

REG Complete Study Guide, Part 3

Olivia Anderson · True North Accounting & Business Solutions · Study notes for educational use. Always confirm details against the current AICPA Blueprints and authoritative standards.

Taxation and Regulation, Area IV: Federal Taxation of Individuals (22–32%) and Area V: Federal Taxation of Entities (23–33%).

About the dollar amounts: tax figures change every year, and the One Big Beautiful Bill Act (OBBBA), enacted July 4, 2025, changed many rules. Amounts below are for **tax year 2026** from IRS Revenue Procedure 2025-32 and IRS announcements, unless noted. Exam questions usually give you the figures you need, so focus on the rules. Check the AICPA's current policy on which tax year is tested before you sit.

The Individual Tax Formula

STEP

Gross income	All income from whatever source, less exclusions
– Adjustments ("for AGI" or above-the-line deductions)	= Adjusted gross income (AGI)
– The greater of the standard deduction or itemized deductions	
– Qualified business income deduction and other below-the-line deductions	= Taxable income
× Tax rates	= Tax before credits
– Credits	= Tax liability, plus other taxes such as self-employment tax
– Withholding and estimated payments	= Tax due or refund

Filing Status

1. **Single:** unmarried on the last day of the year and not qualifying for another status.

2. **Married filing jointly:** married on the last day of the year, or the spouse died during the year. Both spouses are jointly and severally liable.
3. **Married filing separately:** generally less favorable. If one spouse itemizes, the other must too.
4. **Head of household:** unmarried, or a qualifying "abandoned spouse" who lived apart from the spouse for the last six months of the year, who pays more than half the cost of a home for a qualifying person. A qualifying child or relative generally must live with the taxpayer more than half the year. A dependent **parent** doesn't have to live with the taxpayer.
5. **Qualifying surviving spouse:** for the two years after the year the spouse died, if the taxpayer hasn't remarried and maintains a home for a dependent child. This status uses joint rates and the joint standard deduction.

Dependents

Personal and dependency exemptions are permanently \$0 under OBBBA. Dependents still matter for the child tax credit, the credit for other dependents, head of household status, the earned income credit and other benefits.

Qualifying child. All must be met:

1. **Relationship:** child, stepchild, eligible foster child, sibling, step-sibling or a descendant of any of them
2. **Age:** under 19 at year-end, under 24 if a full-time student, or any age if permanently and totally disabled, and younger than the taxpayer
3. **Residence:** lived with the taxpayer more than half the year
4. **Support:** didn't provide more than half of their own support
5. **Joint return:** didn't file a joint return, except only to claim a refund

Tiebreakers: a parent wins over a nonparent. Between parents, the one the child lived with longer wins, then the parent with the higher AGI. Among nonparents, the higher AGI wins.

Qualifying relative. All must be met:

1. Not anyone's qualifying child
2. A listed relative (children and descendants, siblings, parents and ancestors, aunts, uncles, nieces, nephews and in-laws) or a member of the household all year
3. Gross income below **\$5,300** (2026)
4. The taxpayer provides more than half of their support

A **multiple support agreement** lets one of several people who together provide more than half the support claim the dependent, if that person provided more than 10% and the others who provided over 10% sign waivers.

Gross Income

Common Inclusions

Wages and tips, interest, dividends, business and rental income, gains, retirement distributions, unemployment compensation, prizes, gambling winnings, canceled debt and a portion of Social Security benefits.

- **Social Security:** up to 50% or 85% is taxable when provisional income (AGI + tax-exempt interest + half of the benefits) exceeds base amounts.
- **Annuities:** the exclusion ratio (investment ÷ expected return) makes part of each payment tax-free until the investment is recovered.
- **Alimony:** taxable to the recipient and deductible by the payer only under divorce or separation agreements executed **before 2019**. Later agreements are neither taxable nor deductible.
- **Canceled debt** is income unless excluded: discharge in bankruptcy, to the extent of insolvency, qualified farm debt, qualified real property business debt, certain student loan discharges and qualified principal residence debt discharged before 2026.

