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2016-2026

2026 Federal Tax Update-Business

Author: Ron Roberson CPA & Bob Jennings CPA, EA

Speaker: Ron Roberson CPA, Bob Jennings CPA, EA
Bill Leonard CPA, MAFF, CGMA, Terry Bakker CPA, EA
Larry Pon CPA/PFS, CFP, EA, USTCP, AEP

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4403 Hamburg Pike Suite A
Jeffersonville, IN 47130

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877.466.1040
info@taxspeaker.com

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Continuing Education Information

Course Contents: Many firms wish to attend an annual update that covers all of the changes that affect business entities in the current year, as well as detailed analyses of how the new tax laws will affect your business tax clients. Kept up to date through the day before the class, this class will include the latest modifications from Congress as well as other relevant IRS Notices, announcements, ruling and court cases for corporations, S corporations and entities taxed as partnerships and discussion of common compliance issues encountered during tax preparation season.

Learning Objectives: Upon completion of this course you will be able to advise clients about the latest C and S Corporation tax changes, as well as LLC changes and you will be able to explain the latest changes in tax law to your business clients, as well as differences in entity types. Participants will be able to provide clients with the characteristics, advantages, and disadvantages of LLC's and inform clients of the various characteristics and tax implications of the S corporation form of business entity. The course will include the latest modifications from Congress as well as other relevant IRS Notices, announcements, ruling and court cases for corporations, S corporations, and entities taxed as partnerships and discussion of common compliance issues encountered during this year's tax preparation season.

Program Level: Intermediate
Prerequisites: 1 year tax preparation experience
Advance Preparation Required: None
Instructional Method: Group Live/Group Internet-Based
CPE Credit: 8
Field of Study: Update

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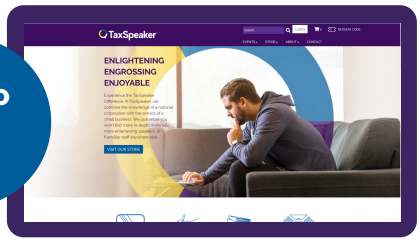

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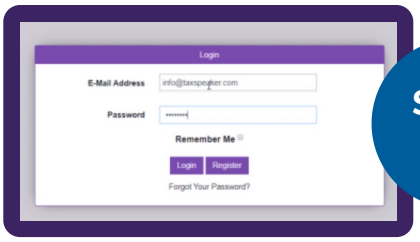

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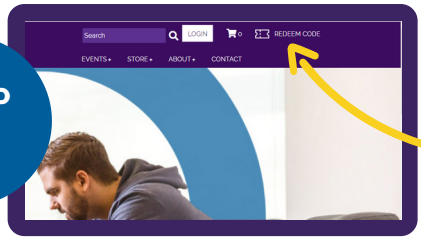

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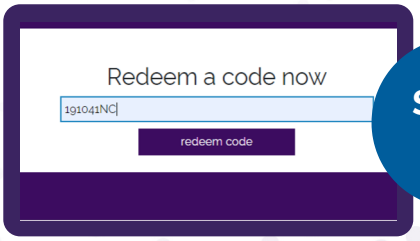

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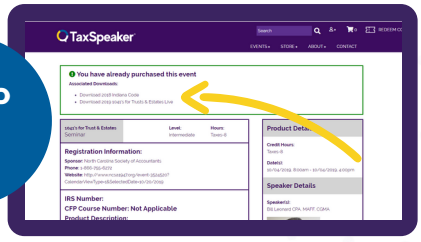

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SEMINAR EVALUATION FORM

Program Title: _____ Date: _____

Location: _____

Instructor:

☐ _____ Speaker 1 ☐ _____ Speaker 2

Instructions

On a scale of 1 (Low) to 10 (High), please evaluate the following:

Seminar & Manual: (1-Low, 10-High)

1. Were the stated learning objectives met? ___
2. If applicable, were prerequisite requirements appropriate & satisfactory? ___
3. Were course materials accurate? ___
4. Were the handouts or advance preparation materials satisfactory? ___
5. Was the power point presentation accurate & effective? ___
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives? ___
7. Was the time allotted to the learning activity appropriate? ___
8. If applicable, were the instructors effective? ___
9. Were the facilities and/or technological equipment appropriate? ___

