

**superfast**CPA

# TCP REVIEW NOTES

*2026*

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## How to Use These Review Notes:

The best way to use these review notes is in the following ways:

1. Read from these review notes as a part of your mini sessions each day. Switch between reading a few pages of these notes and taking quizzes on the SuperfastCPA app. Doing this multiple times a day will get you through the notes at least a couple or more times throughout your study process.
2. When doing your 2-hour main study session each day, before starting a new section or topic, find that topic in these review notes and read through it to get a base understanding of what you are about to study. This doesn't need to be a deep read, just a primer to get you started.
3. Read through these review notes all the way through at least 2-3 times in the two days of your 48-hour cram session before your exam.

### AICPA Blueprints and “Representative Tasks”

We have made these review notes to mirror the AICPA blueprints. You will notice that each section says one of the following: Remembering and Understanding, Application, Analysis, or Evaluation (Evaluation will only be on the Audit exam).

- If a section says Remembering and Understanding, that means it will almost certainly be tested as a Multiple Choice Question if it is tested.
- If a section says Application, that means it could be tested as either a Multiple Choice Question or a Simulation.
- If a section says either Analysis or Evaluation (for Audit only), it will almost certainly be tested as a Simulation.

## A Note on Year-Specific Tax Figures

One thing that's very helpful for you to know, is that with all the year-specific tax figures, such as deduction amounts, credit amounts, phase-outs, and income ranges, etc, is that the AICPA doesn't expect you to memorize all these figures.

What they want to see is that you know how to apply the deduction or credit. Therefore, the specific figures will almost always be given to you in the problem itself.

**Here's a direct quote from the AICPA Blueprints for TCP:**

*"Candidates will **not be tested on their knowledge of specific tax rate percentage, amounts or limitations** that are indexed to inflation. To the extent a question addresses a topic that could have different tax treatments based on timing (e.g., net operating losses), it will include a clear indication of the timing (e.g., use of real dates) so that the candidates can determine the appropriate portions of the Internal Revenue Code or Treasury Regulations to apply to the question. Absent such an indication of timing or other stated assumptions, candidates should assume that transactions or events referenced in the question occurred in the current year and should apply the most recent provisions of the tax law in accordance with the timing specified in the CPA Exam Policy on New Pronouncements."*

# Area I – Tax Compliance and Planning for Individuals and Personal Financial Planning

## A. Individual Compliance and Tax Planning Considerations for Gross Income, Adjusted Gross Income, Taxable Income, and Estimated Taxes

*Remembering and Understanding: Recall the impact of equity compensation awards on taxable income.*

### Step 1: Understand the Basics

Equity compensation refers to the practice of granting company shares or options to purchase shares as part of an employee's compensation. Common types include Restricted Stock Units (RSUs), stock options, and employee stock purchase plans (ESPPs).

### Step 2: Identify the Type of Equity Compensation

- Restricted Stock Units (RSUs): These are a promise to give an employee a set number of shares (or the cash equivalent) on a future date, subject to certain conditions, usually including a vesting schedule.
- Stock Options: These are the rights to purchase stock at a predetermined price (the strike price). They come in two types:
  - Incentive Stock Options (ISOs)
  - Non-qualified Stock Options (NSOs)
- Employee Stock Purchase Plans (ESPPs): These allow employees to purchase company stock at a discount through payroll deductions.

### Step 3: Determine the Taxation Timing

RSUs: Taxed when they vest. The value of the shares on the vesting date becomes taxable as ordinary income.

ISOs: Generally, no ordinary income tax upon exercise, but Alternative Minimum Tax (AMT) might apply. Capital gains tax will apply upon sale.

NSOs: The difference between the market price on the date of exercise and the strike price is considered taxable income when exercised.

ESPPs: The discount at which you're allowed to purchase the stock is generally considered taxable income. Further taxation may occur when selling the stock.

### Step 4: Calculate the Taxable Amount

RSUs: Taxable income = Number of shares x Fair Market Value on vesting date

*Example: RSUs and Taxable Income*

*John is granted 1,000 RSUs by his employer, TechCorp, on January 1, 20X2.*

*Each RSU represents one share of TechCorp stock.*

*The RSUs have a vesting period of 1 year.*

*Fast forward to January 1, 20X3:*

*The RSUs vest (meaning John now actually owns the shares, or their cash equivalent).*

*On the vesting date, TechCorp's stock price is \$50.*

*Now, let's calculate the tax implications:*

**Step 1: Calculate the Value of RSUs on Vesting**

*The value of the RSUs on the vesting date would be:*

*Number of RSUs x Stock Price on Vesting Date*

*= 1,000 RSUs x \$50*

*= \$50,000*

**Step 2: Determine Taxable Income from RSUs**

*The entire value of the RSUs on the vesting date becomes taxable as ordinary income. Therefore, John will have an additional \$50,000 added to his taxable income for 20X3.*

**Step 3: Estimate Tax Owed** *(For simplicity, let's use a flat tax rate)*

*Assuming John is in a 25% federal tax bracket:*

*Tax owed on RSUs = 25% of \$50,000*

*= \$12,500*

*So, John will owe an additional \$12,500 in federal taxes for 20X3 due to the RSUs. Note that this doesn't account for any state taxes, Social Security, Medicare, or other potential deductions and credits. It's just a simple illustration.*

#### **Step 4: Consider Future Implications**

*If John decides to sell the shares in the future, there could be additional tax implications based on capital gains or losses. The cost basis for the shares would be \$50 (the value when they vested). If he sells them for more than \$50 per share, he'll have a capital gain. If he sells them for less, he'll have a capital loss.*

ISOs: AMT calculations may be required. When sold, the difference between the sale price and the exercise price becomes the capital gain or loss.

#### **Example: ISOs and Taxable Income**

*Sarah is granted 1,000 ISOs by her employer, HealthTech Inc., on January 1, 20X2.*

*The strike price (price she can buy the stock at) for these ISOs is \$20.*

*She can exercise (buy) these options starting January 1, 20X3.*

*On January 1, 20X3:*

*HealthTech Inc.'s stock price rises to \$60.*

*Sarah decides to exercise all her ISOs.*

#### **Step 1: Calculate the Bargain Element (Spread)**

*The bargain element, or spread, is the difference between the stock's market price and the strike price on the exercise date:*

*Bargain Element = (Market Price - Strike Price) x Number of ISOs exercised*

*= (\$60 - \$20) x 1,000*

*= \$40,000*

### **Step 2: Determine AMT Implication**

*For ISOs, the bargain element can be subject to the Alternative Minimum Tax (AMT). AMT is a separate tax system designed to ensure that taxpayers pay at least a minimum amount of tax.*

*Assuming Sarah has to pay AMT:*

*She would include the \$40,000 bargain element in her AMT calculation for 20X3.*

### **Step 3: Assess Ordinary Income Tax**

*Here's where ISOs differ from non-qualified stock options (NSOs): Sarah doesn't owe ordinary income tax on the bargain element when she exercises the ISOs. She only needs to consider it for AMT purposes.*

### **Step 4: Selling the Stock**

*If Sarah decides to sell the stock:*

*Same Year Sale: If Sarah sells the stock in 20X3 for, say, \$70 per share, she'll have a total gain of  $(\$70 - \$20) \times 1,000 = \$50,000$ . However, because she sold the stock in the same year she exercised the options, the entire gain would be treated as ordinary income, not capital gain.*

*Qualified Disposition: If Sarah holds onto the stock and sells it in a later year, say 20X4, for \$70 per share, she'd ideally want it to be a qualified disposition. For a sale to be qualified, it must occur at least 2 years from the grant date and at least 1 year from the exercise date. If she meets these criteria, she'll have a long-term capital gain of  $(\$70 - \$20) \times 1,000 = \$50,000$ . This is typically taxed at a lower rate than ordinary income.*

### **Step 5: Tax Planning**

*Given the AMT implications, it's crucial for Sarah to consider her entire tax situation, including other potential AMT triggers, deductions, and credits. She might find that exercising a portion of her ISOs in one year and another portion in a subsequent year may be a more optimal tax strategy.*

NSOs: Taxable income = (Fair Market Value on exercise date - Strike price) x Number of shares exercised

*Example: Taxable Income Calculation for an NSO*

*Given:*

*Number of stock options granted: 1,000*

*Exercise (or strike) price: \$20 per share*

*Market value of the stock when exercised: \$50 per share*

*Steps to Calculate Taxable Income:*

### **Step 1: Determine the Spread at Exercise:**

*Remember, the spread is the difference between the market value of the stock when exercised and the exercise (or strike) price.*

*Spread = (Market Value at Exercise - Exercise Price) \*  
Number of Shares Exercise*

*Spread = (\$50 - \$20) \* 1,000 = \$30 \* 1,000 = \$30,000*

### **Step 2: Determine the Taxable Income:**

*For NSOs, the spread is treated as ordinary income in the year of exercise.*

*Taxable Income due to NSO exercise = \$30,000*

*In this example, the individual would need to report an additional ordinary income of \$30,000 for the year in which the NSOs were exercised.*

*Additional Notes:*

*The individual would also have payroll taxes (like Social Security and Medicare taxes) on this income.*

*If the individual later sells the shares, there would be further tax implications based on the selling price and the market value at the time of exercise (i.e., capital gains or losses).*

*Tax rates for ordinary income can vary depending on the taxpayer's total income and filing status, so it's essential to incorporate this additional income into the individual's broader tax situation.*

ESPPs: Taxable income initially is the discount provided on the purchase. Then, the additional gain or loss will be recognized upon sale.

*Example: Taxable Income Calculation for an ESPP*

*Given:*

*Number of shares purchased: 100*

*Purchase (or offer) price without discount: \$50 per share*

*Actual discounted purchase price: \$40 per share (20% discount)*

*Market value of the stock when sold: \$70 per share*

**Steps to Calculate Taxable Income:**

**1. Determine the Discount (Ordinary Income Component):**

*This is the difference between the fair market value on the purchase date and the actual price paid.*

*Discount = (Offer Price - Actual Purchase Price) \* Number of Shares Purchased*

*Discount = (\$50 - \$40) \* 100 = \$10 \* 100 = \$1,000*

**2. Calculate Capital Gains/Losses:**

*Determine the cost basis. The cost basis is the fair market value on the date of purchase (not the discounted price paid, but the price before the discount).*

*Cost Basis = Offer Price \* Number of Shares Purchased =  
\$50 \* 100 = \$5,000*

*Determine the selling amount.*

*Selling Amount = Market Value at Sale \* Number of Shares  
Sold = \$70 \* 100 = \$7,000*

*Calculate the capital gain.*

*Capital Gain = Selling Amount - Cost Basis*

*Capital Gain = \$7,000 - \$5,000 = \$2,000*

*Subtract the ordinary income component (the discount) from  
the capital gain.*

*Adjusted Capital Gain = Capital Gain - Discount*

*Adjusted Capital Gain = \$2,000 - \$1,000 = \$1,000*

**3. Determine the Total Taxable Amounts:**

*Ordinary Income = \$1,000 (from the discount)*

*Capital Gain = \$1,000 (adjusted capital gain)*

**Summary:**

*In this example:*

*The individual would report an additional ordinary income of  
\$1,000 due to the ESPP discount.*

*The individual would also report a capital gain of \$1,000 from  
the sale of the ESPP shares.*

### *Additional Notes:*

*The tax treatment of the capital gain (long-term vs. short-term) will depend on the holding period of the shares. Generally, if the shares are sold at least 2 years after the beginning of the offering period (and at least 1 year after purchase), the gain is long-term. Otherwise, it might be short-term.*

*The ESPP may have a "look-back" provision, allowing employees to purchase the stock at the lower of the price at the beginning of the offering period or the price at the end. This can further complicate tax calculations.*

### **Step 5: Understand the Impact of Selling**

ISOs: Holding the stock for at least 1 year from the date of exercise and 2 years from the grant date qualifies for long-term capital gains rates. Otherwise, it's taxed as ordinary income.