Common Exclusions

- Gifts and inheritances
- Life insurance paid because of death. Cash surrender gains above premiums paid are taxable.
- **Qualified scholarships** for tuition, fees, books and required supplies. Amounts for room and board are taxable.
- Municipal bond interest for federal purposes, although it must be reported
- Child support
- Property settlements in a divorce, with carryover basis
- **Damages** for physical injury or sickness. Punitive damages, lost wages and emotional distress damages not tied to physical injury are taxable.
- **Employer-provided fringe benefits**, within limits: health coverage, the first \$50,000 of group-term life insurance, meals and lodging for the employer's convenience on the premises, qualified employee discounts, working condition and de minimis fringes, qualified transportation, educational assistance up to \$5,250 and dependent care assistance up to **\$7,500 starting in 2026**
- **Foreign earned income exclusion:** up to **\$132,900** (2026) for bona fide foreign residents or those physically present abroad 330 days in a 12-month period, plus a housing exclusion
- **Sale of a principal residence (§121):** exclude up to \$250,000 of gain, or \$500,000 on a joint return, if owned and used as the principal residence for two of the last five years. Generally once every two years.
- **Qualified Roth IRA distributions:** five years after the first contribution and after age 59½, death or disability

Adjustments to Gross Income (For AGI)

- Educator expenses, up to an annual limit
- Health savings account contributions
- Half of self-employment tax
- Self-employed health insurance premiums
- Contributions to self-employed retirement plans, such as SEP, SIMPLE and solo 401(k) plans
- Penalty on early withdrawal of savings
- Alimony paid under pre-2019 agreements
- Traditional IRA contributions, if deductible
- Student loan interest, up to \$2,500, phased out at higher incomes. Not available to someone claimed as a dependent.
- Moving expenses, for members of the armed forces only

IRA limits for 2026: \$7,500, plus a \$1,100 catch-up for those 50 and older. If the taxpayer is covered by a workplace plan, the deduction phases out between \$81,000 and \$91,000 of modified AGI for single filers and between \$129,000 and \$149,000 for joint filers.

Deductions From AGI

The Standard Deduction (2026)

FILING STATUS	AMOUNT
Single or married filing separately	\$16,100
Married filing jointly or qualifying surviving spouse	\$32,200
Head of household	\$24,150

- **Additional amount for age 65 or older, or blind:** \$1,650 each, or \$2,050 if unmarried and not a surviving spouse.
- **A dependent's standard deduction:** the greater of \$1,350 or earned income plus \$450, up to the regular amount.

New deductions under OBBBA, available whether or not the taxpayer itemizes and subject to income phaseouts:

- **Seniors:** an extra \$6,000 per person age 65 or older, for 2025 through 2028
- **Qualified tips:** up to \$25,000, for 2025 through 2028
- **Qualified overtime premium pay:** up to \$12,500, or \$25,000 on a joint return, for 2025 through 2028

- **Interest on a loan for a new U.S.-assembled personal vehicle:** up to \$10,000, for 2025 through 2028

Itemized Deductions

Medical expenses above **7.5% of AGI**: doctors, dentists, hospitals, prescription drugs, health insurance premiums, long-term care premiums (limited) and medical equipment. Cosmetic surgery isn't deductible unless it corrects a deformity from an accident, disease or birth defect.

State and local taxes (SALT): state and local income taxes, or sales taxes instead, plus real and personal property taxes.

- **2026 cap: \$40,400**, or \$20,200 if married filing separately.
- The cap is reduced by 30% of modified AGI above \$505,000, but not below \$10,000.
- The cap is scheduled to return to \$10,000 in 2030.
- Federal income tax is never deductible.

Mortgage interest: on up to **\$750,000** of acquisition debt, used to buy, build or substantially improve a qualified home. Home equity interest is deductible only if the loan is used to buy, build or improve the home. OBBBA made these limits permanent and treats qualified mortgage insurance premiums as deductible interest starting in 2026.

