductions	3
Schedule B	Interest and ordinary dividends; foreign account question	2
Schedule C	Profit or loss from business	2, 4
Schedule D / Form 8949	Capital gains and losses	2
Schedule E	Rental, royalty, partnership, S corporation, estate, and trust income	2
Schedule EIC	Qualifying child information for the EITC	3
Schedule H	Household employment taxes	4
Schedule R	Credit for the elderly or the disabled	3
Schedule SE	Self-employment tax	4
Schedule 8812	Child tax credit and credit for other dependents	3
Form 56	Notice concerning fiduciary relationship	6
Form 706	Estate (and GST) tax return	6

Form or schedule	Purpose	Chapter
Form 709	Gift (and GST) tax return	6
Form 982	Reduction of tax attributes due to discharge of indebtedness	2
Form 1041	Income tax return for estates and trusts	6
Form 1095-A	Health Insurance Marketplace statement	1
Form 1098-T	Tuition statement	3
Form 1099-DA	Digital asset proceeds from broker transactions (new for 2025)	2
Form 1116	Foreign tax credit	2, 3
Form 1310	Statement of person claiming refund due a deceased taxpayer	6
Form 2106	Employee business expenses (reservists, performing artists, fee-basis officials)	2
Form 2120	Multiple support declaration	1
Form 2210	Underpayment of estimated tax	4
Form 2441	Child and dependent care expenses	3
Form 2555	Foreign earned income exclusion	2
Form 2848	Power of attorney	5
Form 3520 / 3520-A	Foreign trusts and foreign gifts	6
Form 3903	Moving expenses (Armed Forces)	2, 4
Form 4137	Social Security and Medicare tax on unreported tip income	2, 4
Form 4361	Minister's exemption from SE tax	4
Form 4684	Casualties and thefts	3
Form 4768	Extension to file Form 706	6
Form 4868	Automatic extension for Form 1040	1
Form 4952	Investment interest expense deduction	3
Form 5329	Additional taxes on IRAs and other tax-favored accounts	2, 4
Form 5405	Repayment of the first-time homebuyer credit	4

Form or schedule	Purpose	Chapter
Form 5471	U.S. persons with respect to certain foreign corporations	6
Form 5695	Residential energy credits	3
Form 6198	At-risk limitations	2
Form 6251	Alternative minimum tax	4
Form 6252	Installment sale income	2
Form 8283	Noncash charitable contributions	3
Form 8300	Cash payments over \$10,000 received in a trade or business	5
Form 8332	Release of claim to exemption for child by custodial parent	1
Form 8379	Injured spouse allocation	1, 5
Form 8396	Mortgage interest credit (mortgage credit certificates)	3
Form 8582	Passive activity loss limitations	2
Form 8594	Asset acquisition statement	5
Form 8606	Nondeductible IRAs	2
Form 8615	Tax for certain children with unearned income (kiddie tax)	1
Form 8621	Passive foreign investment company shareholder return	6
Form 8801	Credit for prior-year minimum tax	4, 5
Form 8814	Parents' election to report child's interest and dividends	1
Form 8815	Exclusion of interest from Series EE and I bonds	2, 5
Form 8824	Like-kind exchanges	2
Form 8833	Treaty-based return position disclosure	2
Form 8839	Qualified adoption expenses	3
Form 8840	Closer connection exception statement	1
Form 8857	Request for innocent spouse relief	5
Form 8862	Information to claim certain credits after disallowance	3

Form or schedule	Purpose	Chapter
Form 8865	U.S. persons with respect to certain foreign partnerships	6
Form 8867	Paid preparer's due diligence checklist	1, 3
Form 8880	Credit for qualified retirement savings contributions	3
Form 8889	Health savings accounts	2
Form 8919	Uncollected Social Security and Medicare tax on wages	2, 4
Form 8936	Clean vehicle credits	3
Form 8938	Statement of specified foreign financial assets	1, 6
Form 8949	Sales and other dispositions of capital assets	2
Form 8958	Allocation of community property amounts	5
Form 8959	Additional Medicare Tax	4
Form 8960	Net investment income tax	4
Form 8962	Premium tax credit	1, 3
Form 8971	Information regarding beneficiaries acquiring property from a decedent	6
Form 8995 / 8995-A	Qualified business income deduction	3
Form 15227	Application for an IP PIN	1
Form SS-8	Determination of worker status	2, 4
Form W-4	Employee's withholding certificate	5
Form W-7	Application for an ITIN	1
Form W-9	Request for taxpayer identification number	5
FinCEN Form 114	Report of Foreign Bank and Financial Accounts (FBAR)	1, 6

Appendix C. Glossary

Above the line. An adjustment to income on Schedule 1 that reduces adjusted gross income, as opposed to a deduction from AGI.