NSOs, ESPPs, RSUs: The difference between the sale price and the stock's value at the time of exercise/purchase is either a capital gain or loss. If held for more than a year, it qualifies for long-term capital gains rates.

*Remembering and Understanding: Recall items included in determination and computation of Alternative Minimum Taxable income.*

The Alternative Minimum Tax (AMT) is designed to ensure that taxpayers, especially high-income ones, pay a minimum amount of tax, even if they have substantial regular tax deductions. The tax is computed on an alternative set of rules for some income and deductions. Here's a step-by-step guide to determine and compute Alternative Minimum Taxable Income (AMTI):

### **Step 1: Start with Regular Taxable Income:**

Begin with your regular taxable income, which is calculated on your tax return after you've considered all of your normal tax deductions.

### **Step 2: Add Back Certain Deductions:**

Some deductions that are permissible for regular tax purposes may not be for AMT. Common add-backs include:

- Personal and standard deductions.
- State and local taxes deducted on the regular tax return.
- Miscellaneous itemized deductions no longer allowed.
- Interest on some private activity bonds.

### **Step 3: Adjust Income for Specific Items:**

The following income adjustments can occur:

- Incentive Stock Options (ISOs): If you exercised but did not sell ISOs during the year, the difference between the stock's

market value and the exercise price is a **positive** AMT adjustment.

- Depreciation: If you've claimed accelerated depreciation on your regular tax return, you may need to recalculate depreciation using the straight-line method for AMT purposes.
- Long-term contracts: Income from certain long-term contracts may need to be recalculated using the percentage-of-completion method for AMT.

#### **Step 4: Subtract AMT Exemption:**

AMT provides an exemption amount that is phased out at higher income levels. Determine your AMT exemption based on your filing status and income.

#### **Step 5: Account for AMT-specific Deductions:**

While many deductions are added back to compute AMTI, certain expenses like interest on mortgages for a primary or secondary residence and medical expenses (subject to limits) can still be deducted.

#### **Step 6: Arrive at the AMTI:**

After making all adjustments, additions, and subtractions, you'll have your Alternative Minimum Taxable Income.

#### **Step 7: Compute the Tentative Minimum Tax (TMT):**

Apply the AMT tax rates to your AMTI. As of the last update, there are two AMT tax rates: **26% and 28%**. The exact rate will depend on your AMTI level. The result is the Tentative Minimum Tax.

As of 2025:

- For most filers (single, head of household, married filing jointly, and qualifying widow(er)):
- The 26% rate applies to AMTI up to a certain amount and the 28% rate applies to everything over that amount. What's important here is knowing the tax rates, not the amounts.
- For married filing separately:
- The 26% rate applies to AMTI up to a certain amount which will be half of the amount that all other filers use. The 28% rate still applies after that amount is reached.

### **Step 8: Compare TMT to Regular Tax:**

Subtract your regular tax from the Tentative Minimum Tax. If TMT is greater than the regular tax, the difference is the AMT you owe.

### **Step 9: Claim AMT Credit (if applicable):**

In some situations, if you pay AMT in one year, you may be entitled to a credit in a future year when you're not subject to AMT. Track and utilize this credit in subsequent years.

### **Step 10: Report on Form 6251:**

All the AMT calculations and adjustments are reported on IRS Form 6251. This form helps you compute AMT and determine if you owe any AMT.

*Application: Consider the impact to an individual's taxable income for certain items of gross income, including imputed interest on below-market rate loans and compensation earned while employed outside the U.S.*

## **Considering the Effect of Imputed Interest on Below-Market Rate Loans on Taxable Income:**

### **1. Introduction to Below-Market Rate Loans:**

A below-market rate loan is one where the interest rate charged is less than the applicable federal rate (AFR). The AFR is determined by the U.S. Treasury and varies based on the length of the loan.

### **2. Concept of Imputed Interest:**

Imputed interest arises when the IRS deems that the lender should have received more interest than was actually charged. The difference between the interest that should have been charged at the AFR and the interest actually charged is considered "imputed" and may be subject to tax.

### **3. Basic Steps for Calculating Imputed Interest:**

- Determine the AFR for the duration of your loan.
- Calculate the interest that would be charged on the loan at the AFR.
- Subtract the interest that was actually charged on the loan.
- The difference between the two is the imputed interest.

## 4. Tax Consequences of Imputed Interest:

### For the Lender (Party Providing the Loan):

The imputed interest is treated as though the lender actually received that interest as income. Thus, even if no cash was exchanged for the difference between the below-market interest rate and the AFR, the lender still must report this imputed interest as income on their tax return.

*For example, if a lender gives a loan of \$10,000 at a 1% interest rate when the AFR is 3%, and the borrower pays \$100 in actual interest, the imputed interest income would be \$200 ( $\$10,000 \times 3\% - \$100$ ). **The lender would need to report this \$200 as taxable interest income, even though they never received it in cash.***

### Potential Gift Implications:

In some instances, especially in personal or family loans, the imputed interest might be treated as a gift from the lender to the borrower. This can have gift tax implications if the amount exceeds the annual gift exclusion.

### For the Borrower (Party Receiving the Loan):

#### Gift or Demand Loans:

Typically, the borrower does not recognize the imputed interest as income when it comes to personal loans. However, the imputed interest might be treated as a deemed gift received from the lender. While this might not immediately impact the borrower's income tax, it's essential

to be aware of any potential gift tax implications for the lender.

### **Compensation-Related or Employee Loans:**

If the loan is related to compensation (for instance, an employer provides a below-market loan to an employee as a form of compensation), the borrower (employee) might need to recognize the imputed interest as wage income. The lender (employer) would similarly get a wage expense deduction.

### **Corporation-Shareholder Loans:**

If a corporation extends a below-market loan to a shareholder, the imputed interest might be treated as a deemed dividend to the shareholder. This can have more significant tax implications, as dividends might be taxed at different rates than regular income.

It's crucial for both parties involved in a below-market rate loan to understand their respective tax consequences. While the borrower might not always face direct income tax consequences, the treatment of imputed interest can affect other areas of their financial and tax planning, such as potential gift recognition.

## **5. Exceptions and Special Rules:**

**Tax Avoidance Loans:** If the primary purpose of the loan is tax avoidance, then the imputed interest rules apply irrespective of the loan amount.

**Demand Loans vs. Term Loans:** The calculation and treatment of imputed interest can differ based on whether the loan is a **demand loan** (no specific repayment term) or a **term loan** (has a specific repayment time frame).

## 6. Reporting:

Report any imputed interest as income on the appropriate tax forms. For lenders, this will typically be on Schedule B of Form 1040.

## Compensation Earned While Employed Outside the U.S.

### 1. Understand the U.S. Tax System:

The U.S. taxes its citizens and resident aliens on their worldwide income, regardless of where they earn it. This means that if a U.S. citizen works abroad and earns income, **they still have a tax obligation to the U.S.**

### 2. Familiarize Yourself with the Foreign Earned Income Exclusion (FEIE):

Qualified individuals can exclude a certain amount of their foreign earned income from U.S. taxation using the FEIE.

The maximum earned income exclusion is the **lesser** of the foreign income earned or a certain amount per qualifying person (for example in 2025 this amount is \$130,000)

### 3. Determine Eligibility for the FEIE:

To claim the FEIE, one must meet either:

**Bona Fide Residence Test:** An individual must reside in a foreign country for an uninterrupted period that includes **at least an entire tax year**.

**Physical Presence Test:** An individual is present in foreign countries for at least 330 full days during any 12 consecutive months.

### 4. Understand the Foreign Housing Exclusion/Deduction:

Apart from the FEIE, one can also claim an exclusion or a deduction for certain foreign housing amounts if they qualify.

### 5. Claim Tax Credits for Foreign Taxes Paid:

If you pay or accrue tax to a foreign government on your foreign earned income, you might be eligible to claim a Foreign Tax Credit on your U.S. tax return, which can offset your U.S. tax liability.

This ensures that you aren't double-taxed on the same income.

*Example:*

*Alex, a U.S. citizen, is employed in Germany for the entire tax year. She earns \$60,000 (after any applicable exclusions) from her job in Germany and pays \$10,000 in income taxes to the German government. Alex has no other income for the year.*

*When she prepares her U.S. tax return:*

*U.S. Tax Liability: Alex calculates her tax liability on her worldwide income, which includes the \$60,000 she earned in Germany. Let's assume her U.S. tax liability on the \$60,000 is \$8,000.*

### **Foreign Tax Credit Calculation:**

*Alex has already paid \$10,000 in taxes to Germany.*

*She can claim a foreign tax credit on her U.S. tax return for the taxes she paid to Germany to avoid being double-taxed on the same income.*

### **Claiming the Credit:**

*Alex would fill out Form 1116 to calculate and claim her Foreign Tax Credit.*

*Given her circumstances, Alex can claim the full \$8,000 as a Foreign Tax Credit because her German tax (\$10,000) exceeds her U.S. tax liability (\$8,000). This means she'll owe no U.S. income tax for that year on her foreign earnings.*

*However, Alex cannot get a refund for the difference between the German tax and the U.S. tax liability (i.e.,  $\$10,000 - \$8,000 = \$2,000$ ). The excess \$2,000 can be carried forward to offset future U.S. tax liabilities.*

## **6. Reporting Requirements:**

Use Form 2555 (or Form 2555-EZ) to claim the FEIE and the Foreign Housing Exclusion/Deduction.

Use **Form 1116** to claim the Foreign Tax Credit.

## **7. Know the Self-Employment Tax:**

While you can exclude foreign-earned income from U.S. income tax, **you cannot exclude it from self-employment tax**. If you're self-employed and qualify for the FEIE, you must consider self-employment tax on your net earnings.