Speaker: (1-Low, 10-High)	Speaker No. #1	#2
1. Did the instructor cover the material in an effective manner?	___	___
2. Did the instructor clearly state his/her objectives?	___	___
3. Did the instructor meet the stated learning objectives?	___	___
4. Please rate the instructor's ability as a speaker	___	___
5. Please rate the instructor's ability as a teacher	___	___
6. Please rate the instructor's use of power point?	___	___

Facilities (1-Low, 10-High):

1. Were the meeting area and technological equipment appropriate? ___
2. Were the restroom facilities adequate? ___
3. Was parking adequate? ___
4. Was the seminar location convenient? ___

Other Items:

What additional topics would you like covered in future seminars?

_____

What was personally the most beneficial thing to you in this seminar?

_____

What was personally the least beneficial thing to you in this seminar?

_____

Other:_____

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Notes-You should take 2 types of notes during this seminar. The first type (margin notes) should be your notes to yourself in the pertinent manual topic area that helps you understand the material. The second type (specific notes) requires specific, immediate duties as soon as you return to the office.

Specific Notes	Client	Page

Notes-You should take 2 types of notes during this seminar. The first type (margin notes) should be your notes to yourself in the pertinent manual topic area that helps you understand the material. The second type (specific notes) requires specific, immediate duties as soon as you return to the office.

Specific Notes	Client	Page

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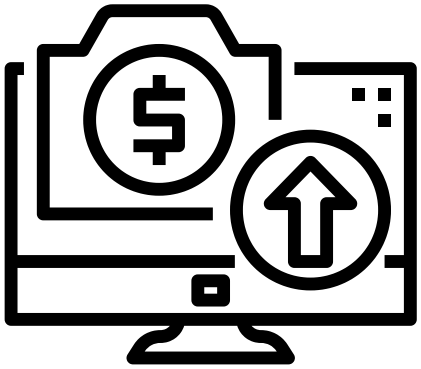

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MEET OUR **SPEAKERS**



Bob Jennings: CPA, EA

A prolific author, Bob has published over 60 professional articles in publications such as the Journal of Accountancy and was once a regular columnist for FoxBusiness.com; his award winning 1040 In Depth Manual is his Crown Jewel of penmanship. With over 45 years of continued practice, Bob brings humor and unmatched experience to his courses to keep listeners engaged and learning. As TaxSpeaker's founder and owner, he takes our motto of Excellence in Education seriously, leading our team of speakers and staff in continual growth and expansion over the last 20 years.



Bill Leonard: CPA, MAFF, CGMA

Bill Leonard CPA, CFFA holds licenses and memberships in Massachusetts, Rhode Island, Alaska and Singapore. He is the sole shareholder of W.A. Leonard & Company, P.C. and PT W.A. Leonard employing sixteen multi-lingual professionals that focus on meeting the needs of small businesses, individuals and fiduciaries. A graduate of Bentley University and Babson College, Bill has been in practice since 1981. He has over twenty years of college and seminar teaching experience.



Bob is dynamic and his style creates an environment for learning!



Terry Bakker: CPA, EA

Owner of O'Leary's Tax Service, Ltd. in Vancouver, Washington, Terry graduated with her BS in Business Administration from Portland State University in 1988 and has practiced tax services since. She has shown her dedication to the profession by serving as head of the Education Committee and former President of the Oregon Association of Independent Accountants. Terry continues to uphold her commitment by continually speaking and practicing, reaching the milestone of having spoken for all Tax Preparation associations in Oregon; she is now one of our nation-wide speakers.

MEET OUR **SPEAKERS**



Ron Roberson: CPA

Ron Roberson is a well-known tax lecturer who has more than 25 years of experience teaching throughout the United States. Ron annually speaks to thousands of tax professionals about the latest business and personal tax law developments, using his sense of humor and friendly speaking style to keep people coming back year after year. In addition to authoring multiple tax articles and manuals, Ron also actively works in his tax and accounting practice in Sonora, California. Ron uses real life examples from his practice to make tax issues come alive and to help complicated subject matter become clear.