Acquisition indebtedness. Debt used to buy, build, or substantially improve a qualified residence and secured by it; interest is deductible within the \$750,000 limit.

Adjusted basis. Original basis plus improvements, minus depreciation allowed or allowable and other reductions.

Adjusted gross income (AGI). Gross income minus adjustments to income; the base for most phaseouts and floors.

Alternate valuation date. The date six months after death that an executor may elect for valuing the gross estate.

Alternative minimum tax (AMT). A parallel tax computed on a broader base with its own exemption and rates; paid to the extent it exceeds regular tax.

Amount realized. Cash plus the fair market value of property received plus liabilities assumed by the buyer, minus selling expenses.

Boot. Cash or non-like-kind property received in a like-kind exchange; triggers gain recognition.

Capital asset. Property other than inventory, business receivables, depreciable or real business property, self-created works, and supplies.

Carryover basis. The donor's basis, which transfers to the donee of a gift or the recipient of property in a divorce.

Considered unmarried. A married taxpayer who meets the tests to file as head of household because the spouse did not live in the home during the last six months of the year.

Constructive receipt. Income is taxed when made available without substantial restriction, even if not physically received.

Custodial parent. The parent with whom a child spent the greater number of nights during the year.

Deceased spousal unused exclusion (DSUE). The portion of a deceased spouse's basic exclusion amount that may be transferred to the surviving spouse through a portability election on Form 706.

Distributable net income (DNI). The ceiling on the distribution deduction of an estate or trust and on the amount taxable to beneficiaries.

Earned income. Wages, salaries, tips, and net self-employment income; required for IRA contributions, the EITC, the dependent care credit, and the additional child tax credit.

Exclusion. An item that is never included in gross income, such as gifts, inheritances, municipal bond interest, and life insurance proceeds.

Foreign earned income exclusion. The election on Form 2555 to exclude up to \$130,000 (2025) of wages or self-employment income earned abroad.

Gross income. All income from whatever source derived, unless specifically excluded.

Head of household (HOH). Filing status for an unmarried (or considered unmarried) taxpayer who pays more than half the cost of a home that is the main home of a qualifying person.

Income in respect of a decedent (IRD). Income the decedent had earned but not received at death; taxed to the recipient with no basis step-up.

Incident of ownership. Any right in a life insurance policy (to change beneficiaries, borrow, surrender) that causes inclusion in the insured's gross estate.

Itemized deductions. Schedule A deductions for medical expenses, taxes, interest, charitable gifts, casualty losses, and certain other items, taken instead of the standard deduction.

Kiddie tax. The tax on a child's net unearned income above \$2,700 (2025) at the parents' marginal rate.

Like-kind exchange. A section 1031 exchange of business or investment real property that defers gain.

Material participation. Regular, continuous, and substantial involvement in an activity (commonly more than 500 hours) that makes its income or loss nonpassive.

Modified adjusted gross income (MAGI). AGI with specified items added back; the definition differs from one provision to another.

Nonrefundable credit. A credit that can reduce tax to zero but cannot generate a refund.

Passive activity. A business in which the taxpayer does not materially participate, or any rental activity; losses are limited to passive income.

Portability. The election that allows a surviving spouse to use a deceased spouse's unused estate tax exclusion.

Present interest. An unrestricted right to the immediate use or enjoyment of property; required for the gift tax annual exclusion.

Provisional income. AGI plus tax-exempt interest plus half of Social Security benefits; used to determine the taxable portion of benefits.

Qualified business income (QBI). Net income from a qualified trade or business eligible for the 20% deduction.

Qualified charitable distribution (QCD). A direct transfer from an IRA to a charity by an owner 70½ or older, excluded from income and counted toward the RMD.

Qualified child / qualifying relative. The two categories of dependent, each with its own tests (Chapter 1).

