

TCP Complete Study Guide

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

Tax Compliance and Planning, the discipline section for nonroutine federal tax compliance, tax planning and personal financial planning. Organized by the 2026 AICPA Blueprint.

AREA	TOPIC	WEIGHT
I	Tax Compliance and Planning for Individuals and Personal Financial Planning	30–40%
II	Entity Tax Compliance	30–40%
III	Entity Tax Planning	10–20%
IV	Property Transactions (disposition of assets)	10–20%

About the dollar amounts: the blueprint says candidates **won't be tested on rates, amounts or limits that are indexed to inflation**, so questions give you those numbers. Figures here are for **tax year 2026**, from IRS Revenue Procedure 2025-32, IRS announcements and the One Big Beautiful Bill Act (OBBBA, enacted July 4, 2025), and are included for context. Focus on the rules. State taxes and transfer pricing aren't on the TCP blueprint, and international topics are limited to general sourcing concepts.

Area I: Individuals and Personal Financial Planning

Timing Income and Deductions

Deferral means postponing income and accelerating deductions. It helps when rates are expected to fall or a deduction is needed now.

Acceleration means recognizing income now and delaying deductions. It helps when rates are expected to rise, legislation is scheduled to change, or a benefit is about to expire.

Deferral example for a cash-basis consultant: bill December work in January, pay deductible expenses in December and make charitable gifts before year-end.

Limits on timing

- **Constructive receipt:** income is taxed when it's credited or made available without substantial restriction, even if the taxpayer doesn't take it.
- **Economic benefit doctrine:** income is taxed when an economic benefit is set aside for the taxpayer.
- **Accounting method:** cash and accrual taxpayers have different timing rules.

Shifting Income

- Gifts of income-producing property, family partnerships, trusts and employing family members at reasonable wages can move income to lower-bracket relatives.
- **Assignment of income doctrine:** income is taxed to the person who earns it. Assigning the right to a paycheck doesn't shift the tax, but giving away the income-producing property does shift future income.
- **The kiddie tax** applies to children under 19, or under 24 if full-time students, whose earned income doesn't exceed half their support. Unearned income above a threshold (\$2,700 for 2026) is taxed at the parents' rate. Earned income isn't subject to the kiddie tax.

Capital Gains Planning

- **Holding period:** more than one year qualifies for long-term rates of 0%, 15% or 20%.
- **Tax-loss harvesting:** realized losses offset gains. Up to \$3,000 of net capital loss (\$1,500 if married filing separately) offsets ordinary income each year, and individuals carry the excess forward indefinitely.
- **The wash sale rule** disallows a loss if substantially identical securities are bought within 30 days **before or after** the sale. The disallowed loss is added to the basis of the new shares.
- **The net investment income tax** is 3.8% of the lesser of net investment income or modified AGI over \$200,000 (single) or \$250,000 (joint). These thresholds aren't indexed.

Qualified small business stock (§1202) must be original-issue stock of a domestic C corporation with an active business and limited gross assets.

- For stock issued after July 4, 2025, OBBBA allows a 50% exclusion after three years, 75% after four and 100% after five. The per-issuer cap is the greater of \$15 million or 10 times basis, and the gross asset limit is \$75 million.
- Stock issued earlier needs a five-year holding period, and the cap is the greater of \$10 million or 10 times basis.

Qualified opportunity funds: gains invested under the original program are deferred until December 31, 2026, and appreciation in the fund is excluded after ten years. OBBBA made the program permanent with new rules for investments starting in 2027.

Investment Income

- **Qualified dividends** are taxed at capital gains rates if the stock is held more than 60 days during the 121-day period around the ex-dividend date.

- **Municipal bond interest** is exempt from federal tax. Interest on private activity bonds is generally an AMT preference.
- **Tax-equivalent yield** = tax-free yield $\div$ (1 – marginal rate). A 3% municipal bond for someone in the 37% bracket equals $3\% \div 0.63 = 4.76\%$ taxable.

Passive Activity and At-Risk Limits

Losses are tested in order:

1. **Basis**
2. **At-risk amount (§465)**: cash and adjusted basis of property contributed, plus debt the taxpayer is personally liable for, plus qualified nonrecourse real estate financing. Losses above the at-risk amount are suspended.
3. **Passive activity rules (§469)**: passive losses offset only passive income.
4. **Excess business loss rules**: noncorporate taxpayers' net business losses above an annual threshold become an NOL carryforward. OBBBA made this limit permanent.

Passive activities are trade or business activities in which the taxpayer doesn't **materially participate**, plus most rental activities.

Material participation tests include more than 500 hours a year, or more than 100 hours and at least as much as anyone else.

Exceptions for rental real estate

- **Active participation**: up to \$25,000 of rental losses can offset nonpassive income. The allowance phases out by 50% of modified AGI between \$100,000 and \$150,000.
- **Real estate professionals**, with more than 750 hours and more than half their personal services in real property businesses, who materially participate aren't treated as passive.

Suspended passive losses carry forward and are fully released when the taxpayer disposes of the entire interest in a taxable transaction to an unrelated party.