## **8. Understand the Implications of FBAR and FATCA:**

If you have foreign bank accounts or financial assets, you might have additional reporting requirements:

**FBAR (Report of Foreign Bank and Financial Accounts):** You may need to file FinCEN Form 114 if you had more than \$10,000 in foreign financial accounts at any time during the year.

**FATCA (Foreign Account Tax Compliance Act):** U.S. taxpayers holding foreign financial assets may need to report them on Form 8938 if they exceed certain thresholds.

## **9. Consider Tax Treaties:**

The U.S. has tax treaties with several countries. These treaties can affect how a taxpayer is taxed on income earned abroad.

*Application: Calculate the tax on a child's investment and other unearned income.*

## **Calculating the Tax on a Child's Investment Income and other unearned income:**

### **Step 1: Determine Eligibility for the Kiddie Tax:**

- The child is under age 18 at the end of the tax year, OR
- The child is aged 18 at the end of the tax year and did not have earned income that was more than half of their support, OR
- The child is a full-time student over age 18 but under age 24 at the end of the tax year and did not have earned income that was more than half of their support.

### **Step 2: Calculate Total Investment Income:**

Sum up all sources of unearned income for the child. This can include interest, dividends, capital gains, and other types of investment income.

### **Step 3: Determine the Amount of Income Subject to Kiddie Tax:**

- As of 2025, the first \$1,350 of a child's unearned income is not subject to tax due to the standard deduction.
- The next \$1,350 is taxed at the child's rate, which is typically much lower than the parents' rate.
- Unearned income over \$2,700 is subject to the kiddie tax and is generally taxed at the parents' marginal tax rate.

## **Step 4: File the Appropriate Tax Form:**

If the child's interest and dividends total less than a given amount and certain other conditions are met, parents might be able to elect to report the child's income on their return using Form 8814.

If not, then the child must file their own return using Form 8615 to calculate the kiddie tax.

### **Consider Tax Planning Strategies:**

To minimize the impact of the kiddie tax, parents and guardians might consider strategies such as:

- Shifting investments to those that produce tax-free income, like certain municipal bonds.
- Deferring the sale of investments that have gained value until the child is no longer subject to the kiddie tax.
- Investing in growth stocks that don't pay dividends currently but might appreciate over time.
- Using the child's income for educational expenses, which could qualify for tax benefits.

*Application: Consider the effect of changing tax rates and legislation on the timing of income and expense items for planning purposes given a specific scenario.*

## **1. Importance of Timing:**

Tax planning often involves strategically timing income and expenses to minimize overall tax liability.

Changes in tax rates and legislation can greatly influence the ideal timing.

## **2. Time Value of Money:**

- Money today has more value than the same amount in the future due to its earning potential.
- Deferring tax payments, when beneficial, is similar to obtaining an interest-free loan from the government.

## **3. Impact of Rate Changes on Income and Deductions:**

**If tax rates are expected to increase:**

- Consider accelerating income to a year with a lower rate.
- Consider deferring deductions to a year with a higher rate.

**If tax rates are expected to decrease:**

- Consider deferring income to a year with a lower rate.
- Consider accelerating deductions to a year with a higher rate.

## **Example Scenario:**

*XYZ Corp. is a company that has historically had a consistent taxable income of around \$500,000 each year. It's currently 20X3, and the tax rate for corporations is 21%. XYZ Corp. becomes aware that in 20X4, new tax legislation will increase the corporate tax rate to 28%. Additionally, XYZ Corp. anticipates a large contract in December 20X3 that will generate an extra \$200,000 in income. They also plan on making a significant equipment purchase in early 20X4.*

## **Tax Planning Decisions**

### ***Timing of Income:***

- *With the pending tax rate increase, XYZ Corp. may want to accelerate the recognition of the income from the large contract into 20X3 to take advantage of the lower 21% tax rate, rather than defer it to 20X4 where it would be taxed at 28%.*
- *By doing so, XYZ Corp. would pay \$42,000 (21% of \$200,000) in taxes for 20X3 instead of \$56,000 (28% of \$200,000) if recognized in 20X4.*

### ***Timing of Expenses:***

- *Considering the anticipated equipment purchase in 20X4, XYZ Corp. might decide to defer this expense to 20X4 when the tax rate is higher. If, for instance, the equipment costs \$150,000 and is fully deductible in the year of purchase, it would save XYZ Corp. \$42,000 (28% of \$150,000) in 20X4 taxes. If purchased in 20X3, the savings would be only \$31,500 (21% of \$150,000).*

**Outcome:** *By accelerating income into 20X3 and deferring the equipment expense to 20X4, XYZ Corp. effectively minimizes its tax liability over the two years by strategically timing its income and expenses in response to changing tax rates.*

SAMPLE

*Application: Identify projected tax savings through utilization of flexible spending accounts (FSAs) and qualified health savings accounts (HSAs) for planning purposes given a specific scenario.*

## **Understanding Flexible Spending Accounts (FSAs)**

- A Flexible Spending Account (FSA) is a type of savings account that provides the account holder with specific tax advantages. Set up by an employer, it allows employees to contribute a portion of their regular earnings to pay for qualified expenses, such as medical expenses or dependent care expenses.
- Money contributed to an FSA is taken from an employee's paycheck before taxes are taken out, which means the contributions are pre-tax. As a result, they reduce an individual's taxable income.

## **Understanding Qualified Health Savings Accounts (HSAs)**

An HSA is a tax-advantaged savings account designed to help individuals who have a High Deductible Health Plan (HDHP) save for out-of-pocket medical expenses. Tax Benefits include:

- **Pre-tax Contributions:** Contributions to an HSA are made with pre-tax dollars, which reduces taxable income.
- **Tax-free Withdrawals:** Amounts withdrawn from an HSA for qualified medical expenses are not taxed.
- **Tax-deferred Growth:** Earnings and gains on assets in the HSA are not taxed unless withdrawn for non-medical expenses.

## **Steps to Identify Projected Tax Savings Using FSAs or HSAs**

### **Step 1: Determine the Maximum Annual Contribution:**

For FSAs and HSAs, you should first determine the current annual limits.

For FSAs, the IRS allows employees to contribute a given amount to a health FSA and another given amount to a dependent care FSA.

For HSAs, the IRS allows individuals to contribute a given amount and families to contribute double that given amount. There is also an additional catch-up contribution allowed for those aged 55 and older.

### **Step 2: Estimate Annual Qualified Expenses:**

Estimate how much the individual expects to spend on qualified expenses in the upcoming year. This will help in deciding how much to contribute to the FSA or to the HSA.

### **Step 3: Calculate the Taxable Income Without FSA/HSA:**

- Start with the individual's expected annual gross income.
- Subtract the standard or itemized deductions, and any other applicable above-the-line deductions, to get the taxable income without using the FSA.

### **Step 4: Calculate the Taxable Income With FSA/HSA:**

- From the expected annual gross income, subtract the intended FSA contribution.

- Subtract other deductions as done in the previous step. This will give you the taxable income with FSA contribution.

### **Step 5: Determine Tax Liability for Both Scenarios:**

Using the current year's tax brackets, determine the tax liability for both the taxable income without FSA/HSA and with FSA/HSA.

### **Step 6: Calculate the Projected Tax Savings:**

Subtract the tax liability with FSA/HSA from the tax liability without FSA/HSA. The difference will represent the tax savings due to the FSA contribution.

### **Step 7: Consider Other Benefits:**

- Remember, not only does an FSA reduce taxable income, but the funds in an FSA can also be withdrawn tax-free when used for qualified expenses. So, there's a double benefit: reducing taxable income and avoiding taxes on withdrawals for qualified expenses.
- Also, remember that HSAs offer not just a current-year tax deduction, but also tax-free growth. While estimating current year tax savings, also consider the long-term tax benefits of allowing the HSA to grow over time, especially if the individual does not plan to withdraw the funds immediately.

### **Things to keep in mind:**

FSAs are typically “use-it-or-lose-it” accounts. This means that if an individual doesn’t use the funds by the end of the plan year (or

grace period if provided by the plan), they could lose the unused funds. It's crucial to not over-contribute.

### **Example of an FSA:**

- *John, a single taxpayer, has an annual gross income of \$60,000.*
- *He expects to have \$2,500 in medical expenses in the upcoming year.*
- *The standard deduction for his filing status in this given year is \$12,550*

*Tax brackets for a single filer in this example:*

*10% on income up to \$9,950*

*12% on income from \$9,951 to \$40,525*

*22% on income from \$40,526 to \$86,375*

### **Scenario Without Using FSA:**

*Taxable Income = Gross Income - Standard Deduction*  
*= \$60,000 - \$12,550 = \$47,450*

*Tax Liability Without FSA:*

*10% on first \$9,950 = \$995*

*12% on the amount from \$9,951 to \$40,525 = \$3,669*

*22% on the amount from \$40,526 to \$47,450 = \$1,522.28*

*Total Tax Liability = \$6,186.28*

### **Scenario With Using FSA:**

*Contribution to FSA = Expected medical expenses = \$2,500*

*Taxable Income = (Gross Income - FSA contribution) -  
Standard Deduction  
= (\$60,000 - \$2,500) - \$12,550 = \$44,950*

#### **Tax Liability With FSA:**

*10% on first \$9,950 = \$995*

*12% on the amount from \$9,951 to \$40,525 = \$3,669*

*22% on the amount from \$40,526 to \$44,950 = \$973.28*

*Total Tax Liability = \$5,637.28*

#### **Projected Tax Savings:**

*Tax Liability Without FSA - Tax Liability With FSA  
= \$6,186.28 - \$5,637.28  
= \$549*

*Result: By contributing \$2,500 to the FSA, John effectively reduces his tax liability by \$549 for the year.*

#### **Example of an HSA:**

- *Alice, a single taxpayer, has an annual gross income of \$50,000.*
- *She's enrolled in a qualifying High Deductible Health Plan (HDHP).*
- *Alice decides to contribute \$3,500 to her HSA this year.*

- The standard deduction for her filing status in this given year is \$12,550.

*Tax brackets for a single filer in the given year:*

*10% on income up to \$9,950*

*12% on income from \$9,951 to \$40,525*

*22% on income from \$40,526 to \$86,375*

### **Scenario Without Using HSA:**

*Taxable Income = Gross Income - Standard Deduction*  
*= \$50,000 - \$12,550 = \$37,450*

*Tax Liability:*

*10% on first \$9,950 = \$995*

*12% on the amount from \$9,951 to \$37,450 = \$3,300*

*Total Tax Liability = \$4,295*

### **Scenario With Using HSA:**

*Contribution to HSA = \$3,500*

*Taxable Income = (Gross Income - HSA contribution) -*  
*Standard Deduction*  
*= (\$50,000 - \$3,500) - \$12,550 = \$33,950*

*Tax Liability:*

*10% on first \$9,950 = \$995*

*12% on the amount from \$9,951 to \$33,950 = \$2,880*

*Total Tax Liability = \$3,875*

***Projected Tax Savings:***

*Tax Liability Without HSA - Tax Liability With HSA*

*= \$4,295 - \$3,875*

*= \$420*

*Result: By contributing \$3,500 to her HSA, Alice effectively reduces her tax liability by \$420 for the year.*

*Application: Calculate estimated tax payments required for an individual to avoid underpayment penalties given a specific planning scenario.*

## **Calculating Estimated Tax Payments for Individuals**

Before diving into calculations, know that estimated tax payments are made quarterly to the IRS by individuals who earn income not subject to withholding, like income from self-employment, interest, dividends, rents, and more.