Qualifying surviving spouse (QSS). Filing status for a widow or widower with a dependent child for the two years after the year of the spouse's death.

Recapture. Treating gain on the sale of depreciated property as ordinary income (section 1245) or at a 25% maximum rate (unrecaptured section 1250 gain).

Refundable credit. A credit that is treated as a payment and can produce a refund even when no tax is owed.

Required minimum distribution (RMD). The annual amount that must be withdrawn from a traditional IRA or employer plan beginning at age 73 (75 for those born after 1959).

Section 121 exclusion. The \$250,000 (\$500,000 MFJ) exclusion of gain on the sale of a main home owned and used for two of the last five years.

Specified service trade or business (SSTB). A service business (health, law, accounting, consulting, financial services, and others) whose QBI deduction phases out above the taxable income threshold.

Standard deduction. The fixed deduction from AGI available to taxpayers who do not itemize.

Stepped-up basis. The fair market value at the date of death that becomes the basis of inherited property.

Substantial presence test. The 31-day and weighted 183-day test for resident alien status.

Tax benefit rule. A recovery of a previously deducted amount is income only to the extent the earlier deduction reduced tax.

Tie-breaker rules. The rules that determine which of several eligible taxpayers may claim a child.

Unified credit. The credit against estate and gift tax equal to the tax on the basic exclusion amount (\$5,541,800 for 2025).

Wash sale. A loss sale followed or preceded within 30 days by a purchase of substantially identical securities; the loss is disallowed and added to the basis of the new shares.

Appendix D. Sources and Authorities

This guide is built on the following primary sources, as amended through December 31, 2025. Every figure in Appendix A traces to one of them. Readers should consult the current versions of these documents, since the IRS updates publications and instructions each year.

Exam administration

- PSI Services LLC, Candidate Information Bulletin: IRS Enrolled Agent Special Enrollment Examination (revised 2026), including the Part 1 Examination Content Outline and scoring information. <https://test-takers.psigo.gov.us/irs>
- Internal Revenue Service, “Enrolled Agents: Frequently Asked Questions.” <https://www.irs.gov/tax-professionals/enrolled-agents/enrolled-agents-frequently-asked-questions>
- Internal Revenue Service, “Become an Enrolled Agent.” <https://www.irs.gov/tax-professionals/enrolled-agents/become-an-enrolled-agent>

Inflation adjustments and 2025 figures

- Rev. Proc. 2024-40, 2025 inflation adjustments (tax rate schedules, kiddie tax, AMT, capital gain breakpoints, EITC, adoption credit, estate and gift exclusion, FEIE, and other items). <https://www.irs.gov/pub/irs-drop/rp-24-40.pdf>
- Notice 2024-80, 2025 retirement plan and IRA limits. <https://www.irs.gov/pub/irs-drop/n-24-80.pdf>
- IRS News Release, “IRS releases tax inflation adjustments for tax year 2025.” <https://www.irs.gov/newsroom/irs-releases-tax-inflation-adjustments-for-tax-year-2025>
- IRS News Release, “IRS releases tax inflation adjustments for tax year 2026, including amendments from the One Big Beautiful Bill” (confirms the 2025 standard deduction as amended). <https://www.irs.gov/newsroom/irs-releases-tax-inflation-adjustments-for-tax-year-2026-including-amendments-from-the-one-big-beautiful-bill>

One Big Beautiful Bill Act (Public Law 119-21) guidance

- IRS, “Working Families Tax Cuts: Individuals and workers” (tips, overtime, car loan interest, senior deduction). <https://www.irs.gov/newsroom/working-families-tax-cuts-individuals-and-workers>
- IRS, “Working Families Tax Cuts: Tax deductions for working Americans and seniors.” <https://www.irs.gov/newsroom/working-families-tax-cuts-tax-deductions-for-working-americans-and-seniors>
- IRS, “Notable changes to the Adoption Credit.” <https://www.irs.gov/newsroom/notable-changes-to-the-adoption-credit>
- IRS, “FAQs for modification of sections 25C, 25D, 25E, 30C, 30D, 45L, 45W, and 179D under Public Law 119-21” (energy credit termination dates). <https://www.irs.gov/newsroom/faqs-for-modification-of-sections-25c-25d-25e-30c-30d-45l-45w-and-179d-under-public-law-119-21-139-stat-72-july-4-2025-commonly-known-as-the-one-big-beautiful-bill-obbb>
- IRS, “Child Tax Credit.” <https://www.irs.gov/credits-deductions/individuals/child-tax-credit>