Example: a taxpayer with \$120,000 of modified AGI who actively participates has a \$30,000 rental loss. The allowance is $\$25,000 - 50\% \times (\$120,000 - \$100,000) = \$15,000$, and \$15,000 is suspended.

Estimated Taxes

Individuals generally pay quarterly estimates (April 15, June 15, September 15 and January 15) if they expect to owe \$1,000 or more after withholding.

Safe harbors avoid the underpayment penalty:

- 90% of the current year's tax
- 100% of the prior year's tax, or 110% if the prior year's AGI exceeded \$150,000

The **annualized income method** helps taxpayers whose income arrives late in the year.

Incentive Compensation

Incentive stock options (ISOs)

- No regular tax at grant or exercise. The bargain element at exercise is an **AMT adjustment**.
- **Qualifying disposition:** held two years from grant and one year from exercise. The entire gain is long-term capital gain.
- **Disqualifying disposition:** the spread at exercise is ordinary income, and any further gain is capital gain.

Nonqualified stock options: no tax at grant (if no readily ascertainable value). The spread at exercise is ordinary wage income, and basis becomes fair value at exercise.

Restricted stock (§83)

- Taxed as ordinary income when it vests, on fair value less any amount paid.
- A **§83(b) election** within 30 days of the transfer taxes the spread at grant instead. Later appreciation becomes capital gain. There's no deduction if the stock is later forfeited.

Restricted stock units: ordinary income at settlement. A §83(b) election isn't available.

Employee stock purchase plans (§423): a discount of up to 15% and a \$25,000 annual limit. A qualifying disposition needs two years from the offering date and one year from purchase.

Nonqualified deferred compensation (§409A)

- Deferral elections must generally be made before the year the services are performed.
- Distributions are allowed only on permitted events: separation from service, disability, death, a fixed date, a change in control or an unforeseeable emergency.
- A violation makes the deferred amounts currently taxable, plus a **20% additional tax** and interest.
- A **rabbi trust** stays subject to the employer's creditors, so taxation remains deferred. A **secular trust** is beyond creditors' reach and is taxable to the employee when funded.

Retirement Planning

Traditional IRA (2026)

- Contribution limit: \$7,500, plus \$1,100 catch-up at 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 (single) or \$129,000 and \$149,000 (joint).
- Distributions are ordinary income, with a 10% additional tax before age 59½ unless an exception applies.

Roth IRA (2026)

- The same contribution limit. Eligibility phases out between \$153,000 and \$168,000 (single) and \$242,000 and \$252,000 (joint).

- **Qualified distributions are tax-free** if the account is at least five years old and the owner is 59½, disabled, deceased or using up to \$10,000 for a first home.
- **Ordering rules for other distributions:** contributions come out first, tax-free. Conversions come next, tax-free but subject to the 10% additional tax if withdrawn within five years of the conversion before age 59½. Earnings come last, taxable and possibly penalized.
- There are no required distributions during the owner's lifetime.
- **Conversions** are taxable in the year of conversion and work well in low-income years.
- **Backdoor Roth:** a nondeductible traditional IRA contribution converted to a Roth. The **pro rata rule** makes the conversion partly taxable if the taxpayer has other pretax IRA balances.

Exceptions to the 10% additional tax

- Death or disability
- Substantially equal periodic payments
- Medical expenses above 7.5% of AGI
- An IRS levy
- Qualified birth or adoption distributions, up to \$5,000
- *IRA only:* first-time homebuyer expenses (up to \$10,000 lifetime), qualified higher education expenses and health insurance premiums while unemployed
- *Employer plan only:* separation from service in or after the year the employee turns 55

Required minimum distributions begin at age 73, and at 75 for those born in 1960 or later. The penalty for a shortfall is 25%, reduced to 10% if corrected promptly. Since 2024, designated Roth accounts in employer plans aren't subject to lifetime RMDs.

Employer plans (2026)

- **401(k), 403(b) and governmental 457(b):** \$24,500 of elective deferrals, plus \$8,000 catch-up at 50 and older, or \$11,250 at ages 60 to 63. Catch-ups for employees who earned more than \$150,000 from the employer in the prior year must be Roth contributions.
- **Total annual additions** to a defined contribution plan: \$72,000.
- **SEP IRA:** employer contributions up to 25% of compensation, within the \$72,000 limit. All eligible employees must be covered.
- **SIMPLE IRA:** employers with 100 or fewer employees. Employee deferrals of \$17,000 for 2026, with a required employer match or nonelective contribution.
- **Solo 401(k):** self-employed people with no employees can defer as an employee and contribute up to 25% of compensation as the employer, within the overall limit.
- **Safe harbor 401(k):** avoids nondiscrimination testing with a 3% nonelective contribution or a match of 100% of the first 3% and 50% of the next 2%, fully vested.
- **Defined benefit and cash balance plans** allow much larger deductible contributions for older owners, at a higher administrative cost.

- **Plan loans:** up to the lesser of \$50,000 or 50% of the vested balance, generally repaid within five years. An unpaid loan becomes a taxable distribution.