Charitable contributions

GIFT	AGI LIMIT
Cash to public charities	60%
Long-term capital gain property at fair value to public charities	30%
Cash to most private foundations	30%
Long-term capital gain property to private foundations	20%

- Excess contributions carry forward five years.
- A written acknowledgment is required for gifts of \$250 or more, and a qualified appraisal for most noncash gifts over \$5,000.
- **Starting in 2026:** only contributions above **0.5% of AGI** are deductible for itemizers, and taxpayers who **don't itemize** may deduct up to **\$1,000**, or \$2,000 on a joint return, of cash gifts to public charities.

Casualty and theft losses of personal-use property are deductible only for federally declared disasters, plus certain state-declared disasters under OBBBA. Each loss is reduced by \$100, and the total by 10% of AGI.

Other itemized deductions

- Gambling losses, up to gambling winnings. Starting in 2026, only 90% of losses count.
- Impairment-related work expenses
- **Miscellaneous itemized deductions subject to the 2% floor**, such as unreimbursed employee expenses, tax preparation fees and investment expenses, are **permanently eliminated**.

Limit for high earners: starting in 2026, taxpayers in the 37% bracket get the benefit of itemized deductions at a maximum 35% rate. This replaces the old "Pease" limitation.

The Qualified Business Income Deduction (§199A)

Owners of sole proprietorships, partnerships, S corporations and some trusts may deduct up to **20% of qualified business income**, subject to limits based on W-2 wages, the basis of qualified property and whether the business is a specified service business, once taxable income exceeds the thresholds. OBBBA made the deduction permanent.

Credits

Nonrefundable credits reduce tax to zero. **Refundable credits** can produce a refund.

CREDIT	KEY RULES
Child tax credit	\$2,200 per qualifying child under 17, with up to \$1,700 refundable (2026). Phases out above \$400,000 of modified AGI on a joint return and \$200,000 for others
Credit for other dependents	\$500 per dependent who doesn't qualify for the child tax credit. Nonrefundable
Child and dependent care credit	A percentage of up to \$3,000 of expenses for one qualifying person or \$6,000 for two or more, for care of a child under 13 or a disabled dependent so the taxpayer can work. OBBBA raised the maximum percentage starting in 2026
American opportunity credit	Up to \$2,500 per eligible student for the first four years of postsecondary education: 100% of the first \$2,000 and 25% of the next \$2,000. Up to 40% is refundable
Lifetime learning credit	20% of up to \$10,000 of expenses per return, so \$2,000 maximum. Nonrefundable. Any postsecondary courses
Earned income credit	Refundable, for low- and moderate-income workers. Depends on earned income and the number of qualifying children
Adoption credit	Up to \$17,670 of qualified expenses per child (2026), with up to \$5,120 refundable
Premium tax credit	Refundable, for Marketplace health coverage, and reconciled on the return
Foreign tax credit	Limited to the U.S. tax on foreign income. Excess carries back one year and forward ten

Only one education credit may be claimed per student per year. The residential clean energy credit ended for expenditures after 2025.

Alternative Minimum Tax

STEP

Regular taxable income

± Adjustments and + preferences = Alternative minimum taxable income (AMTI)

– Exemption = AMT base

× 26% and 28% = Tentative minimum tax

– Regular tax = AMT, if positive

Common adjustments and preferences: the standard deduction (if taken) and state and local taxes are added back. Others include private activity bond interest, the bargain element of incentive stock options when exercised, and depreciation differences.

2026 exemptions: \$90,100 for single filers and \$140,200 for joint filers. The exemption phases out above \$500,000 and \$1,000,000 respectively. **Starting in 2026, the phaseout rate is 50 cents per dollar**, up from 25 cents.

AMT paid because of timing items creates a **minimum tax credit** that carries forward to years when regular tax exceeds tentative minimum tax.