- IRS, “Refundable tax credits.” <https://www.irs.gov/credits-deductions/individuals/refundable-tax-credits>

Forms and instructions (2025)

- Instructions for Form 1040 (2025), including “What’s New,” filing requirement charts, and Schedule 1-A. <https://www.irs.gov/instructions/i1040gi>
- Instructions for Form 8615 (2025), kiddie tax. <https://www.irs.gov/pub/irs-pdf/i8615.pdf>
- Instructions for Form 8995 (2025), QBI thresholds. <https://www.irs.gov/instructions/i8995>
- Instructions for Form 8962 (2025), premium tax credit. <https://www.irs.gov/pub/irs-pdf/i8962.pdf>
- Instructions for Form 709 (2025), gift tax. <https://www.irs.gov/instructions/i709>
- Instructions for Form 3520 (12/2025). <https://www.irs.gov/instructions/i3520>
- Instructions for Form 8938. <https://www.irs.gov/instructions/i8938>
- Instructions for Form 8867 (11/2025), preparer due diligence. <https://www.irs.gov/instructions/i8867>
- Instructions for Forms 1099-A and 1099-C (2025). <https://www.irs.gov/instructions/i1099ac>

Publications (2025 editions)

- Publication 17, Your Federal Income Tax. <https://www.irs.gov/publications/p17>
- Publication 501, Dependents, Standard Deduction, and Filing Information. <https://www.irs.gov/pub/irs-prior/p501-2025.pdf>
- Publication 502, Medical and Dental Expenses. <https://www.irs.gov/publications/p502>
- Publication 503, Child and Dependent Care Expenses. <https://www.irs.gov/publications/p503>
- Publication 519, U.S. Tax Guide for Aliens. <https://www.irs.gov/publications/p519>
- Publication 523, Selling Your Home. <https://www.irs.gov/publications/p523>
- Publication 525, Taxable and Nontaxable Income. <https://www.irs.gov/publications/p525>
- Publication 526, Charitable Contributions. <https://www.irs.gov/publications/p526>
- Publication 527, Residential Rental Property. <https://www.irs.gov/publications/p527>
- Publication 334, Tax Guide for Small Business. <https://www.irs.gov/pub/irs-pdf/p334.pdf>
- Publication 544, Sales and Other Dispositions of Assets. <https://www.irs.gov/publications/p544>
- Publication 550, Investment Income and Expenses. <https://www.irs.gov/publications/p550>
- Publication 551, Basis of Assets. <https://www.irs.gov/publications/p551>
- Publication 554, Tax Guide for Seniors. <https://www.irs.gov/publications/p554>
- Publication 555, Community Property. <https://www.irs.gov/publications/p555>
- Publication 559, Survivors, Executors, and Administrators. <https://www.irs.gov/publications/p559>
- Publication 575, Pension and Annuity Income. <https://www.irs.gov/publications/p575>
- Publication 590-A, Contributions to IRAs. <https://www.irs.gov/pub/irs-pdf/p590a.pdf>
- Publication 590-B, Distributions from IRAs. <https://www.irs.gov/pub/irs-pdf/p590b.pdf>
- Publication 596, Earned Income Credit. <https://www.irs.gov/pub/irs-pdf/p596.pdf>
- Publication 915, Social Security and Equivalent Railroad Retirement Benefits. <https://www.irs.gov/publications/p915>
- Publication 925, Passive Activity and At-Risk Rules. <https://www.irs.gov/publications/p925>

- Publication 926, Household Employer's Tax Guide. <https://www.irs.gov/publications/p926>
- Publication 936, Home Mortgage Interest Deduction. <https://www.irs.gov/publications/p936>
- Publication 969, Health Savings Accounts and Other Tax-Favored Health Plans. <https://www.irs.gov/publications/p969>
- Publication 970, Tax Benefits for Education. <https://www.irs.gov/publications/p970>
- Publication 971, Innocent Spouse Relief. <https://www.irs.gov/publications/p971>
- Publication 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments. <https://www.irs.gov/publications/p4681>
- Publication 6144, One, Big, Beautiful Bill Act Provisions for SPEC Employees and Partners. <https://www.irs.gov/pub/irs-pdf/p6144.pdf>