Qualified charitable distributions: IRA owners 70½ or older can transfer up to \$111,000 for 2026 directly to charity. The amount is excluded from income and counts toward the RMD.

Personal Financial Planning

Education funding

- **Section 529 plans** grow tax-free. Withdrawals are tax-free for qualified higher education expenses and for up to \$10,000 a year of K–12 tuition, rising to \$20,000 starting in 2026 under OBBBA.
- Contributions are gifts. Donors can elect to spread a large contribution over five years for gift tax purposes, which is \$95,000 at 2026 exclusion levels.
- Unused balances can be rolled into a Roth IRA for the beneficiary, up to \$35,000 lifetime, if the account is at least 15 years old.
- **The American opportunity credit** is up to \$2,500 per student for the first four years of college, 40% refundable.
- **The lifetime learning credit** is up to \$2,000 per return, nonrefundable.
- Both credits can't be claimed for the same student in the same year, and the same expenses can't be used for both a credit and a tax-free 529 withdrawal.

Health savings accounts (2026): \$4,400 self-only and \$8,750 family, plus a \$1,000 catch-up at 55 and older, with a high-deductible health plan. HSAs are triple tax-advantaged: deductible contributions, tax-free growth and tax-free withdrawals for medical expenses.

Insurance and risk management

- **Life insurance proceeds** paid because of death are generally excluded from income. Transfers of a policy for value can make proceeds taxable.
- **Disability benefits** are taxable if the employer paid the premiums tax-free, and tax-free if the employee paid them with after-tax dollars.
- **Long-term care** premiums may be deductible medical expenses within age-based limits.

Investing: asset location means holding tax-inefficient assets, such as taxable bonds, in tax-deferred accounts and tax-efficient assets, such as index funds and municipal bonds, in taxable accounts. Tax diversification across pretax, Roth and taxable accounts gives flexibility in retirement.

Credits worth knowing for planning

- **Child tax credit:** \$2,200 per qualifying child for 2026, with up to \$1,700 refundable.
- **Child and dependent care credit:** based on up to \$3,000 of expenses for one qualifying person or \$6,000 for two or more. OBBBA raised the maximum rate to 50% starting in 2026, and the dependent care assistance exclusion rose to \$7,500.
- **Clean energy credits:** OBBBA ended the residential clean energy credit and the energy efficient home improvement credit for expenditures after 2025, and the clean vehicle credit for vehicles acquired after

September 30, 2025.

Charitable Giving

GIFT	AGI LIMIT
Cash to public charities	60%
Long-term capital gain property at fair value to public charities	30%
Cash to private nonoperating foundations	30%
Capital gain property to private foundations, generally at basis except qualified appreciated stock	20%

- Excess contributions carry forward five years.
- **Starting in 2026**, itemizers deduct only contributions above 0.5% of AGI, and nonitemizers may deduct up to \$1,000 (\$2,000 joint) of cash gifts to public charities.
- **Appreciated stock held more than a year:** the donor deducts fair value and never pays tax on the gain.
Example: stock with a \$10,000 basis and a \$50,000 value produces a \$50,000 deduction and avoids tax on the \$40,000 gain.
- **Ordinary income property**, such as inventory or short-term holdings, is deductible only at basis.
- **Donor-advised funds:** an immediate deduction, with grants recommended over time. Useful for **bunching** several years of gifts into one year to exceed the standard deduction (\$32,200 for joint filers in 2026).
- **Private foundations** offer control but must distribute about 5% of assets each year, pay an excise tax on investment income and file Form 990-PF.
- **Conservation easements:** up to 50% of AGI (100% for qualified farmers and ranchers), with a 15-year carryforward and a qualified appraisal.

Gift Taxation Compliance and Planning

Annual exclusion: \$19,000 per donee for 2026, for gifts of a **present interest**.

- **Gift splitting** lets spouses treat a gift as made half by each, so \$38,000 per donee. Both must consent on Form 709.
- **Unlimited exclusions** apply to tuition paid directly to a school, medical expenses paid directly to a provider, gifts to a U.S. citizen spouse and gifts to charity.
- **Basic exclusion amount:** OBBBA permanently set it at **\$15 million** per person for 2026, indexed afterward. The generation-skipping transfer exemption is the same. The top rate is 40%.

Form 709 is required for gifts above the annual exclusion, gifts of future interests, gift splitting and 529 five-year elections. It's due with the individual return, April 15, and the income tax extension extends it.

Example: a parent gives \$1,019,000 to a child in 2026. The first \$19,000 is excluded, and the \$1,000,000 taxable gift uses that much of the parent's \$15 million exclusion. No tax is due, but Form 709 must be filed.

Basis of gifted property

- **Gain basis:** the donor's basis, plus any gift tax paid on the appreciation.
- **Loss basis:** if fair value at the gift is less than the donor's basis, the donee uses the lower fair value to measure a loss. A sale between the two values produces no gain or loss.
- Inherited property instead gets a **stepped-up basis** to fair value at death, which is why holding appreciated assets until death can beat gifting them.