### **Who Needs to Make Estimated Tax Payments:**

Typically, you need to pay estimated taxes if:

- You expect to owe at least \$1,000 in tax for the year **after** subtracting withholding and credits.
- You expect your withholding and credits to be less than the smaller of:
  - 90% of the tax you'll owe for the current year, or
  - 100% of the tax you owed for the previous year.

### **Step 1: Calculate Your Estimated Tax:**

- **Start with Adjusted Gross Income (AGI):** Estimate your AGI for the year. Consider any changes in your income, deductions, or credits.
- **Subtract Deductions and Credits:** Estimate your deductions (standard/itemized) and applicable credits. Subtract these from your AGI to find taxable income.
- **Apply Tax Rate:** Use the tax tables or rate schedules to calculate your estimated tax liability.

## **Step 2: Determine the Required Annual Payment to Avoid Penalty:**

Use the smaller of:

- 90% of your current year's total tax, or
- 100% of your previous year's total tax (110% if your AGI was more than \$150,000 or \$75,000 if married filing separately).

## **Step 3: Subtract Withholding from Required Annual Payment:**

If you have income subject to withholding (e.g., from wages or retirement distributions), subtract these amounts from the required annual payment calculated in step 2 to determine how much you'll need to pay through estimated taxes.

## **Step 4: Divide by Four for Quarterly Payments:**

Take the amount from step 3 and divide by four. This will give you the amount to pay each quarter.

## **Step 5: Adjust for Seasonal Income (if applicable):**

If your income is not received evenly throughout the year (e.g., you have a seasonal business), you might be able to adjust payments using the Annualized Income Method. This allows you to make payments that correspond with when you earn income.

## **Step 6: Make Payments on Schedule:**

For the most years, payments are generally due:

- 1st Quarter: April 15
- 2nd Quarter: June 15
- 3rd Quarter: September 15
- 4th Quarter: January 15 of the following year

If the date falls on a weekend or holiday, the payment is due the next business day.

## **Step 7: Adjust for Any Overpayment or Underpayment:**

After making your 2nd and 3rd quarter payments, revisit your estimated income and expenses to check if you're on track. If there's a significant change, adjust your 4th quarter payment accordingly.

## **To Avoid Underpayment Penalty:**

If you don't pay enough through withholding and estimated taxes or you don't make the required payments on time, you may be subject to an underpayment penalty.

## **Example:**

- *John is self-employed and does not have any tax withheld from his earnings.*
- *In 20X2, John had an Adjusted Gross Income (AGI) of \$100,000, and his total tax was \$15,000.*
- *For 20X3, he expects his AGI to be \$120,000 due to an increase in business.*

- John estimates that he will take \$12,500 in itemized deductions in 20X3.
- For simplicity, let's assume a flat tax rate of 15% and no credits.

### **Step-by-Step Calculation:**

#### **Step 1: Calculate Estimated Tax for 20X3:**

*Expected AGI for 20X3: \$120,000*

*Subtract Deductions:  $\$120,000 - \$12,500 = \$107,500$   
taxable income*

*Apply Tax Rate:  $\$107,500 \times 15\% = \$16,125$  expected tax for 20X3*

#### **Step 2: Determine Required Annual Payment to Avoid Penalty:**

- 90% of 20X3's expected tax:  $0.90 \times \$16,125 = \$14,512.50$
- 100% of 20X2's total tax (since it's the previous year): \$15,000

*Use the smaller amount: \$14,512.50*

#### **Step 3: Since John has no withholdings:**

*The amount from estimated taxes = \$14,512.50*

**Step 4: Divide by Four for Quarterly Payments:**

$$\$14,512.50 \div 4 = \$3,628.13$$

*John should make estimated tax payments of \$3,628.13 each quarter in 20X3 to avoid underpayment penalties.*

**Step 5: Payments Schedule:**

- 1st Quarter (by April 15): \$3,628.13
- 2nd Quarter (by June 15): \$3,628.13
- 3rd Quarter (by September 15): \$3,628.13
- 4th Quarter (by January 15 of 20X4): \$3,628.13

*Application: Calculate the potential tax savings when donating noncash property to a charitable organization given a specific planning scenario, including identification of the property to be donated to minimize the individual's current-year tax liability.*

## **Calculating Tax Savings from Donating Noncash Property to Charity**

### **Step 1: Determine the Fair Market Value (FMV) of the Property:**

The FMV is generally considered to be the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. For items that have appreciated in value, you may need an appraisal to substantiate the FMV, especially for larger donations.

### **Step 2: Determine the Adjusted Basis:**

For most property, this is the original cost plus any improvements, minus any depreciation taken (if any).

### **Step 3: Determine the Charitable Contribution Deduction:**

- If the property has been held for more than one year (long-term):
  - Deduct the FMV of the property, subject to certain limitations.
- If the property is considered "ordinary income property" (like inventory), the deduction is limited to the adjusted basis or FMV, **whichever is lower**.
- If donating appreciated capital assets (like stocks or real estate), you can generally deduct the FMV.

- If the property has been held for one year or less (short-term):
  - Your deduction is limited to the lesser of FMV or your adjusted basis in the property.

#### **Step 4: Apply AGI Limitations:**

- Your deduction for charitable contributions of noncash property may be limited based on your Adjusted Gross Income (AGI).
- Generally, the limit is 50% of your AGI for public charities and certain private foundations.
- For donations of appreciated capital assets to public charities, the limit is usually 30% of AGI.
- Contributions exceeding these limits can typically be carried over for up to 5 years.

#### **Step 5: Calculate the Tax Savings:**

Multiply the allowable charitable deduction by the taxpayer's marginal tax rate.

*For example, if the deductible amount is \$10,000 and the taxpayer's marginal tax rate is 24%, the potential tax savings would be \$2,400 ( $\$10,000 \times 0.24$ ).*

#### **Step 6: Consider Other Tax Implications:**

Donating property may have other tax implications such as:

Avoiding capital gains tax on appreciated property.

Impact on state taxes.

## Step 7: Reporting on Tax Return:

- For donations over \$5,000 (excluding publicly traded securities), a qualified appraisal may be required, and you must fill out IRS Form 8283 and attach it to your return.
- Report noncash charitable contributions on Schedule A of Form 1040 if itemizing deductions.

### ***Example:***

*Amy owns shares in a tech company. She bought these shares 5 years ago for \$5,000. Today, the shares are worth \$20,000. Amy is in the 24% federal income tax bracket and wants to donate these shares to her favorite charity.*

*Let's calculate the potential tax savings:*

### ***Step 1: Determine the Fair Market Value (FMV) of the Property.***

*The shares are currently worth \$20,000.*

### ***Step 2: Determine the Adjusted Basis.***

*Amy's adjusted basis in the shares is \$5,000 (the amount she originally paid for them).*

### **Step 3: Determine the Charitable Contribution Deduction.**

*Since Amy held the shares for more than one year, they are considered long-term capital assets. She can generally deduct the FMV of the shares.*

*Deductible amount = \$20,000.*

### **Step 4: Apply AGI Limitations.**

*Assume Amy is donating to a public charity. The limit for donating appreciated capital assets to public charities is 30% of AGI.*

*For simplicity, let's assume Amy's AGI is \$100,000.*

*Maximum deduction based on AGI = 30% of \$100,000 = \$30,000.*

*Since her contribution (\$20,000) is less than \$30,000, she can deduct the entire \$20,000.*

### **Step 5: Calculate the Tax Savings.**

*Potential tax savings = deductible amount x taxpayer's marginal tax rate.*

*Tax savings = \$20,000 x 24% = \$4,800.*

### *Benefits:*

- *Amy receives a tax savings of \$4,800 due to the charitable contribution deduction.*
- *Amy avoids paying capital gains tax on the \$15,000 appreciation (\$20,000 - \$5,000) in the shares.*

*In this example, by donating her appreciated shares to charity, Amy can achieve a significant reduction in her current-year tax liability, both from the charitable deduction and from avoiding capital gains tax.*

When an individual has multiple properties or investments, each might have different tax implications. By specifically identifying which property or asset to donate, the taxpayer can optimize the tax benefits from the donation. Here's a breakdown:

### **Appreciated vs. Depreciated Property:**

- **Appreciated Property:** Donating property that has appreciated in value (e.g., stocks or real estate) can provide significant tax benefits. If the donor has held the asset for more than one year, they generally can deduct the fair market value of the property without recognizing the capital gain on the appreciation. This means they avoid paying capital gains tax on the increase in value.
- **Depreciated Property:** If a taxpayer has property that has decreased in value, it might be more beneficial from a tax perspective to sell the asset, recognize the capital loss (which can offset other capital gains or, to a limited extent, ordinary income), and then donate the cash proceeds to the

charity. This way, the taxpayer gets both the capital loss deduction and the charitable contribution deduction.

### **Holding Period:**

As mentioned earlier, the length of time the donor has held an asset can affect its tax treatment upon donation. Long-term held assets (more than one year) might provide a bigger tax benefit than short-term assets because the deduction is generally the fair market value for long-term assets versus the cost basis for short-term assets.

### **Type of Property:**

Different types of property have different tax implications. For example, donating tangible personal property that is related to a charity's exempt function (like donating a painting to a museum) might allow a deduction at the full fair market value. However, if the property is not related to the charity's mission, the deduction might be limited to the cost basis.

### **Type of Charitable Organization:**

The tax benefits can also vary based on the type of charity. Donations to public charities usually have more favorable AGI limitations compared to donations to private foundations.

### **Potential Income Production:**

If a taxpayer has an asset that produces income (like dividend-paying stocks), they might consider whether they want to continue receiving that income or whether donating the asset and getting the tax deduction is more beneficial.

**Consideration of Future Tax Rates:**

If a taxpayer believes that their tax rate might be higher in future years, they might decide to hold off on donating certain assets now and donate in a later year when the tax benefit could be greater.

*Analysis: Review an individual's projected income and expenses prior to year end to determine the tax implications, and provide options to minimize tax liability given a specific planning scenario.*

### **Step 1: Gather Relevant Information:**

- Obtain the individual's prior year tax return. This will serve as a starting point.
- Collect information on any significant financial changes during the year (e.g., sale of property, inheritance, or changes in employment).