Larry Pon CPA/PFS, CFP, EA, USTCP, AEP

Mr. Pon is a Certified Public Accountant, Personal Financial Specialist, Certified Financial Planner, Enrolled Agent, United States Tax Court Practitioner, and Accredited Estate Planner in Redwood Shores, CA. Mr. Pon has been in practice since 1986 providing comprehensive tax and financial planning, tax preparation and representation. Mr. Pon received his BS in Business Administration with emphases in Accounting and Finance from the University of California, Berkeley and MS in Taxation from Golden Gate University in San Francisco.



Ryan Jennings: IT

After setting up the network in his Dad's CPA firm at age 12, Ryan later went on to attend Ball State University and operate a computer security consulting business. He has been the Jennings Seminar IT Director since 2009, responsible for all IT, technological research, and development. He is a member of the Indiana IT Directors Association and a regular participant in the world wide Consumer Electronics show. He keeps TaxSpeaker on the cutting edge of business tech.

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10/26/26	Big Beautiful Bill: Version 2	8-4pm	$410
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11/2/26	Federal Tax Update - Individual	9-5pm	$410
11/2 -11/3/26	1040 Tax in Depth	8-4pm	$410
11/5 -11/6/26	1040 Tax In Depth	10-6pm	$410
11/9-11/10/26	1040 Tax In Depth	10-6pm	$410
11/12-11/13/26	1040 Tax In Depth	9-5pm	$410
11/12/26	Federal Tax Update- Business & Individual	9-5pm	$300
11/13/26	Federal Tax Update - Business	9-5pm	$300
11/16-11/17/26	1040 Tax In Depth	8-4pm	$410
11/16-11/17/26	1040 Tax in Depth	9-5pm	$410
11/23-11/24/26	1040 Tax In Depth	10-6pm	$410
11/23-11/24/26	1040 Tax in Depth	9-5pm	$410
12/14-12/15/26	1040 Tax in Depth	8-4pm	$410
12/15/26	Payroll – Year end Compliance: W-2's and 1099's	12-2pm	$135
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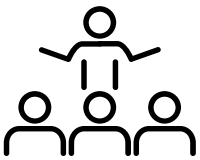

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We break down each provision with clear explanations, real-world examples, and direct citations to the relevant statutory and regulatory authority. You'll see how the changes apply in practical scenarios, how they affect different taxpayer profiles, and what planning opportunities or compliance considerations may arise. The goal is simple: equip you to confidently apply the new law in your daily practice.

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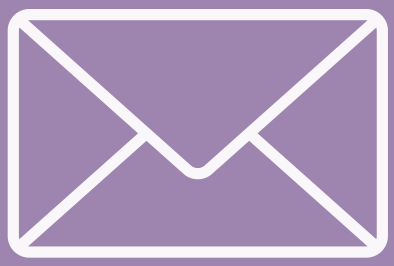

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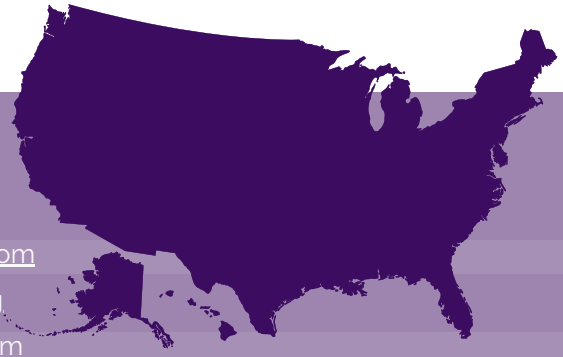

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General Business Topics

2026 Business Tax Provisions Inflation Adjustments (Notice 2025-32)

IRC Section	Description	2026 Amount
§125	FSA Contribution / carryover to next year	**$3,400 / $680**
§127	Employer Provided Education Assistance	**$5,250**
§128	Employer Trump Account Contributions	**$2,500**
§132(f)	Qualified Transportation Fringe	**$340**
§137	Adoption Assistance Program	**$17,670**
§179	Election to Expense Assets	**$2,560,000**
§199A	Qualified Business Income	**MFJ $403,500 – 553,500 S, HOH $201,750 - $276,750**
§448	Limitation on Use of Cash Method of Accounting	**$32,000,000**
§461(l)	Limits on Excess Business Losses	**$256,000, $512,000 MFJ**
§6698	Failure to File Partnership Return	**$260 per partner per month – 12 months max**
§6699	Failure to file S Corporation Return	**$260 per SH per month – 12 months max**
§9831	QSEHRA limits	**$6,450 self only $13,100 family**