Estate and gift planning techniques

- **Crummey powers:** trust beneficiaries get a temporary right to withdraw contributions, which turns gifts to the trust into present interests that qualify for the annual exclusion.
- **Irrevocable life insurance trust:** owns the policy, so proceeds stay out of the insured's estate. If an existing policy is transferred, the insured must live three years.
- **Grantor retained annuity trust:** the grantor keeps an annuity for a term. Growth above the §7520 rate passes to beneficiaries free of gift tax if the grantor survives the term.
- **Family limited partnership:** gifts of limited partnership interests may qualify for discounts for lack of control and marketability.
- **Charitable remainder trust:** income to the donor, then the remainder to charity. An immediate deduction for the remainder's value, and a tax-free sale of appreciated property inside the trust.
- **Charitable lead trust:** income to charity for a term, then the remainder to family at a reduced transfer tax value.
- **Portability:** a surviving spouse can use the deceased spouse's unused exclusion if the executor elects it on a timely estate tax return, even when no return is otherwise required.
- **Credit shelter and QTIP trusts:** a credit shelter trust uses the first spouse's exclusion. A QTIP trust qualifies for the marital deduction while the first spouse chooses who receives the remainder.

Alternative Minimum Tax Planning

AMTI = regular taxable income + adjustments and preferences. Subtract the exemption, multiply by 26% and 28%, and the excess of tentative minimum tax over regular tax is the AMT.

- **2026 exemptions:** \$90,100 single and \$140,200 joint, phased out at **50 cents per dollar** above \$500,000 and \$1,000,000.
- **Common items:** state and local taxes and the standard deduction are added back. Others include private activity bond interest, the ISO bargain element and depreciation differences.
- **Planning:** spread ISO exercises across years to stay under the AMT, and time state tax payments. AMT caused by timing items, such as ISOs, creates a **minimum tax credit** that carries forward to years when regular tax exceeds tentative minimum tax.

Area II: Entity Tax Compliance

C Corporations

NET OPERATING LOSSES

- NOLs arising after 2020 **can't be carried back**, except for farming losses and certain insurance company losses, and carry forward **indefinitely**.
- Post-2017 NOLs can offset only **80% of taxable income** (computed before the NOL deduction) in a carryforward year.
- *Example:* taxable income of \$500,000 before a \$600,000 NOL carryforward. The deduction is limited to \$400,000, so \$100,000 of income is taxed and \$200,000 of NOL carries forward.
- **Section 382** limits the annual use of NOLs after an ownership change of more than 50 percentage points within three years. The limit is the value of the loss corporation times the long-term tax-exempt rate.

CONSOLIDATED RETURNS

- An **affiliated group** has a common parent owning at least **80% of the voting power and 80% of the value** of each member. All members must be includible corporations, which excludes S corporations, most foreign corporations and tax-exempt organizations.
- The group files one **Form 1120** with a common tax year. Members consent by joining in the first return, and Form 851 lists them.
- **Intercompany transactions** are deferred until the item leaves the group. Dividends between members are eliminated.
- **Advantages:** losses of one member offset income of another, and intercompany gains are deferred.

OTHER C CORPORATION ITEMS

- **Tax rate:** a flat 21%. The 50% or 65% **dividends received deduction** depends on ownership, and 100% applies to dividends from affiliated members.
- **Charitable contributions:** limited to 10% of taxable income. Starting in 2026, OBBBA adds a floor, so only contributions above 1% of taxable income are deductible.
- **Accrued bonuses** are deductible in the year accrued if paid within 2½ months after year-end, unless paid to a more-than-50% shareholder.
- **Accumulated earnings tax:** 20% on earnings kept beyond reasonable business needs to avoid shareholder tax. The accumulated earnings credit is \$250,000, or \$150,000 for personal service corporations.
- **Personal holding company tax:** 20% on undistributed income when more than 50% of the stock is owned by five or fewer individuals and at least 60% of adjusted ordinary gross income is passive income such as dividends, interest, rents and royalties.

INTERNATIONAL TAX: SOURCING INCOME

A U.S. corporation is taxed on its **worldwide income** and claims a **foreign tax credit**, limited to the U.S. tax on foreign-source income. Sourcing rules decide what's foreign:

INCOME	SOURCE
Interest	The residence of the payer
Dividends	Generally where the paying corporation is organized
Compensation for services	Where the services are performed
Rents and royalties	Where the property is located or used
Sale of real property	Where the property is located
Sale of purchased inventory	Generally where title passes
Sale of inventory produced by the taxpayer	Where the production activity occurs

The foreign tax credit limit = U.S. tax × foreign-source taxable income ÷ worldwide taxable income, computed separately by category, such as general and passive. Excess credits carry back one year and forward ten.

Example: worldwide taxable income of \$200,000 includes \$100,000 from foreign sources. U.S. tax before credits is \$42,000, and foreign taxes paid are \$30,000. The limit is $\$42,000 \times 50\% = \textbf{\$21,000}$, so \$9,000 of credit carries over.

S Corporations

Eligibility: a domestic corporation with no more than 100 shareholders (family members can count as one), only eligible shareholders (U.S. citizens and residents, estates and certain trusts and exempt organizations) and one class of stock. Differences in voting rights alone are allowed.