Self-Employment Tax

- Net self-employment earnings = 92.35% of net self-employment income.
- **Rate:** 12.4% Social Security on earnings up to the wage base (**\$184,500** for 2026), plus 2.9% Medicare on all earnings.
- **Additional Medicare tax:** 0.9% on earnings over \$200,000 for single filers or \$250,000 on a joint return.
- Half of the self-employment tax, not counting the additional Medicare tax, is deductible for AGI.

Area V: Federal Taxation of Entities

Partnerships

FORMATION

Generally, **no gain or loss** is recognized when property is contributed for a partnership interest. Gain is recognized if the partner's **net liability relief exceeds the partner's basis**.

A partner's outside basis = cash contributed + adjusted basis of property contributed – liabilities the partnership assumes + the partner's share of partnership liabilities + any gain recognized.

Example: a partner contributes property with a \$50,000 basis and \$80,000 value, subject to a \$20,000 mortgage the partnership assumes, for a 25% interest. Basis is $\$50,000 - \$20,000 + 25\% \times \$20,000 = \mathbf{\$35,000}$. Net liability relief of \$15,000 is less than \$50,000, so no gain is recognized.

The **partnership's basis** in contributed property carries over from the partner, and the holding periods tack.

OPERATIONS

The partnership files **Form 1065** and gives each partner a **Schedule K-1**. It doesn't pay income tax itself.

- **Ordinary business income** is allocated to partners.
- **Separately stated items** keep their character because they may be treated differently on each partner's return: capital gains and losses, Section 1231 gains and losses, charitable contributions, Section 179 deductions, tax-exempt income, interest, dividends and royalties, and guaranteed payments.
- **Allocations** follow the partnership agreement if they have substantial economic effect. Otherwise they follow the partners' interests in the partnership.
- **Guaranteed payments** for services or the use of capital, determined without regard to partnership income, are deductible by the partnership and are ordinary income to the partner. Payments for services are self-employment income.

BASIS ADJUSTMENTS

- **Increases:** the partner's share of income, including tax-exempt income, additional contributions and increases in the partner's share of liabilities.
- **Decreases:** distributions, decreases in the share of liabilities, the share of losses and nondeductible expenses. Basis can't go below zero.

Losses are deductible only to the extent of the partner's outside basis, then the at-risk rules, then the passive activity rules. Suspended losses carry forward.

DISTRIBUTIONS

Nonliquidating (current) distributions

- Gain is recognized only when **cash** distributed exceeds outside basis.
- No loss is recognized.
- Distributed property takes the partnership's basis, limited to the partner's remaining outside basis after cash.

Example: outside basis is \$40,000. The partner receives \$10,000 cash and property with a partnership basis of \$35,000. Basis after the cash is \$30,000, so the property's basis is limited to **\$30,000** and the partner's outside basis becomes \$0.

Liquidating distributions: gain is recognized if cash exceeds basis. A loss is recognized only if the partner receives nothing but cash, unrealized receivables and inventory, and their total is less than outside basis.

SALE OF A PARTNERSHIP INTEREST

Gain or loss equals the amount realized, including the partner's share of liabilities relieved, minus outside basis. Gain attributable to **"hot assets"** (unrealized receivables and inventory) is ordinary income. The rest is capital gain or loss.

Example: a 50% interest with a \$60,000 basis sells for \$100,000. The partnership holds \$20,000 of zero-basis unrealized receivables. The total gain is \$40,000, of which \$10,000 ($50\% \times \$20,000$) is ordinary and \$30,000 is capital gain.

C Corporations

FORMATION (SECTION 351)

No gain or loss is recognized if property is transferred to a corporation solely for stock and the transferors **control at least 80%** of the corporation immediately afterward.

- **Boot** received triggers gain up to the lesser of realized gain or boot.
- **Liabilities** the corporation assumes are not boot, unless they exceed the total basis of property transferred (gain to the extent of the excess) or have a tax avoidance purpose.
- **Shareholder's stock basis** = basis of property transferred + gain recognized – boot received, including liabilities assumed.
- **Corporation's basis** in the property = the transferor's basis + gain the transferor recognized.
- Holding periods tack for capital and Section 1231 assets.