### **Step 2: Classify Income and Deductions:**

#### **Income:**

- Wages and Salaries
- Interest and Dividend Income
- Capital Gains/Losses
- Business Income
- Rents and Royalties
- Other income sources

#### **Deductions:**

- Itemized Deductions (e.g., mortgage interest, state taxes, charitable donations)
- Standard Deduction
- Above-the-line Deductions (e.g., student loan interest, contributions to certain retirement accounts)

### **Step 3: Project Annual Totals:**

- Annualize any year-to-date amounts to project full-year figures.
- Consider any seasonality or special events (e.g., bonus in December) that might impact the projections.

### **Step 4: Determine Tax Implications:**

- Apply the projected income against the current year's tax brackets to estimate tax liability.
- Evaluate the impact of any tax credits the individual might qualify for.
- Determine if there are any Alternative Minimum Tax (AMT) implications.
- Calculate the estimated self-employment tax, if applicable.

### **Step 5: Identify Tax Minimization Opportunities:**

#### **Determine the Timing:**

- Decide whether certain income or expenses should be deferred or accelerated:
- For instance, if the individual expects to be in a lower tax bracket next year, consider deferring income.
- Conversely, if they anticipate a higher bracket next year, they might accelerate income into the current year.

#### **Maximize Deductions:**

- Contribute to retirement accounts (e.g., 401(k), IRA).
- Bunch itemized deductions in one year to exceed the standard deduction (if feasible).

## **Tax-efficient Investments:**

- Consider tax-free bonds or other tax-efficient investments.
- Review investment portfolio for tax loss harvesting opportunities.

## **Gift Strategy:**

Consider gifting to reduce the taxable estate or to shift income to family members in lower tax brackets.

## **Example:**

*Jane Doe is a single taxpayer. She has **projected Income** consisting of:*

- *Salary: \$90,000*
- *Dividend Income: \$2,000*
- *Interest from Savings Account: \$500*
- *Rental Income (after expenses): \$15,000*

## **Projected 20X3 Deductions:**

- *Mortgage Interest: \$7,000*
- *State Taxes Paid: \$4,500*
- *Charitable Donations: \$3,000*

## **Analysis and Recommendations**

### **Step 2 (from above): Classify Income and Deductions:**

#### **Income:**

*Total projected income: \$107,500 (\$90,000 + \$2,000 + \$500 + \$15,000)*

***Deductions:***

*Total itemized deductions: \$14,500 (\$7,000 + \$4,500 + \$3,000)*

*In this example, the standard deduction for a single filer is \$12,950. Since Jane's itemized deductions exceed this amount, she will itemize.*

***Determine Tax Implications:***

*Using a hypothetical tax bracket for single filers, Jane's tax on her salary of \$90,000 falls in the 24% bracket. However, remember that the U.S. uses a progressive tax system, meaning not all her income will be taxed at that rate.*

*Her dividend, interest, and rental income will also have their respective tax rates.*

### **Identify Tax Minimization Opportunities:**

- **Retirement Contributions:** *If Jane hasn't maxed out her 401(k) or IRA contributions, she could contribute more, reducing her taxable income.*
- **Rental Property:** *Jane might consider making improvements to her rental property, which could provide additional depreciation benefits or offset rental income.*
- **Investment Review:** *If Jane has unrealized capital losses in her investment portfolio, she might consider tax loss harvesting to offset her dividend income.*
- **Charitable Contributions:** *If Jane is inclined, she can make additional charitable donations before the year-end. She could also consider donating appreciated stock from her investment portfolio, which could offer a dual benefit: getting a deduction at the stock's market value and avoiding capital gains tax on the appreciation.*

## B. Compliance for Passive Activity and At-Risk Loss Limitations (Excluding Tax Credit Implications)

*Application: Calculate the at-risk loss limitation for an activity in which an individual materially participates, including losses from pass-through entities and losses from real estate rental activities with active participation.*

### **At-Risk Loss Limitation for Pass-Through Entities and Rental Real Estate Activities**

The at-risk rules limit the amount of loss an individual can deduct from certain business or income-producing activities in which they materially participate. Losses that aren't deductible because of the at-risk rules are carried over to the next year and are deductible against at-risk income from that activity in that year.

#### **Pass-Through Entities:**

- Sole proprietorships
- S Corporations
- Limited partnerships and other partnerships (to the extent an individual partner materially participates)

#### **Step 1: Determining Material Participation:**

To determine material participation, one must be involved in the operations of the activity on a regular, continuous, and substantial basis. There are multiple tests to meet material participation, but commonly, **if an individual works more than 500 hours in the business during the year, they will be considered as materially participating.**

## **Step 2: Calculating the At-Risk Amount:**

The at-risk amount generally includes:

- Money contributed by the individual to the activity.
- Borrowed amounts for which the individual is personally liable.
- Borrowed amounts for which the individual has pledged property (other than property used in the activity) as security.

### **Not At-Risk Amounts:**

- Amounts borrowed from a person who has an interest in the activity (other than as a creditor) or from someone related to a person (other than the borrower) with such an interest.
- Amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements.

## **Step 3: Applying the Limitation:**

- Calculate your total at-risk investment at the end of the year.
- Determine your share of the entity's/rental activities annual loss.
- Deduct the lesser of your total at-risk amount or your share of the annual loss from the activity.
- If the at-risk amount is less than the entire loss for the year, the difference is carried forward and may be deducted in a later year when there is sufficient at-risk amount or the activity generates income.

## Step 4: Reporting and Documentation:

Losses limited by the at-risk rules should be reported on IRS Form 6198, "At-Risk Limitations". This form will help determine the deductible loss, if any, for the year, and the amount of loss carried over, if any.

### Important Notes:

- When the individual disposes of their interest in the activity, the amounts not previously allowed as a deduction due to at-risk limitations become deductible.
- At-risk rules apply at the individual level, even for pass-through entities.
- Always differentiate between passive activity limitations and at-risk limitations as they're two separate provisions, both of which could limit the deductibility of losses.

### **Example:**

*John is a CPA who also owns a rental property. He actively participates in the property's management, spending over 500 hours annually, so he's considered to materially participate in the rental activity. The property generates a loss of \$25,000 this year. At the beginning of the year, his at-risk amount for this activity was \$15,000.*

### *Breakdown of John's At-Risk Amount:*

- *Initial cash investment: \$10,000*
- *Personal loan where he's personally liable: \$5,000*

### *Non At-Risk Amount:*

- *Nonrecourse loan (a loan where John isn't personally liable, and the lender's only recourse is the property itself): \$20,000*

### ***Applying the At-Risk Rules:***

***Determine the Deductible Loss:*** Compare the loss from the activity to John's at-risk amount. The lesser of the two is the deductible loss.

- *Loss from activity: \$25,000*
- *John's at-risk amount: \$15,000*
- *John can deduct \$15,000.*

***Calculate the Non-Deductible Loss:*** Subtract the deductible loss from the total loss to determine the amount that John can't currently deduct due to the at-risk rules.

*Total loss: \$25,000*

*Deductible loss: \$15,000*

*Non-deductible loss = \$25,000 - \$15,000 = \$10,000*

*This \$10,000 is carried forward to the next year. If John increases his at-risk amount next year or if the property generates income, he may be able to deduct some or all of this carried-forward loss.*

*Application: Calculate the passive activity loss limitations given a specific scenario, including the netting of passive activity gains and losses.*

## **Passive Activity Loss Limitations**

A passive activity is any activity in which the taxpayer does not "materially participate." This typically includes rental real estate and business activities in which the taxpayer isn't significantly involved.

### **Understanding Passive Activity Loss (PAL):**

PAL arises when the expenses from all passive activities exceed the income from those activities. The tax law limits the ability to use these losses to offset other types of income (like wages or portfolio income).

### **General Rule:**

**Losses from passive activities can only offset income from passive activities.** If you have a net passive loss, you cannot use it to reduce your non-passive income.

### **Step 1: Calculating Passive Activity Gains and Losses:**

- List all your passive activities.
- For each activity, determine the income or loss.
- Net all passive incomes and losses together.

### **Step 2: Applying the Limitation:**

- **Net Passive Income:** You'll report and pay tax on this income.

- **Net Passive Loss:** You can't deduct this loss against non-passive income. You'll carry it forward to future years until you have enough passive income to offset it or you dispose of the activity.
- **Exception - Real Estate Professionals:** There's an exception to the PAL rules for real estate professionals. If you meet **both** the following specific criteria, you may be able to treat rental real estate activities as non-passive.
  - **More than 50% of personal services:** The taxpayer must spend more than half of their "personal service" time (i.e., working hours) in real property trades or businesses in which they materially participate.
  - **Material participation in real property trade or business:** The taxpayer must perform more than 750 hours of services during the tax year in real property trades or businesses in which they materially participate.

### Form 8582:

This is the form used to calculate the allowable PAL for the tax year. It helps in:

- Calculating total passive activity income and losses.
- Determining the amount of PAL that can be claimed in the current year.
- Computing any carryforward amounts.

### Example:

*Jane has investments in three different passive activities:*

- **Rental Property A:** This property earned a net rental income of \$5,000 this year.
- **Rental Property B:** This property incurred a net loss of \$12,000 due to significant repairs.
- **Limited Partnership in a friend's business:** Jane is not actively involved in this business. This year, her share of the business income was \$3,000.

### **Calculation:**

To determine Jane's overall passive activity gains and losses, we'll simply net the income and losses from each of her passive activities:

Rental Property A: +\$5,000 (gain)

Rental Property B: -\$12,000 (loss)

Limited Partnership: +\$3,000 (gain)

Net Passive Activity Result = \$5,000 + (-\$12,000) + \$3,000  
= \$4,000 (loss)

Jane has a **net passive activity loss of \$4,000** for the year.

### **Tax Implications:**

Since Jane has a net passive loss, she cannot use the \$4,000 loss to offset her non-passive income, such as wages from her day job or interest and dividends from investments.

*This \$4,000 loss can be carried forward to future years, where she can offset it against passive income in those years.*

*If Jane had a net passive gain instead, she would report and pay tax on that income.*

*Application: Calculate utilization of suspended losses on the disposition of a passive activity for tax purposes.*

## **Suspended Losses:**

When passive activity losses (PALs) exceed passive activity income in a given year, these losses are not deductible against other types of income (like wages or portfolio income). Instead, they're "suspended" and carried forward to be used in future tax years against passive income or upon the disposition of the passive activity.

## **Disposition of a Passive Activity:**

When you dispose of your entire interest in a passive activity, there are special rules that apply, especially regarding the treatment of suspended losses.