Election: Form 2553, with consent from all shareholders, by the 15th day of the third month of the tax year (March 15 for calendar years) to be effective that year.

Termination

- **Voluntary revocation:** shareholders owning more than 50% of the shares.
- **Automatic:** an ineligible shareholder, a second class of stock, or passive investment income above 25% of gross receipts for three consecutive years while the corporation has accumulated C corporation earnings and profits.
- A new election generally can't be made for five years without IRS consent.

Shareholder stock basis

- *Increases:* contributions and the shareholder's share of all income items, including tax-exempt income.
- *Decreases, in order:* distributions, then nondeductible expenses, then losses and deductions. Basis can't go below zero.

- **Debt basis** comes only from loans the shareholder makes directly to the corporation, not from the corporation's bank debt or the shareholder's guarantees.
- Losses are deducted against stock basis first, then debt basis. Excess losses carry forward indefinitely. Later income restores debt basis before stock basis.

Example: beginning stock basis is \$20,000. The shareholder's share of ordinary income is \$15,000 and tax-exempt income is \$2,000. Distributions are \$10,000, and nondeductible expenses are \$1,000. Ending basis is $\$20,000 + \$15,000 + \$2,000 - \$10,000 - \$1,000 = \mathbf{\$26,000}$.

Distributions

- **No accumulated E&P:** tax-free up to stock basis, with the excess taxed as capital gain.
- **With accumulated E&P from C corporation years:** first from the **accumulated adjustments account**, tax-free to the extent of basis, then dividends from E&P, then a return of remaining basis, then capital gain.
- **Property distributions:** the corporation recognizes gain, but not loss, as if it sold the property at fair value, and the gain passes through.

Built-in gains tax: 21% on net built-in gains recognized within **five years** after a C corporation converts to S status.

Reasonable compensation: shareholder-employees must receive reasonable wages subject to payroll tax before taking distributions. The IRS can recharacterize distributions as wages.

Partnerships

Partner's basis

- *Starts with:* cash contributed plus the adjusted basis of property contributed, plus the partner's share of partnership liabilities.
- *Increases:* share of income, including tax-exempt income, and increases in the partner's share of liabilities.
- *Decreases:* distributions, decreases in the share of liabilities (treated as cash distributions), and the share of losses and nondeductible expenses.

Contributions of property are generally tax-free under §721. Gain is recognized if the decrease in the partner's liabilities exceeds the partner's basis. Built-in gain or loss on contributed property is allocated back to the contributing partner under **§704(c)**.

Services: receiving a **capital interest** for services is ordinary income at fair value. A **profits interest** generally isn't taxable when received.

Allocations follow the partnership agreement if they have **substantial economic effect**: they're reflected in capital accounts, liquidating distributions follow capital accounts, and a partner with a deficit must restore it, or a qualified income offset applies. Otherwise allocations follow the partners' interests in the partnership.

Guaranteed payments for services or capital are deductible by the partnership and are ordinary income to the partner, subject to self-employment tax when for services.

Partnership and partner elections

- **§754:** adjusts the basis of partnership assets when an interest is sold or property is distributed, so a buyer's inside basis matches what was paid. Once made, it applies to all later years unless revoked with IRS consent. A basis adjustment is mandatory when the partnership has a substantial built-in loss of more than \$250,000.
- **Other elections** are made by the partnership, not the partners, such as the accounting method, the tax year, depreciation methods, §179 and electing out of the centralized audit regime. Foreign tax credits and certain debt discharge choices are made by each partner.

§754 example: a buyer pays \$150,000 for a 50% interest when the partnership's inside basis for that share is \$100,000. With the election, the buyer gets a \$50,000 step-up in the partnership's assets.

Ownership changes

- When an interest is sold, income for the year is allocated between seller and buyer using either an **interim closing of the books** or a **proration** by days.
- The selling partner's gain is capital except to the extent of **hot assets**, meaning unrealized receivables and inventory under §751, which produce ordinary income.
- **Technical terminations** were repealed after 2017. A partnership terminates only when no part of its business continues to be carried on by any partners in a partnership.

Distributions

- **Current distributions:** gain only if cash, including relief from liabilities, exceeds basis. Property takes the partnership's basis, limited to the partner's remaining basis.
- **Liquidating distributions:** the partner's remaining basis is allocated to the property received. A loss is recognized only if the partner receives nothing but cash, unrealized receivables and inventory, and these total less than basis.

Trusts

Types of trusts

- **Simple trust:** must distribute all income currently, makes no charitable contributions and doesn't distribute principal. Exemption: \$300.
- **Complex trust:** any trust that isn't simple. Exemption: \$100.
- **Grantor trust:** the grantor keeps powers or interests, such as the power to revoke, so the grantor is taxed on the income. Revocable living trusts are grantor trusts.
- **Estates:** exemption: \$600.