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IRS Industry Specific Info for Businesses (Industry and Professions Tax Centers)

The IRS continues to add information to its website to provide industry specific guidance to taxpayers and business owners. The IRS now has Business Tax Centers and Industry Specific Tax Centers webpages, which contain useful information such as tax tips, forms, financial resources, industry trends, and statistics. Its Business Tax Centers include:

1. Small Business and Self-Employed Tax Center.
2. Self-Employed Individual Tax Center
3. Tax Professionals
4. Large Business and International Tax Center
5. Disaster Assistance and Emergency Relief for Individuals and Businesses

The IRS Industry Specific Centers include:

1. Agriculture Tax Center
2. Automotive
3. Cannabis Industry Tax Center
4. Child and Adult Care Tax Center
5. Gig Economy
6. Indoor Tanning Services Center
7. Industries Where Tips are Customary
8. Money Services Information Center
9. Payroll Professionals Tax Center
10. Real Estate Tax Center
11. Restaurants Tax Center
12. Trucking Tax Center

The Industries/Professions Tax Centers also includes a link to all the IRS's current industry specific Audit Techniques Guides (ATGs).

Revised Audit Technique Guides issued. The most recent ATGs issued by industry are:

1. Cost Segregation – 348 pages (Pub 5653, February 2025)
2. Excise Tax on Indoor Tanning Services – 30 pages (Pub 6052, January 2025)
3. Low-Income Housing Credit – 214 pages (Pub 5913, January 2024)
4. Non-qualified Deferred Comp – 23 pages (Pub 5528, March 2024)
5. Split Dollar Life Insurance – 5 pages (Pub 5962, April 2024)
6. Stock (Equity)-Based Compensation – 15 pages (Pub 5992, June 2024)

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Business v. Hobby (§183)

Generational Rancher's Losses Were From a Business (Kenward Kolar, Jr. v. Comm. TCM 2026-15).

Overview. Ken Kolar took over management of a multi-generation, 836-acre Texas ranch in 2016 when his mother became incapacitated. The operation was in disrepair due to his parents' long time illness, requiring restoration of fencing, equipment, and the beef cattle herd essentially from scratch. The ranch generated income from three different sources: 1) land appreciation, 2) oil and gas royalty income (approximately $390,000 per year from 2017–2022) and 3) cattle ranching. The Court ruled that the land appreciation and oil and gas royalties were separate, unrelated activities, meaning the ranch activity had to be addressed separately. The royalty income and any land appreciation could not be used to demonstrate overall profitability for the ranching enterprise.

Ranching as a stand-alone activity. The Court used the none factors from IRS Reg Section §1.183-2(b) to determine the profit motive behind the ranch activity:

1. **Manner of conducting the activity – favors a profit motive.** Separate bank accounts, multi-step bookkeeping (daily ledger, weekly reconciliations, monthly/annual spreadsheets), and a credible informal business plan sufficed despite the absence of formal financial statements.

2. **Taxpayer's expertise – favors profit motive.** Kolar held degrees in animal science and biology from Texas A&M and a master's degree in water supply and wastewater disposal from Sam Houston State. He also had decades of firsthand experience working on the ranch and ranch related activities.

3. **Time and effort expended – favors profit motive.** Th Court found Kolar credibly testified about the long hours he spent working the cattle herd and working to improve the ranch. Kolar was not a cattle ranch dilettante; he had been working on the Kolar ranch most of his life.

4. **Expectation of asset appreciation – neutral.** The Court specifically excluded land appreciation from consideration.

5. **Success in similar activities – neutral.** While Kolar argued he'd been successful in other ventures (water sales, rental real estate, etc.), the Court ruled there was insufficient evidence to show such success and, even if there was adequate evidence, those activities were deemed dissimilar to ranching.