## **How Suspended Losses are Used in Disposition:**

- **Full Disposition to Unrelated Party:** If you dispose of your entire interest in a passive activity to an unrelated party in a fully taxable transaction, any suspended losses related to that activity become fully deductible in that year. These losses can offset any type of income on your tax return, not just passive income.
- **Partial Dispositions:** If only a part of the activity is disposed of, a proportional amount of the suspended losses become deductible.
- **Installment Sales:** If the disposition occurs via an installment sale, the suspended losses are realized proportionally with the principal payments received.

## Tax Reporting and Form 8582:

The IRS Form 8582, "Passive Activity Loss Limitations", is used to calculate and report PALs, including any previously suspended losses. When disposing of a passive activity:

- Report the income or loss from the disposition on the appropriate form/schedule (like Schedule D or Form 4797).
- Also report any previously suspended losses on the same form/schedule, allowing them to offset any other type of income.

### Example:

*John has a passive rental property that he has not materially participated in for several years. Over the years, he's accumulated \$25,000 in suspended losses because the rental expenses exceeded the rental income. In the current year, John sells the property to an unrelated party for a \$20,000 gain.*

### Outcome:

*Upon sale, the \$25,000 of suspended losses is released. John will report the \$20,000 gain and can use the \$25,000 of losses against it. This results in a net loss of \$5,000, **which can offset other income on John's tax return.***

*Analysis: Review an individual's basis schedules and supporting documentation for a pass-through entity, including any source data used to create the schedules, to confirm the correct allocation of a loss between the amounts suspended for at-risk limitations, suspended for passive activity rules, and allowed for tax purposes.*

**Example:**

*Jane Doe has basis in an S Corporation called JD Real Estate, LLC.*

**Initial Document Review:**

- **K-1 from JD Real Estate, LLC:** Reports a total loss of \$100,000 to be allocated to Jane.
- **Basis Schedule provided by Jane for prior year-end:** Indicates a total adjusted basis in JD Real Estate, LLC of \$70,000.
- **Loan Documentation:** Indicates a nonrecourse loan of \$30,000. Jane has personally guaranteed this loan.

**Analysis:**

**1. Review At-Risk Limitations:**

- *Jane's at-risk amount includes her basis in the entity and any amounts she is personally liable for.*
- *From the documents, Jane's at-risk amount is her basis (\$70,000) plus her personally guaranteed loan (\$30,000) = \$100,000.*
- *As the at-risk amount (\$100,000) equals the reported loss from the K-1 (\$100,000), no losses need to be suspended due to at-risk limitations.*

## **2. Review Passive Activity Limitations:**

- *Determine if Jane materially participates in JD Real Estate, LLC.*
- *Jane provides a log showing 500 hours spent on real estate activities for JD Real Estate, LLC, indicating material participation (assuming she meets one of the tests for material participation).*
- *As Jane materially participates, there's no loss suspension due to passive activity rules.*

## **3. Allocate Loss:**

*\$0 of the loss is suspended for at-risk limitations.*

*\$0 of the loss is suspended for passive activity rules.*

*\$100,000 of the loss is allowed for tax purposes.*

## C. Gift Taxation Compliance and Planning

*Remembering and Understanding: Recall allowable gift tax deductions and exclusions for federal gift tax purposes.*

### 1. Annual Exclusion:

There is an annual exclusion for each tax year.

This means you can gift up to a given amount to any individual, and any number of individuals, each year without incurring the gift tax.

This amount is adjusted periodically for inflation, but in 2025 the gift tax exclusion is \$19,000.

### 2. Spousal Deduction:

Gifts made to a spouse who is a U.S. citizen are generally unlimited and do not incur gift tax due to the unlimited marital deduction.

However, gifts to a non-U.S. citizen spouse have an annual exclusion limit.

### 3. Charitable Deduction:

Gifts made to qualifying charities are deductible from the total gifts made in the year.

This means if you give a gift to a **qualifying** charitable organization, it won't be subject to gift tax.

#### **4. Educational Exclusion:**

Payments **made directly to educational institutions** for someone's tuition (but not room, board, books, or other related expenses) are excluded from the gift tax.

It's crucial that the payment is made **directly** to the institution.

#### **5. Medical Exclusion:**

Payments made **directly** to a medical care provider for someone's medical care are excluded from gift tax.

This includes expenses like medical insurance premiums.

#### **6. Unified Credit:**

In addition to annual exclusions, each individual has a lifetime gift tax exemption. This is combined with the individual's estate tax exemption.

Gifts that exceed the annual exclusion will reduce this lifetime exemption amount.

#### **7. Gift Splitting:**

Married couples can split gifts. This means if one spouse gives a gift to a third party, the gift can be considered as made one-half by each.

This allows for double the annual exclusion amount to be gifted without reducing the lifetime exemption.

## **Gift Tax Return (Form 709):**

If the total gifts to one individual exceed the annual exclusion or if you want to split gifts with your spouse, you'll generally need to file Form 709, even if no gift tax is owed.

This helps to keep track of your lifetime exemption.

*Application: Calculate the amount of taxable gifts for federal gift tax purposes.*

To calculate the amount of taxable gifts for federal gift tax purposes, a CPA would typically follow these steps:

**Step 1: Determine the total amount of gifts made during the tax year:**

The CPA would first determine the total amount of gifts made by the taxpayer during the tax year. This includes all gifts of present interests and certain gifts of future interests.

**Step 2: Subtract the annual exclusion amount:**

The CPA would then subtract the annual exclusion amount from each separate gift made. So if the annual exclusion was \$15,000, and you gave a gift of \$20,000 to one relative and \$10,000 to another relative, they are each calculated separately. The \$20,000 gift would have \$5,000 that then went against your lifetime exclusion, and would require filing form 709, and the \$10,000 gift would all be covered by the \$15,000 annual exclusion amount. You can't "combine" gifts of varying amounts to stay under the exclusion, the exclusion applies on a per-gift basis.

**Step 3: Apply the unified credit:**

The CPA would then apply the unified credit against any remaining taxable gifts. Any gifts made in excess of the annual exclusion may be offset by the unified credit.

## Step 4: Calculate the gift tax:

If there are any remaining taxable gifts after applying the annual exclusion and unified credit, the CPA would calculate the gift tax owed using the given gift tax rate.

### Example:

- *John is single.*
- *He has never given taxable gifts before, so his entire lifetime exemption of \$12,060,000 (in this example) is intact.*
- *In this example, the annual exclusion is \$15,000*

*In the tax year, John made the following gifts:*

- *\$20,000 to his friend, Steve.*
- *\$50,000 to his daughter, Amy.*
- *\$20,000 to pay for his niece's college tuition, paid directly to the university.*
- *\$30,000 to pay for his nephew's medical bills, paid directly to his nephew.*

### Determine Gifts Subject to the Annual Exclusion:

- *John gave Steve \$20,000. The first \$15,000 is covered by the annual exclusion, leaving \$5,000 as potentially taxable.*
- *For Amy, the first \$15,000 of the \$50,000 is covered by the annual exclusion, leaving \$35,000 as potentially taxable.*

### **Consider Direct Payments for Medical and Educational Exclusions:**

- The \$20,000 for his niece's tuition is excluded since it was paid directly to the educational institution.
- The \$30,000 for his nephew's medical bills is NOT all excluded because it was paid directly to his nephew instead of to the medical provider. Only the first \$15,000 is covered by the annual exclusion.

### **Calculate Total Potentially Taxable Gifts:**

- From Steve's gift: \$5,000
- From Amy's gift: \$35,000
- From nephew's gift: \$15,000
- Total:  $\$5,000 + \$35,000 + \$15,000 = \$55,000$

### **Account for the Unified Credit (Lifetime Exemption):**

Since John hasn't given any taxable gifts before, his entire \$12,060,000 lifetime exemption is available. The \$55,000 of taxable gifts will reduce this lifetime exemption, but won't trigger any gift tax because it's well below the threshold.

New lifetime exemption =  $\$12,060,000 - \$55,000 = \$12,005,000$ .

### **Determine Gift Tax Owed:**

Since John's cumulative taxable gifts have not exceeded his lifetime exemption, he doesn't owe any gift tax for the current tax year.

***Filing Requirement:***

*Although John doesn't owe any gift tax, he needs to file Form 709 because he made gifts to Steve, Amy, and his nephew that exceeded the annual exclusion amount.*

*Application: Identify the potential tax savings from gifting ownership of noncash property to an individual given a specific planning scenario, including identification of the property to be gifted to minimize the donor's future estate.*

## **Tax Savings from Gifting Noncash Property**

### **1. Identify Appreciated Assets:**

- Start by identifying assets that have appreciated significantly since their acquisition. Gifting these can be beneficial because any future appreciation will be outside of the donor's estate.
- Examples include stocks, real estate, or valuable collectibles.

### **2. Understand Capital Gains Implications:**

Unlike with bequests at death, gifted assets carry over the **donor's original cost basis** to the recipient.

If the recipient sells the gifted asset in the future, they'll recognize capital gains based on the donor's original cost basis. It's essential to weigh this potential capital gains tax against the estate tax savings.

### **3. Assess the Income Tax Bracket of the Recipient:**

If the recipient is in a lower income tax bracket, the capital gains tax upon selling the gifted asset might be lower than if the donor sold the asset themselves.

#### **4. Consider Potential Estate Tax Savings:**

By removing appreciating assets from the donor's estate, potential future estate tax can be reduced. This is especially relevant if the donor's estate is close to or exceeds the federal estate tax exemption limit.

#### **5. Utilize Annual Exclusion and Lifetime Exemption:**

Amounts over the annual exclusion count against the donor's lifetime gift and estate tax exemption. Use this strategically to reduce the size of the donor's taxable estate.

#### **6. Evaluate the Potential Reduction in the Donor's Estate:**

- Calculate the future potential value of the gifted assets within the donor's estate versus outside the estate.
- Factor in expected appreciation, potential income generation, and any other financial implications.

#### **7. Consider Family Dynamics and Financial Needs:**

While tax savings are essential, also consider the family dynamics. Will gifting create any conflicts among family members? Does the donor need the income or value from the asset for future living expenses?

#### **8. Factor in Generation-Skipping Transfer (GST) Tax:**

If gifting to a person two or more generations younger (like a grandchild), consider the implications of the GST tax. This is an additional tax that applies to transfers to generations below the children of the donor.