Fiduciary accounting income is determined by the trust instrument and state law, and allocates items between income and corpus (principal):

USUALLY INCOME**USUALLY CORPUS**

Interest, dividends and rents

Capital gains

Ordinary operating income

Proceeds from selling trust assets

A share of trustee fees, often half

Stock dividends and splits; the other share of trustee fees

Distributable net income (DNI) caps the trust's distribution deduction and the amount beneficiaries are taxed on, and keeps the character of income such as tax-exempt interest. Capital gains allocated to corpus are generally excluded from DNI and taxed to the trust.

Form 1041 is due by the 15th day of the fourth month after year-end, April 15 for calendar years, with a 5½-month extension. Trusts reach the 37% bracket at low income levels, so distributing income to lower-bracket beneficiaries often saves tax.

Tax-Exempt Organizations

Obtaining exempt status

- 501(c)(3) organizations apply on **Form 1023** or the streamlined Form 1023-EZ, and most others on Form 1024. A 501(c)(3) must apply within 27 months of formation for exemption to be retroactive.
- It must pass the **organizational test** (governing documents limit its purposes and dedicate assets to exempt purposes) and the **operational test** (no private inurement, no substantial lobbying and no political campaign activity).

Maintaining exempt status

- Annual **Form 990**, 990-EZ or 990-N depending on size, and 990-PF for private foundations.
- Failing to file for three consecutive years automatically revokes exemption.

Unrelated business income comes from a trade or business that's regularly carried on and not substantially related to the exempt purpose.

- *Common examples:* advertising income in a magazine, an unrelated retail operation, and income from debt-financed property.
- *Excluded:* dividends, interest, royalties and most rents from real property (unless debt-financed), activities run mostly by volunteers, sales of donated goods, activities for the convenience of members, students or employees, and qualified sponsorship payments.
- A **\$1,000 specific deduction** applies. Income from each unrelated business is computed separately (silo rules), and UBIT is reported on **Form 990-T** if gross UBI is \$1,000 or more.

Area III: Entity Tax Planning

Choosing an Entity

FACTOR	SOLE PROPRIETORSHIP	PARTNERSHIP OR LLC	S CORPORATION	C CORPORATION
Owner liability	Unlimited	Limited for LLC members and limited partners	Limited	Limited
Taxation	Owner	Pass-through	Pass-through	Entity level, 21%
Self-employment tax	All net earnings	General partners and active members	Wages only	Not applicable
\$199A deduction	Yes	Yes	Yes	No
Losses	Pass through	Pass through, entity debt adds basis	Pass through, entity debt doesn't add basis	Stay in the corporation
Owners	One	Two or more (one for a single-member LLC)	Up to 100 eligible shareholders	Unlimited

The qualified business income deduction (\$199A) allows up to 20% of QBI, limited to 20% of taxable income minus net capital gain. OBBBA made it permanent and widened the phase-in range to \$75,000 (\$150,000 joint) starting in 2026.

- Above the threshold (\$201,750 single and \$403,500 joint for 2026), the deduction is limited to the greater of 50% of W-2 wages or 25% of wages plus 2.5% of the unadjusted basis of qualified property.
- **Specified service trades or businesses**, such as health, law, accounting, consulting and financial services, lose the deduction above the phase-in range. Engineering and architecture aren't specified services.

Self-employment tax planning with an S corporation

Example: a business nets \$200,000.

- **As a sole proprietorship:** self-employment tax is about **\$28,200**, based on 92.35% of net earnings, with Social Security tax up to the \$184,500 wage base.
- **As an S corporation** paying a reasonable \$100,000 salary: payroll taxes on the salary are about **\$15,300**. The other \$100,000 passes through free of payroll tax.

The savings must be weighed against payroll costs, the effect of lower wages on the \$199A deduction and the risk of an unreasonable salary.

Double taxation: C corporation income is taxed at 21%, and dividends at up to 23.8% including NIIT, for a combined rate of about **39.8%** ($21\% + 79\% \times 23.8\%$). Retaining earnings in a C corporation makes sense when the owners

don't need distributions and the 21% rate is below their individual rate.

Formation and Liquidation

Corporate formation (§351): transferors of property who control **at least 80%** of the voting power and 80% of each other class of stock immediately afterward recognize no gain or loss.

- **Boot** received triggers gain up to the boot's value.
- **Liabilities** assumed by the corporation aren't boot, unless there's a tax-avoidance purpose. Gain is recognized to the extent they exceed the transferor's basis in the property contributed.
- **Basis:** the shareholder's stock takes the basis of the property, plus gain recognized, minus boot. The corporation's basis in the property is the transferor's basis plus gain recognized.
- Shareholders who contribute only **services** don't count toward the 80% control test and are taxed on the stock received.

Partnership formation under §721 has no control requirement, which makes partnerships more flexible for adding owners later.

Corporate liquidations

- **Shareholders (§331):** capital gain or loss equal to the property received less stock basis. Property takes a fair value basis.
- **The corporation (§336):** gain or loss as if it sold the property at fair value, with limits on losses for distributions to related parties.
- **Liquidating an 80%-owned subsidiary (§332 and §337):** neither the parent nor the subsidiary recognizes gain or loss. The parent takes carryover basis and inherits tax attributes such as NOLs and E&P.