6. **History of income and losses – slightly against.** During 2017 – 2022, the years at issue, Kolar reported ranch income of just $26,000 and related expenses of $2 million. The Court ruled that, while the losses were large and sustained, they were at least partially explained as startup conditions, herd-rebuilding timelines (5–6 years), and unforeseeable casualty events (Hurricane Harvey, COVID-19 deaths among staff, 2021 winter storms, etc.). While the Court ruled in favor of the IRS on this factor, it did so only "slightly."

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7. **Amount of occasional profits – slightly against.** The Court noted that over a multiyear period, Kolar's ranching activities generated only limited gross receipts that were offset by significant losses. As with factor 6, the Court determined this factor weighed slightly against a finding of a profit motive.

8. **Financial status of the taxpayer – against.** Kolar had substantial oil and gas royalty income that was being offset by the ranching losses, which is a classic hobby-loss red flag. The Court determined this was the strongest factor in favor of the IRS and against Kolar, but it ruled this one factor was not dispositive.

9. **Personal pleasure/recreation – favors profit motive.** Kolar gave credible testimony of the long hours of grueling work he provided in his attempt to make the ranching activity profitable. Clearing 826 acres of invasive plants, building fences, working cattle day in and day out. He did not do rodeos, attend plush conventions, or engage in any other pleasurable activities. The Court agreed there was no pleasure or fun going on here.

Court rules ranch is a trade or business and allowed loss deductions. Noting that the factors totaled: 4 favored profit motive, 2 were neutral, and 3 favored the IRS, the Court emphasized a qualitative weighing rather than a mechanical tally, finding the profit-motive factors were overall more persuasive.

Preparer note. Substantial outside income (Factor 8) doesn't defeat profit motive alone, but it remains the single most scrutinized factor when losses are large and persistent. Taxpayers who find success in court cases have contemporaneous documentation of a credible profit timeline. Informal but consistent recordkeeping can suffice, though a written business plan and retained financial statements/profitability analyses would strengthen the position significantly. Casualty and macroeconomic setbacks should be documented in real time (drought, disease, weather events, etc.) to preserve the "unforeseen circumstances" defense to a loss-history challenge.

Software Development and Real Estate Development – Yes; Mulching – No (James and Colleen Sullivan v. Comm., TC Memo 2026-13, Feb. 5, 2026)

Overview. Jim Sullivan served as a vice president of sales for an independent employer in 2017, 2018, and 2019 where he earned annual wages of $355,734, $178,332, and $226,857, respectively. Colleen Sullivan did not work outside the home from 2017 through 2019. James Sullivan operated several side ventures from 2003 through 2019 under the umbrella of Traders Abacus, a single member LLC, including 2017–2019, the years at issue. Specifically, he operated:

- SelfChanger – an app-based pornography-addiction therapy tool James began developing in 2013. He funded the development efforts with his wage income, sale proceeds from a prior home, and retirement savings.

- Lincolnville lot development – James and Colleen owned 51.6-acres located in Maine that they split into a 3.9-acre parcel (owned by Traders Abacus) and a 47.7-acre parcel (owned by the Sullivans personally). They planned to further develop the 47.7 acres to a small subdivision of "passive homes."

- Leaf-Cutter – Colleen Sullivan's mulching/landscaping business, which was both begun and abandoned in 2019.

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Businesses analyzed separately. Because the three activities were only minimally interconnected (shared equipment/occasional commingled funds), the Court analyzed each activity separately rather than as one combined enterprise.

- **SelfChanger (software development).** Analyzing the 9 factors in the Regulations, the Court found most factors favored the Sullivans. James Sullivan created a business plan, conducted market surveys, hired employees (including a full-time hire in 2019), ran targeted advertising, protected IP rights, and made businesslike adjustments, including abandoning unprofitable machine-learning approaches and reducing costs when the venture stalled. His broadcast/advertising sales background supported sufficient expertise despite lacking formal psychology credentials. The Court treated the 2013–2019 losses as falling within a reasonable five-year startup period. Further, the Court found that the two factors that cut against the taxpayers: lack of any similar past success in software ventures, and the absence of any profits whatsoever, were more than offset by the remaining factors. The Sullivans were found to have a true profit objective and the Court emphasized that continued losses alone don't defeat profit motive during a legitimate startup phase. James Sullivan's businesslike loss-control decisions were persuasive and the Court ruled there was a legitimate profit motive for all years.