CORPORATE TAXABLE INCOME

The **flat rate is 21%**.

Dividends-received deduction

OWNERSHIP	DEDUCTION
Under 20%	50%
20% to under 80%	65%
80% or more	100%

The 50% and 65% deductions are limited to that percentage of taxable income computed without the DRD, NOL deduction and capital loss carryback, **unless** taking the full deduction creates or increases an NOL.

Charitable contributions: limited to **10% of taxable income**, computed before the charitable deduction, DRD, NOL carryback and capital loss carryback. Excess carries forward five years. Starting in 2026, only contributions above **1% of taxable income** are deductible.

Capital losses: deductible only against capital gains. Net capital losses carry back three years and forward five years, as short-term losses.

Net operating losses: generally carried forward indefinitely, with no carryback, and limited to 80% of taxable income in the carryforward year.

Organizational expenditures: deduct up to \$5,000, reduced once costs exceed \$50,000. Amortize the rest over 180 months.

Book-to-tax reconciliation: Schedule M-1, or M-3 for larger corporations, reconciles book income to taxable income.

EARNINGS AND PROFITS AND DISTRIBUTIONS

Distributions are **dividends** to the extent of current and then accumulated **earnings and profits (E&P)**. The excess is a tax-free **return of capital** to the extent of stock basis, then capital gain.

E&P starts with taxable income and adjusts it. Add back tax-exempt income and the dividends-received deduction. Subtract federal income taxes, nondeductible expenses and excess capital losses.

Property distributions

- The corporation recognizes **gain**, but not loss, as if it sold the property at fair value. The gain increases E&P.
- E&P is reduced by the property's fair value, net of liabilities.
- The shareholder's dividend equals the fair value minus liabilities assumed, and the shareholder's basis is the fair value.

STOCK REDEMPTIONS

A redemption is a sale or exchange, with capital gain or loss, if it is:

- **Substantially disproportionate:** after the redemption, the shareholder owns less than 50% of the voting stock and less than 80% of their former percentage
- A **complete termination** of the shareholder's interest
- **Not essentially equivalent to a dividend**, based on a meaningful reduction in interest

Otherwise it is a dividend to the extent of E&P. **Attribution rules** treat stock owned by family members and related entities as owned by the shareholder.

LIQUIDATIONS

- **Shareholders:** gain or loss equals the fair value received minus their stock basis, generally capital.
- **The corporation:** recognizes gain and loss as if it sold its assets at fair value, with limits on losses for distributions to related parties.
- **Liquidating a subsidiary** owned 80% or more by its parent (Sections 332 and 337) is generally tax-free.

PENALTY TAXES

- **Accumulated earnings tax:** 20% of accumulated taxable income retained beyond the reasonable needs of the business. Most corporations get a credit for \$250,000 of accumulated earnings, or \$150,000 for personal service corporations.
- **Personal holding company tax:** 20% of undistributed personal holding company income, when at least 60% of adjusted ordinary gross income is passive and five or fewer individuals own more than 50% of the stock at any

time in the last half of the year.

S Corporations

ELIGIBILITY

- A domestic corporation with **only one class of stock**. Differences in voting rights are allowed.
- **No more than 100 shareholders**. Family members can be counted as one.
- Eligible shareholders are individuals who are U.S. citizens or residents, estates, certain trusts and certain exempt organizations. Nonresident aliens, partnerships and corporations aren't eligible.

Election: all shareholders consent on **Form 2553**, filed by the 15th day of the third month of the tax year to be effective for that year.

Termination

- Voluntary revocation by shareholders holding more than 50% of the shares
- Automatically, if the corporation stops qualifying
- If it has accumulated C corporation E&P and passive investment income exceeds 25% of gross receipts for three consecutive years

OPERATIONS

The S corporation files **Form 1120-S** and issues **Schedules K-1**. Items pass through on a **per-share, per-day** basis, with separately stated items as for partnerships.