## **Example:**

*Donor: Mrs. Clarke, aged 70*

*Recipient: Her daughter, Jessica, aged 40*

*Asset under consideration: A rental property Mrs. Clarke purchased 20 years ago for \$200,000. Its current market value is \$800,000. She expects the property to appreciate significantly over the next decade.*

*Mrs. Clarke's overall estate, including the rental property, is worth \$11,000,000, close to the federal estate tax exemption limit of \$12,060,000 for this example.*

*Jessica is in the 15% capital gains tax bracket, while Mrs. Clarke is in the 20% bracket.*

### **Steps:**

#### **Step 1: Identify Appreciated Assets:**

*The rental property, which was bought for \$200,000 and is now worth \$800,000, has seen substantial appreciation.*

#### **Step 2: Understand Capital Gains Implications:**

*If Jessica sells the property immediately after receiving it, she'll recognize a gain of \$600,000 (\$800,000 - \$200,000).*

#### **Step 3: Assess the Income Tax Bracket of the Recipient:**

*Since Jessica is in the 15% capital gains tax bracket, she'd owe less tax on the sale of the property than her mother would.*

#### **Step 4: Consider Potential Estate Tax Savings:**

*If the property appreciates to, say, \$1,200,000 over the next decade, gifting it now would exclude this extra \$400,000 from Mrs. Clarke's future estate.*

#### **Step 5: Utilize Annual Exclusion and Lifetime Exemption:**

*Mrs. Clarke can utilize her \$15,000 annual exclusion. The remaining \$785,000 of the property's value will count against her lifetime exemption, reducing it to roughly \$11,275,000 million (\$12,060,000 - \$785,000).*

#### **Step 6: Evaluate the Potential Reduction in Mrs. Clarke's Estate:**

*With the gifting, her estate immediately reduces by \$800,000 to \$10.2 million. Further, any future appreciation of that property won't impact her estate.*

#### **Step 7: Consider Family Dynamics and Financial Needs:**

*Mrs. Clarke is financially stable without needing income from the rental property. The family agrees with the decision, seeing the long-term tax benefits.*

#### **Step 8: Factor in GST Tax:**

*Since the gift is to her daughter and not a grandchild, GST tax is not a concern here.*

## D. Personal Financial Planning for Individuals

*Remembering and Understanding: Demonstrate an understanding of the advantages and disadvantages of different qualified retirement plans, including traditional IRAs, Roth IRAs, 401(k)s, annuities, and employer-sponsored plans.*

### Traditional IRAs (Individual Retirement Accounts)

#### Advantages:

- **Tax Deductions:** Contributions are typically tax-deductible in the year they're made, reducing current taxable income.
- **Tax-Deferred Growth:** Earnings and gains grow tax-deferred until withdrawn.
- **Flexible Investments:** You can choose from a wide range of investments (stocks, bonds, mutual funds, etc.).
- **Rollover Options:** You can roll over funds from other retirement accounts into a traditional IRA.

#### Disadvantages:

- **Required Minimum Distributions (RMDs):** Mandatory withdrawals start at age 72.
- **Penalties for Early Withdrawal:** Withdrawals before age 59½ are subject to a 10% penalty (with some exceptions).
- **Taxable Withdrawals:** Withdrawals in retirement are taxed as ordinary income

## Roth IRAs

### Advantages:

- **Tax-Free Growth and Withdrawals:** Qualified distributions are tax-free since contributions are made with after-tax money.
- **No RMDs:** Unlike traditional IRAs, there are no required minimum distributions.
- **Flexible Investments:** Like traditional IRAs, there's a wide choice in investment options.
- **Estate Planning Benefits:** Beneficiaries can inherit and stretch out tax-free distributions.

### Disadvantages:

- **Income Limits:** Higher earners might be restricted or prohibited from contributing.
- **No Tax Break for Contributions:** Contributions are not tax-deductible.
- **Penalties for Early Withdrawal:** Non-qualified withdrawals of earnings before age 59½ are subject to taxation and a 10% penalty (with some exceptions).

## 401(k)s

### Advantages:

- **Higher Contribution Limits:** Often higher than IRAs.
- **Employer Match:** Many employers offer matching contributions.
- **Tax Deductions and Tax-Deferred Growth:** Similar to traditional IRAs.
- **Loan Options:** Some plans allow participants to borrow from their account.

### **Disadvantages:**

- **Limited Investment Options:** Unlike IRAs, investment choices are often limited.
- **Potential for High Fees:** Administrative and management fees can be higher than other options.
- **Penalties for Early Withdrawal:** Like IRAs, early withdrawals can result in penalties.

### **Annuities**

#### **Advantages:**

- **Guaranteed Income:** Can provide a steady stream of income for a set period or for life.
- **Tax-Deferred Growth:** Earnings grow tax-deferred.
- **No Annual Contribution Limits:** Unlike IRAs and 401(k)s.

#### **Disadvantages:**

- **Complex and Expensive:** Often have high fees and complex rules.
- **Penalties for Early Withdrawal:** Withdrawing before a certain age can result in hefty surrender charges.
- **Potential for Limited Returns:** Depending on the type, returns might not keep up with inflation.

### **Employer-Sponsored Plans (e.g., SEP IRAs, SIMPLE IRAs, Pension Plans)**

#### **Advantages:**

- **Higher Contribution Limits:** Often, especially for SEP IRAs.
- **Tax Benefits:** Contributions are often tax-deductible, and growth is tax-deferred.
- **Simplified Administration:** Especially for SIMPLE IRAs.

- **Attracts and Retains Employees:** Can be used as a tool for hiring and employee retention.

**Disadvantages:**

- **Mandatory Contributions:** For some plans, the employer is required to make contributions.
- **Complex Rules and Regulations:** Especially for pension plans and defined benefit plans.
- **Potential for Limited Investment Options:** Depending on the specific plan.

*Remembering and Understanding: Demonstrate an understanding of the risks associated with different investment options, including equity securities, corporate bonds and municipal bonds.*

Equity Securities (Stocks), Corporate Bonds, and Municipal Bonds all have these risks:

### **Equity Securities (Stocks)**

Equity securities represent ownership in a company. When you buy a company's stock, you're purchasing a piece of that company.

#### **Risks:**

- **Market Risk:** The risk that the entire market will decline, which can lead to a decrease in the stock's price.
- **Company or Business Risk:** The risk associated with the specific company you've invested in. If the company performs poorly or faces bankruptcy, the stock's value may decrease.
- **Liquidity Risk:** The risk that you may not be able to sell the stock quickly enough when its price is falling.
- **Volatility Risk:** Stocks can be volatile. The price can go up or down rapidly in short periods.
- **Interest Rate Risk:** Rising interest rates can lead to falling stock prices, especially for companies with high levels of debt.
- **Inflation Risk:** Over time, the return on stocks may not compensate for inflation, eroding purchasing power.

- **Currency Risk:** Relevant for stocks of companies that do significant business internationally. Fluctuations in currency values can impact the stock's returns.

## Corporate Bonds

Corporate bonds are debt securities issued by corporations to raise capital. Bondholders are creditors to the corporation.

### Risks:

- **Credit (or Default) Risk:** The risk that the company will fail to meet its obligations and default on its debt payments.
- **Interest Rate Risk:** When interest rates rise, bond prices fall, and vice versa. This can impact the market value of a bond if you need to sell before maturity.
- **Reinvestment Risk:** The risk that when a bond's interest payments are received, they will have to be reinvested at a lower interest rate if rates have fallen.
- **Liquidity Risk:** Some corporate bonds might not be as easily tradable as others, making them harder to sell at a desirable price.
- **Call Risk:** Some bonds can be "called" or paid off before their maturity by the issuer. This can be done when interest rates drop, forcing the investor to reinvest at a lower rate.
- **Inflation Risk:** The fixed interest payments might be worth less in real terms if inflation rises significantly.

## Municipal Bonds

Municipal bonds are issued by state or local governments or related entities. They are often used to fund public projects.

### Risks:

- **Credit Risk:** While generally seen as safer than corporate bonds, municipal bonds still carry the risk that the issuer will default.
- **Interest Rate Risk:** Like all bonds, the price of municipal bonds can drop when interest rates rise.
- **Reinvestment Risk:** Similar to corporate bonds, there's a risk of having to reinvest at a lower rate.
- **Liquidity Risk:** Some municipal bonds, especially those from smaller municipalities, can be less liquid.
- **Call Risk:** Municipal bonds can also be callable, posing reinvestment risks.
- **Tax-Bracket Changes:** One of the appeals of municipal bonds is their tax-exempt status. However, if an investor's tax bracket changes, the benefits might differ.
- **Legislative Risk:** Changes in tax laws or other regulations can impact the attractiveness and value of municipal bonds.

*Remembering and Understanding: Demonstrate an understanding of planning for funding post-secondary education, including qualified tuition programs, student loans, grants and scholarships.*

### **1. Assess the Total Expected Cost:**

- Tuition and Fees: Gather information about the tuition and other fees associated with the chosen education institution.
- Living Expenses: Factor in housing, meals, transportation, books, and supplies.

### **2. Start Early with Savings:**

- Regular Savings Account: Begin by setting aside money regularly in a basic savings account.
- Qualified Tuition Programs (529 Plans):
  - Prepaid Tuition Plans: Allows you to purchase units of tuition for future use at today's rates.
  - Education Savings Account (ESA): Can be used for both post-secondary education and K-12 expenses.
  - Advantages: Earnings grow tax-deferred and withdrawals for qualified education expenses are tax-free.

### **3. Research Scholarships and Grants:**

- Scholarships: Offered based on academic achievement, talents, or other criteria.
- Grants: Typically need-based financial awards that don't need to be repaid.
- Application: Start early, meet deadlines, and ensure all required documentation is provided.

#### 4. Consider Work-Study Programs:

- Federal Work-Study: Provides part-time jobs for undergraduate and graduate students with financial need.
- School-sponsored Work-Study: Some colleges offer their work-study programs.

#### 5. Understand the Different Types of Student Loans:

- Federal Loans: Often have more favorable terms than private loans.
- Subsidized Stafford Loans: Interest is paid by the government while the student is in school.
- Unsubsidized Stafford Loans: Interest accumulates while the student is in school.
- PLUS Loans: For parents and graduate students. PLUS loans can help cover education expenses not covered by other financial aid.
- Private Loans: Offered by banks or other financial institutions and might have higher or variable interest rates.

#### 6. Take Advantage of Tax Benefits:

- **American Opportunity Tax Credit (AOTC):** A credit for qualified education expenses for the first four years of higher education.
- **Lifetime Learning Credit (LLC):** For qualified tuition and related expenses with no limit on the number of years you can claim it.
- **Student Loan Interest Deduction:** Allows you to deduct the interest paid on student loans.

## **7. Evaluate Education Institutions:**

- In-State vs. Out-of-State: In-state public colleges usually cost less for residents.
- Community College: Consider starting at a community college and then transferring to a four-year institution.
- Online Courses: May offer more affordable options for some programs.

## **8. Graduate On Time:**

Focus on meeting academic requirements to graduate as scheduled, avoiding additional semesters or years of expenses.

*Remembering and Understanding: Explain how insurance is used in planning to mitigate risk, including life insurance, long-term care insurance and umbrella policies.*

## **Insurance in Risk Mitigation Planning**

### **Understanding Risk:**

Risk is the potential for unexpected, adverse financial events. The primary objective of insurance is to transfer specified risks from an individual or business to an insurance company, which pools the risks of many clients.