- **Lincolnville development and home construction.** The Court split the result between the two parcels. It determined that there was a profit motive for the 47.7-acre parcel but no profit motive for the 3.9-acre parcel. The Court based its decision on how the couple used and documented each piece. It factored in:

    - The Sullivans had a strong real estate history – they'd built or renovated two homes in the past – in Minnesota and Hingham – and both projects were profitable. Doing so demonstrated relevant expertise and past success even without formal training. However, permit applications, land-use filings, and wastewater applications all supported the development of the 3.9-acre parcel as the Sullivans' personal residence – not the "passive homes" commercial subdivision they claimed as their business purpose. The Sullivans lived there (in a tent, then more permanent quarters) for years, indicating substantial personal use rather than commercial intent. The Court ruled the property was personal, not a trade or business activity.

    - Colleen Sullivan's put in "enormous effort" to clear and develop the 47.7-acre parcel (year-round labor, trade group memberships, access roads, septic work, etc.). And Traders Abacus office was eventually built on the parcel. The passive-homes subdivision plan never materialized on the 47.7-acre parcel, but the parcel was later sold for a significant profit (in 2025), supporting an appreciation-based profit motive. Losses were allowed during the years at issue.

    - **Poor recordkeeping requires Court to use Cohan rule**. Because the couple commingled funds, equipment, and labor between the two parcels without adequate records to allocate expenses, the Court invoked its Cohan estimation authority. The Court allocated 25% of total home-construction expenses to the 3.9-acre (non-profit) parcel and 75% to the 47.7-acre (profit-motivated) parcel, reflecting the shared use of equipment/labor and the Sullivans' poor recordkeeping (which the court weighed against them).

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- **Leaf-Cutter (mulching business).** The court easily rejected the mulching activity as a for-profit venture. Colleen Sullivan testified that she performed paid work for third-party clients, but she was unable to provide any corroborating evidence. The business reported significant expenses but no income. Colleen's claim that she worked about 50 hours per week lacked credibility. The losses from the mulching business were not allowed to be deducted.

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Employee Business Expenses

Auto Expenses (§162; §274(d))

Overview. Taxpayers are allowed to deduct business related automobile expenses either:

1. Using the actual expenses (gas, insurance, repairs, depreciation, etc.) times the business use percentage; or
2. Using the standard mileage rate per diem.

Taxpayers who choose the standard mileage rate in the first year the vehicle is placed in service may switch to use the actual expense method in a later year. If they do so, they must use the straight-line depreciation method when the vehicle is placed in service. If actual expenses are deducted in the first year, actual expenses must continue to be used for the remaining life of that vehicle.

Standard mileage rates update (Notice 2026-10). Taxpayers use the standard mileage rate to compute the deductible costs of operating an automobile for business, charitable, medical, and moving expenses. Each year the IRS reviews the cost of operating a vehicle and adjusts the current rates accordingly. The most current mileage rates are summarized:

	1/1/2026 – 6/30/26	1/1/2026 – 6/30/26	2027
Business rate	72½¢	76¢	
Medical/moving	20½¢	23½¢	
Charity	14¢	14¢	14¢

Standard mileage rate and depreciation recapture (Notice 2026-10). Taxpayers who use the business standard mileage rate to compute an auto deduction for an automobile in any year must reduce basis in the vehicle using an allowance per mile amount, which is treated as the depreciation claimed by the taxpayer. The amount of the business standard mileage rate treated as depreciation is:

2019	26¢ per business mile
2020	27¢ per business mile
2021	26¢ per business mile
2022	26¢ per business mile
2023	28¢ per business mile
2024	30¢ per business mile
2025	33¢ per business mile
2026	35¢ per business mile