S corporation liquidations cause gain at the corporate level that passes through, increasing shareholder basis and reducing the shareholder's own gain. **Partnership liquidations** generally aren't taxable unless cash exceeds basis.

Planning for C Corporations

- **Tax year:** a C corporation can generally choose any fiscal year, unlike most pass-through entities and personal service corporations.
- **Reasonable compensation:** salaries are deductible, and dividends aren't. Excessive salaries can be recharacterized as dividends.
- **Accumulations:** document the business needs for retained earnings to avoid the accumulated earnings tax.
- **Acquisitions:** sellers usually prefer a **stock sale** for a single level of capital gain. Buyers usually prefer an **asset purchase** for a stepped-up basis and to avoid hidden liabilities.
- **§338(h)(10) and §336(e) elections** treat a qualifying stock sale as an asset sale, giving the buyer a stepped-up basis. They're available when the target is an S corporation or a member of a consolidated group, and the seller pays tax as if it sold assets.

Tax-free reorganizations require continuity of interest, continuity of business enterprise and a business purpose. Gain is recognized only to the extent of boot received, and losses aren't recognized.

TYPE	DESCRIPTION	CONSIDERATION
A	Statutory merger or consolidation	Flexible. Continuity of interest of roughly 40% stock
B	Stock for stock, acquiring 80% control	Solely voting stock
C	Voting stock for substantially all of the target's assets, and the target liquidates	Mostly voting stock, with limited boot
D	Transfer to a controlled corporation, including spin-offs, split-offs and split-ups	Requires an active trade or business test for divisive transactions
E	Recapitalization	
F	Mere change in identity, form or place of organization	

Planning for S Corporations

- Keep the election valid with a single class of stock, eligible shareholders and buy-sell agreements that block transfers to ineligible owners.
- Shareholders need stock or debt basis to deduct losses, such as a direct loan to the corporation.
- Converted C corporations should time sales of appreciated assets for after the five-year built-in gains period, and distribute accumulated E&P to avoid passive income tax and termination.

Planning for Partnerships

- Use **special allocations** with substantial economic effect, for example allocating depreciation to the partner who funded the property.
- Use **guaranteed payments** to pay service partners a fixed amount regardless of profits.
- Consider a **\$754 election** before an interest is sold or property is distributed.
- **Disguised sales:** contributions followed within two years by distributions to the same partner are presumed to be sales.
- **Self-employment tax:** general partners pay it on their distributive shares. Limited partners generally pay it only on guaranteed payments for services.

Area IV: Property Transactions

Nontaxable Dispositions

Like-kind exchanges (§1031): only **real property** held for business or investment qualifies.

- Gain is recognized to the extent of **boot** received, including net liability relief, and losses aren't recognized.
- **Basis of the new property** = fair value of new property – deferred gain, or equivalently the old basis + boot paid + gain recognized – boot received.
- **Deadlines:** identify replacement property within **45 days** and close within **180 days**, or by the return's due date with extensions, if earlier.
- **Related parties:** both must hold the property for two years, or the deferred gain is triggered.

Example: land with a \$100,000 basis and a \$250,000 value is exchanged for land worth \$230,000 plus \$20,000 cash. The realized gain is \$150,000, and the recognized gain is the **\$20,000** of boot. The new land's basis is $\$100,000 - \$20,000 + \$20,000 = \textbf{\$100,000}$, which is \$230,000 minus the \$130,000 deferred gain.

Involuntary conversions (§1033): gain on property destroyed, stolen or condemned can be deferred by buying similar property. Gain is recognized only to the extent the proceeds aren't reinvested. The replacement period is generally **two years** after the year of the gain, and three years for condemned business or investment real estate.

Other nonrecognition rules

- The home sale exclusion of up to \$250,000 (\$500,000 joint) with two years of ownership and use in the last five
- §351 and §721 contributions to corporations and partnerships
- Transfers between spouses or incident to divorce under §1041, where the recipient takes carryover basis

Character of Gains and Losses on Business Property

Section 1231 property is depreciable property and real property used in a business and held more than one year.

Recapture comes first

- **§1245 (equipment and other personal property):** gain is ordinary to the extent of all depreciation taken, including §179 and bonus depreciation.
- **§1250 (real property):** for individuals, gain from straight-line depreciation is long-term capital gain taxed at up to **25%** (unrecaptured §1250 gain). Corporations treat 20% of the lesser of straight-line depreciation or the gain as ordinary income under §291.

Netting the remaining §1231 gains and losses

- A **net gain** is long-term capital gain, except that it's ordinary to the extent of net §1231 losses deducted in the **previous five years** (the lookback rule).
- A **net loss** is fully ordinary.

Example: equipment cost \$80,000, has \$50,000 of depreciation and sells for \$90,000. Basis is \$30,000, so the gain is \$60,000. The first **\$50,000 is ordinary** §1245 recapture, and **\$10,000 is §1231 gain**.

Installment sales

- Gain is reported as payments are received: $\text{gain recognized} = \text{payments} \times \text{gross profit percentage}$ (gross profit $\div$ contract price).