### **Life Insurance:**

Life insurance provides beneficiaries with monetary compensation upon the death of the insured.

### **Types of Life Insurance:**

- **Term Life Insurance:** Provides coverage for a specific term (e.g., 10, 20, or 30 years). No cash value accrues.
- **Whole Life Insurance:** Provides coverage for the lifetime of the insured and can accumulate cash value.

**Tax Implications:** Generally, life insurance proceeds are tax-free to beneficiaries. The cash value growth within a permanent life insurance policy is tax-deferred.

**Planning Uses:** Can be used for family support, business succession, estate liquidity, or as a wealth transfer tool.

## **Long-Term Care Insurance:**

Covers the costs of long-term care services, such as assisted living, home care, and nursing home care.

**Tax Implications:** Premiums may be deductible (subject to limits), and benefits received are generally tax-free up to a certain limit.

**Planning Uses:** Protects personal assets from potential depletion due to long-term care costs and ensures that quality care is affordable.

## **Umbrella Policies:**

Provides additional liability coverage beyond the limits of homeowners, auto, and other standard insurance policies.

Starts where other insurance ends. If you're liable for damages that exceed the liability limits of other policies, an umbrella policy covers the excess.

Typically sold in increments of \$1 million and are relatively inexpensive given the amount of coverage.

**Tax Implications:** Premiums for personal umbrella policies are not deductible. However, if the policy covers business-related risks, a portion of the premium may be deductible.

**Planning Uses:** Protects against large liability claims that can arise from accidents, ensuring that personal assets are shielded from potential lawsuits.

*Remembering and Understanding: Demonstrate an understanding of the implications of legal ownership of an asset and beneficiary designations on an estate and its beneficiaries.*

## **Legal Ownership, Beneficiary Designations, and Estate Implications**

### **1. Define Key Concepts:**

- **Legal Ownership:** The lawful and enforceable right to an asset, providing the owner control and disposition rights.
- **Beneficiary Designation:** A legal document that dictates who will inherit an asset, often seen with retirement accounts, life insurance policies, and certain annuity contracts.

### **2. Types of Ownership:**

- **Sole Ownership:** Asset owned by a single individual.
- **Joint Ownership:** Asset owned by two or more individuals. Varieties include:
  - **Joint Tenancy with Right of Survivorship:** Upon one owner's death, the asset passes to surviving owners.
  - **Tenancy in Common:** Each owner has a distinct share; upon death, that share passes per the decedent's will or intestacy laws.
  - **Tenancy by the Entirety:** Joint ownership for married couples in some states.
  - **Community Property:** In some states, assets acquired during marriage are owned equally by both spouses.

### **3. Beneficiary Designation Implications:**

- Direct Transfer: Assets with a beneficiary designation typically bypass probate and transfer directly to the named beneficiary.
- Overrides the Will: A beneficiary designation typically takes precedence over instructions in a will.
- Contingent Beneficiaries: Can be named to inherit if the primary beneficiary predeceases the owner.

### **4. Tax Implications:**

- Estate Tax: Depending on ownership structure and total value, assets may be subject to estate tax. Beneficiary designations can influence which assets are included in a taxable estate.
- Income Tax: Beneficiaries may owe income tax on inherited assets, particularly those from retirement accounts.

### **5. Impact on Estate Distribution:**

- Probate Assets: Solely owned assets, or those owned as tenants in common, typically go through probate unless they have a beneficiary designation.
- Non-probate Assets: Jointly owned assets and those with beneficiary designations typically avoid probate.
- Estate Liquidity: The distribution of non-probate assets can impact the liquidity of the estate, potentially affecting the estate's ability to settle debts and expenses.

## **6. Rights and Control:**

- During Lifetime: Ownership dictates control of the asset during the owner's lifetime.
- Upon Death: Beneficiary designations dictate who inherits and controls the asset.

## **7. Considerations for Specific Assets:**

- Real Estate: How real estate is owned can impact how it's passed to beneficiaries.
- Retirement Accounts: Often come with beneficiary designations; required minimum distributions (RMDs) and tax treatments depend on the beneficiary type (spouse, non-spouse, entity).
- Life Insurance: Death benefit is typically tax-free to beneficiaries but can be included in the taxable estate if the decedent had "incidents of ownership."

*Application: Prepare a schedule to be used in the decision-making process to select a retirement plan from different options given a specific planning scenario, identifying the related advantages and disadvantages.*

## **Preparing a Decision-making Schedule for Retirement Plan Selection**

Retirement planning is a critical aspect of personal financial planning. It is important to select the best-suited retirement plan based on an individual's financial situation, goals, and preferences.

### **Steps to Prepare the Schedule:**

#### **Step 1: List Available Retirement Plan Options:**

- Traditional IRA
- Roth IRA
- 401(k) Plan
- Annuities
- Employer-Sponsored Pension Plans

#### **Step 2: Define Key Metrics for Comparison:**

Each plan will be evaluated based on:

- Contribution Limits
- Tax Treatment of Contributions and Distributions
- Investment Options
- Early Withdrawal Penalties
- Required Minimum Distributions (RMDs)

### Step 3: Create a Grid/Table for Comparison:

For each retirement plan option, list its characteristics under the defined key metrics.

### Filling the Schedule:

Metric/Plan	Traditional IRA	Roth IRA	401(k)	Annuities	Employer-Sponsored Pension Plan
Contribution Limits	\$7,000	\$7,000	\$23,500	None	Varies by plan
Tax Treatment	Pre-tax contributions; taxable distributions	Post-tax contributions; tax-free distributions	Pre-tax contributions; taxable distributions	Tax-deferred growth; taxable distributions	Typically pre-tax contributions; taxable distributions
Investment Options	Broad	Broad	Limited	Depends on annuity type	Managed by plan
Early Withdrawal Penalties	10% before age 59.5	No penalty on contributions; 10% on earnings before 59.5 without exceptions	10% before age 59.5	Penalties vary by type	Varies by plan
RMDs	Start at age 72	None	Start at age 72	Vary by type	Typically start at age 72

### Traditional IRA:

- Contribution Limits: For 2025, up to \$7,000 (\$8,000 if age 50 or older).
- Tax Treatment: Pre-tax contributions; taxable distributions.
- Investment Options: Broad - stocks, bonds, mutual funds.

- Early Withdrawal Penalties: 10% penalty for withdrawals before age 59½, with certain exceptions.
- RMDs: Start at age 72.

### **Roth IRA:**

- Same contribution limits as Traditional IRA.
- Post-tax contributions; tax-free qualified distributions.
- Similar broad investment options.
- No penalty on withdrawn contributions; earnings subject to a 10% penalty if withdrawn before age 59½ without meeting certain conditions.
- No RMDs.

### **401(k) Plan:**

- For 2025, up to \$23,500 (\$31,000 if age 50 or older).
- Pre-tax contributions; taxable distributions.
- Investment options typically limited to those offered by the plan.
- 10% penalty for withdrawals before age 59½, with exceptions.
- RMDs start at age 72.

### **Annuities:**

- No contribution limits.
- Tax-deferred growth; taxable distributions.
- Investment options depend on the type of annuity.
- Penalties for withdrawals before a specified age or period.

- RMD rules vary by annuity type.

### **Employer-Sponsored Pension Plans:**

- Contribution limits vary by plan.
- Typically pre-tax contributions; taxable distributions.
- Investment choices often managed by the plan.
- Early withdrawal rules vary by plan.
- RMDs usually start at age 72.

### **4. Analyzing Advantages & Disadvantages:**

After filling out the schedule, the next step is to analyze the advantages and disadvantages of each plan in the context of the individual's goals and financial situation. For example:

- An individual in a high tax bracket who believes they'll be in a lower bracket in retirement might prefer the Traditional IRA or 401(k) for the upfront tax deduction.
- Someone prioritizing tax-free withdrawals in retirement might lean towards the Roth IRA.

*Application: Calculate the return on investment (ROI) for different investment options, net of the tax impact, given a specific planning scenario.*

## **Calculating Return on Investment (ROI) Net of Tax Impact**

### **1. Basics of ROI:**

ROI is the percentage increase or decrease in an investment relative to the amount initially invested. It's given by:

$$\text{ROI} = ((\text{Final Value} - \text{Initial Investment}) / \text{Initial Investment}) \times 100$$

### **2. Tax Impact on ROI:**

Taxes can significantly influence the effective returns on an investment. Different investments are taxed at different rates and may have unique tax advantages or implications.

### **3. Calculating After-Tax ROI:**

#### **Step 1: Identify the Tax Rate:**

Determine the applicable tax rate for each investment type. This could be capital gains rates (short-term or long-term), ordinary income rates, or specific rates for certain investment products.

#### **Step 2: Calculate Pre-Tax ROI:**

Using the basic ROI formula, determine the ROI before taxes.

### Step 3: Adjust for Tax Impact:

Subtract the tax liability from the gain on the investment.

$$\text{After-tax ROI} = \frac{\text{Final Value} - \text{Tax Liability} - \text{Initial Investment}}{\text{Initial Investment}} \times 100$$

## 4. Application to Different Investment Options:

### Stock Investments:

- Calculate the gain: Final Sale Price - Purchase Price.
- Determine the tax rate: Long-term (held more than a year) vs. short-term capital gains rates.
- Adjust for tax impact.

### Bond Investments:

- For corporate bonds, interest is taxed as ordinary income. Calculate total interest received.
- Subtract tax liability (ordinary income rate multiplied by interest) from the total interest.
- Adjust for tax impact.

### Mutual Funds:

- Any distributions or capital gains need to be considered.
- Adjust for applicable capital gains rate or ordinary income rate based on the type of distribution.
- Calculate after-tax ROI considering the net distributions and any change in the value of the mutual fund.

## **Real Estate:**

- Determine gain:  $\text{Sale Price} - \text{Purchase Price} - \text{Improvements} + \text{Depreciation}$ .
- Consider specific real estate tax breaks, e.g., the exclusion of gains from the sale of a primary residence.
- Adjust for applicable capital gains tax rate.

## **Dividend Investments:**

- Dividends can be qualified or non-qualified.
- Qualified dividends are taxed at capital gains rates, while non-qualified dividends are taxed as ordinary income.
- Adjust the dividend income for the tax impact to find the after-tax ROI.

## **5. Tips & Considerations:**

- Tax Deferral: Certain accounts, like IRAs or 401(k)s, allow investments to grow tax-deferred. Taxes are due upon withdrawal, not during the growth phase.
- State Taxes: Don't forget about state tax implications, which can vary.
- Tax Credits/Deductions: Some investments may offer tax credits or deductions, which can offset the tax liability.
- Tax Loss Harvesting: This strategy involves selling off losing investments to offset gains, reducing the tax liability.