Shareholders' pass-through income isn't subject to self-employment tax, but shareholder-employees must receive **reasonable compensation** as W-2 wages.

SHAREHOLDER BASIS

- **Stock basis** increases with income items, including tax-exempt income, and contributions. It decreases with distributions, losses and nondeductible expenses.
- **Corporate liabilities don't increase stock basis**, unlike in a partnership.
- **Loans from the shareholder** to the corporation create **debt basis**, which can absorb losses after stock basis reaches zero.

Loss limits: stock basis, then debt basis, then the at-risk rules, then the passive activity rules.

DISTRIBUTIONS

- **No accumulated E&P:** tax-free to the extent of stock basis. The excess is capital gain.
- **With accumulated E&P from C corporation years:** distributions come first from the **accumulated adjustments account (AAA)**, tax-free to the extent of basis, then from E&P as dividends, then from the remaining basis.

The built-in gains tax applies at 21% to net built-in gains recognized within five years after a C corporation converts to S status.

Trusts and Estates

Trusts and estates are separate taxpayers that file **Form 1041**. They face compressed brackets, reaching the top rate at a low level of income.

Distributable net income (DNI) caps both the trust's deduction for distributions and the amount beneficiaries are taxed on. It generally equals taxable income before the distribution deduction and exemption, plus tax-exempt interest (net of related expenses), minus capital gains allocated to principal.

- **Simple trust:** must distribute all income currently, makes no charitable contributions and doesn't distribute principal. Exemption: \$300.
- **Complex trust:** may accumulate income, distribute principal and make charitable contributions. Exemption: \$100.
- **Estates:** exemption of \$600.

The **65-day rule** lets a complex trust or estate treat distributions made within 65 days after year-end as made in the prior year.

Grantor trusts: when the grantor keeps certain powers or interests, the income is taxed to the grantor.

Tax-Exempt Organizations

Common types: 501(c)(3) charitable, religious, educational and scientific organizations, to which contributions are deductible; 501(c)(4) social welfare organizations; 501(c)(6) trade associations; and 501(c)(7) social clubs.

Requirements for 501(c)(3) status

- **Organizational test:** the governing documents limit its purposes to exempt ones and dedicate its assets to them.
- **Operational test:** primarily engaged in exempt activities, with no private inurement, no substantial lobbying and no political campaign activity.

Organizations apply on Form 1023 (or 1023-EZ) for 501(c)(3) status and Form 1024 for most others. Most file an annual **Form 990** information return.

Unrelated business income tax (UBIT) applies to income from a trade or business that is regularly carried on and not substantially related to the exempt purpose.

- **Exceptions:** work performed by volunteers, the sale of donated merchandise, activities for the convenience of members, students or employees, and qualified corporate sponsorship payments.
- A **\$1,000 specific deduction** applies. Tax is computed at corporate rates for corporations and reported on Form 990-T.

Quick Reference

FEATURE	PARTNERSHIP	S CORPORATION	C CORPORATION
Taxation	Pass-through	Pass-through	Entity level, 21%
Owner liability	Unlimited for general partners	Limited	Limited
Number of owners	At least 2	Up to 100	Unlimited
Classes of ownership	Flexible	One class of stock	Multiple
Entity debt in owner's basis	Yes	No (only shareholder loans)	Not applicable
Self-employment tax on owners' share	Yes, for general partners	No, but reasonable salary required	Not applicable

Priorities for study: partnerships and S corporations (formation, basis and distributions), C corporation taxable income and distributions, the individual tax formula, Circular 230 and business law.

Sources for the Dollar Amounts

- IRS Revenue Procedure 2025-32 (2026 inflation adjustments)
- IRS, One, Big, Beautiful Bill provisions for individuals and workers
- IRS, 401(k) limit increases to \$24,500 for 2026, IRA limit increases to \$7,500