- **Depreciation recapture is recognized in full in the year of sale**, even if no payment is received. Installment reporting isn't allowed for inventory, dealer sales or publicly traded securities.
- Selling installment property to a related party who resells it within two years accelerates the original seller's gain.

Example: land with a \$40,000 basis sells for \$100,000: \$20,000 down and four annual payments of \$20,000 plus interest. The gross profit percentage is 60%, so \$12,000 of gain is recognized in the year of sale and \$12,000 with each later payment.

Netting capital gains and losses for individuals: net short-term and long-term gains and losses separately, then net them against each other. Collectibles gain is taxed at up to 28%, unrecaptured §1250 gain at up to 25%, and other long-term gains at 0%, 15% or 20%. Corporations have no capital gains rate preference, deduct capital losses only against capital gains, and carry them back three years and forward five.

Related Party Transactions

§267 related parties include family members (spouse, siblings, ancestors and lineal descendants, but not in-laws), an individual and a more-than-50%-owned corporation, and corporations in a controlled group.

- **Losses** on sales to related parties are **disallowed**. When the buyer later sells at a gain, the gain is reduced by the previously disallowed loss. The disallowed loss can't increase a later loss.
- **Accrued expenses** owed to a cash-method related party aren't deductible until paid.
- **§1239:** gain on the sale of depreciable property to a more-than-50%-controlled entity is ordinary income.

Example: a mother sells stock with a \$10,000 basis to her son for \$7,000. Her \$3,000 loss is disallowed. If he sells for \$12,000, his \$5,000 gain is reduced by \$3,000 to **\$2,000**. If he sells for \$8,000, his \$1,000 gain is fully offset, so he reports **no gain**. If he sells for \$6,000, he has a \$1,000 loss, and the disallowed loss is gone.

Imputed interest

- **Below-market loans (§7872):** for gift and compensation loans, the lender is treated as receiving interest at the applicable federal rate, and the borrower as paying it, with an offsetting gift or compensation.
 - *De minimis exception:* gift loans of \$10,000 or less between individuals, unless used to buy income-producing assets.
 - *\$100,000 exception:* for gift loans of \$100,000 or less, imputed interest is limited to the borrower's net investment income, and is zero if that's \$1,000 or less.
- **Seller financing (§1274 and §483):** if a deferred-payment sale states too little interest, part of the principal is recharacterized as interest using the applicable federal rate.

Tax Practice Essentials

Authority, from strongest to weakest: the Internal Revenue Code; Treasury regulations (final, then temporary, with proposed regulations not binding); revenue rulings and revenue procedures; and court decisions, where the

Supreme Court binds everyone and circuit courts bind their circuits. Private letter rulings and technical advice memoranda bind only the taxpayer involved, and IRS publications aren't authority.

Courts: the **Tax Court** doesn't require paying the tax first and follows the precedent of the taxpayer's circuit (the Golsen rule). **District courts** and the **Court of Federal Claims** require paying first and suing for a refund. Only district courts allow a jury.

Return position standards

STANDARD	ROUGH LIKELIHOOD	USE
More likely than not	Over 50%	Avoids penalties for tax shelter items
Substantial authority	About 40%	Avoids the understatement penalty without disclosure
Realistic possibility of success	About 33%	Associated with the AICPA standards
Reasonable basis	About 20%	Avoids penalties if the position is disclosed

The AICPA Statements on Standards for Tax Services, revised effective January 1, 2024, cover tax return positions, answers to questions on returns, reliance on information from others, use of estimates, departures from positions in prior proceedings, knowledge of errors and written and oral advice. If a member learns of an error, the member tells the client promptly and recommends corrective action, but doesn't tell the IRS without the client's permission. If the client won't correct it, the member considers whether to keep providing services.

Statute of limitations: three years from the later of the due date or filing, six years if gross income is understated by more than 25%, and unlimited for fraud or no return. Refund claims are due within three years of filing or two years of payment, whichever is later.

Quick Reference

TOPIC	REMEMBER
Loss limits	Basis, then at-risk, then passive activity, then excess business loss
S corporation basis	Increases first, then distributions, then nondeductible expenses, then losses
Debt in basis	Partnerships include entity debt. S corporations include only shareholder loans
§351	80% control immediately after. Gain up to boot. Services don't count
Like-kind exchange	Real property only, 45 and 180 days, gain up to boot
§1245 vs. §1250	Full depreciation recapture vs. 25% unrecaptured gain for individuals
§267	Related-party losses disallowed. The buyer may reduce later gain
Gift basis	Carryover for gains, lower fair value for losses
NOLs	80% limit, indefinite carryforward, no carryback
Trusts	Simple \$300, complex \$100, estate \$600. DNI caps the distribution deduction

Sources for the Dollar Amounts

- IRS Revenue Procedure 2025-32 (2026 inflation adjustments)
- IRS, 401(k) limit increases to \$24,500 for 2026, IRA limit increases to \$7,500
- IRS, One, Big, Beautiful Bill provisions
- AICPA, Uniform CPA Examination Blueprints (2026)