Other authorities

- IRS, "Comparison of Form 8938 and FBAR requirements." <https://www.irs.gov/businesses/comparison-of-form-8938-and-fbar-requirements>
- IRS, "Earned income and Earned Income Tax Credit (EITC) tables." <https://www.irs.gov/credits-deductions/individuals/earned-income-tax-credit/earned-income-and-earned-income-tax-credit-eitc-tables>
- IRS, "Adoption Credit." <https://www.irs.gov/credits-deductions/individuals/adoption-credit>
- IRS, "Standard mileage rates." <https://www.irs.gov/tax-professionals/standard-mileage-rates>
- Treasury Department Circular 230, Regulations Governing Practice before the Internal Revenue Service. <https://www.irs.gov/pub/irs-pdf/pcir230.pdf>
- Internal Revenue Code (Title 26, United States Code). <https://uscode.house.gov/browse/prelim@title26>

Appendix E. Changes That Take Effect in 2026 and Are Not on Your Exam

The exam tests law as of December 31, 2025. The following changes, most of them from the One Big Beautiful Bill Act, take effect for tax years beginning after 2025. Knowing them protects you from choosing an answer built on a 2026 rule.

Area	2025 rule (on the exam)	2026 change (not on the exam)
Standard deduction	\$15,750 / \$31,500 / \$23,625	\$16,100 / \$32,200 / \$24,150
Child tax credit	\$2,200	Indexed for inflation beginning 2026
Child and dependent care credit	Maximum 35%, floor 20%	Maximum 50%, phasing to 20% in two stages
Dependent care assistance exclusion	\$5,000	\$7,500
Charitable deduction for non-itemizers	None	Up to \$1,000 (\$2,000 MFJ) for cash gifts
Charitable deduction floor for itemizers	None	0.5% of AGI
Itemized deduction limitation	None	Benefit of itemized deductions capped at 35% for 37%-bracket taxpayers
SALT cap	\$40,000, \$500,000 phase-down threshold	\$40,400 and \$505,000 (1% annual increase through 2029)
Mortgage insurance premiums	Not deductible	Deductible as qualified residence interest
Gambling losses	100% of losses up to winnings	90% of losses, still capped at winnings
QBI deduction phase-in range	\$50,000 / \$100,000	\$75,000 / \$150,000, plus a \$400 minimum deduction
Educator expenses	\$300 above-the-line	Also allowed as an itemized deduction without the 2% floor
529 plans	\$10,000 K–12 tuition	\$20,000 K–12, expanded expenses, postsecondary credentialing
Trump accounts	Election and \$1,000 pilot contribution on Form 4547 for children born 2025–2028	Contributions permitted beginning July 4, 2026
Clean vehicle credits	Available for vehicles acquired by September 30, 2025	Terminated
Residential energy credits	Available through December 31, 2025	Terminated

Area	2025 rule (on the exam)	2026 change (not on the exam)
Qualified principal residence indebtedness exclusion	Available for discharges through December 31, 2025	Expired
Student loan discharge exclusion (non-death/disability)	Excluded under the 2021 rule through 2025	Expired; death and disability discharges remain excluded permanently
Premium tax credit	Enhanced percentages, no 400% cap, repayment caps below 400%	Enhanced percentages expire; repayment caps removed
Estate and gift basic exclusion	\$13,990,000	\$15,000,000
Adoption credit	\$17,280; refundable to \$5,000	\$17,670; refundable to \$5,120
AMT exemption phaseout	25 cents per dollar over \$626,350 / \$1,252,700	50 cents per dollar over \$500,000 / \$1,000,000
Casualty losses	Federally declared disasters only	Extended to certain state-declared disasters
Employer-provided childcare credit	\$150,000 maximum	\$500,000 (\$600,000 small business)
Moving expenses	Armed Forces only	Also certain intelligence community members

A final word from the author. Passing Part 1 is not a matter of memorizing a thousand facts. It is a matter of knowing a few hundred rules well enough to spot which one a question is really about. If you have worked through the examples in this book and can explain each one to someone else in plain English, you are ready. Schedule the exam, bring your government-issued ID, read every question twice, and trust the rule.

Kenneth Omoruyi, M. Tax, EA, CPA
EnrolledAgent.com