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Example. Adam, a self-employed sales rep, purchased a Dodge Challenger for business and personal use in 2022 for $56,000. Adam used the standard mileage rate to calculate his annual business auto deduction. Adam sold the Challenger in 2026 for $18,000. Adam assumed he didn't need to report the sale on his tax return because the Challenger was never depreciated. The total and business miles were:

Year	Total Miles	Business Miles	Recapture Rate	Depreciation
2022	29,000	21,000	26¢	$ 5,460
2023	24,000	17,000	28¢	$ 4,760
2024	22,000	16,000	30¢	$ 4,800
2025	26,000	18,000	33¢	$ 5,940
2026	12,000	9,000	35¢	$ 3,150
Totals	113,000	81,000		$ 24,110

Business use % = 71.68% (81,000 business miles ÷ 113,000 total miles)

Example – continued. Gain/loss calculation upon sale of the Challenger.

Continuing with the same facts, when Adam sells the Challenger in 2026, he calculates the related gain or loss:

Sale price - business portion	$12,902 ($18,000 sales price x 71.68%)
Less business basis	(16,030) – (see calculation below)
Deductible loss	($ 3,128)

Challenger basis calculation:

Challenger's original cost	$ 56,000
Business use percentage	x 71.68%
Business cost basis	$ 40,140
Accumulated depreciation	($24,110)
Remaining business basis	$ 16,030

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Business Meals and Entertainment (§274;TD 9925)

Entertainment expense overview. The TCJA amended §274 to clearly state no deduction is allowed for any entertainment, amusement, or recreation expense or for any facility used in connection with entertainment, amusement, or recreation (§274(a)). This means tickets, trips, green fees, etc. are no longer deductible. Business meals are still deductible and are still limited to 50% of the actual cost incurred. The IRS has clarified that the meal portion of an entertainment activity is deductible subject to all other meal related expense deduction rules.

Meal expenses (§274(e)). Taxpayers may deduct specified meal expenses as long as they are able to prove that: 1) the meal was directly related to the active conduct of the taxpayer's business (e.g., business meeting occurred while eating), or 2) the meal directly preceded or followed a substantial and bona fide business discussion (including business meetings at a convention or otherwise). These are most often referred to as "directly related to" or "associated with" tests. Meals are subject to the enhanced documentation requirements of §274(d) and §274(k) which require taxpayers to document:

- Amount of expenditure;
- Time and place of meal;
- Business purpose; and
- Business relationship between the taxpayer and the person having the meal.

Regulations impose additional rules for deductible meals (§1.274-12). All business expenses must be ordinary, necessary, and directly connected with, or pertain to, the taxpayer's trade or business (§1.162-1). Additionally, no deduction is allowed for any food or beverage expense:

- If the meal or beverage is lavish or extravagant under the circumstances;
- Unless the taxpayer, or an employee of the taxpayer, is present at the furnishing of such food or beverages; and
- Unless the food or beverages are provided to a business associate.

50% limitation to meal deduction (§274(n)). In most circumstances the deduction for business meals is limited to 50% of what was spent (see exceptions below). Deductible meals include any expenses for food or beverages provided by the taxpayer, or an employee of the taxpayer, to a business associate.

Preparer note. "Business associate" means a person the taxpayer could reasonably expect to engage or deal in the active conduct of the taxpayer's trade or business such as the taxpayer's customer, client, supplier, employee, agent, partner, or professional adviser, whether established or prospective. Note the definition does not include those with whom the taxpayer is attempting to generate goodwill. It also does not include the taxpayer's spouse unless he or she is an employee!

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Exceptions to the 50% business meal limitation (§274(n)(2); (§1.274-12(c)). Certain meal expenses are 100% deductible, rather than 50%. This includes:

1. **Meal cost included in employee taxable compensation.** To the extent the cost of the meals, including travel-related meals, are included in an employee's taxable wage compensation.

2. **Meal cost included in contractor income.** To the extent the cost of the meals, including travel related meals, are included in the income of people who are not employees (e.g., independent contractors). This exception ***does not apply*** if the taxpayer fails to report the amount on Form 1099 if otherwise required to do so.

3. **Meals reimbursed to taxpayers by another.** Paid by the taxpayer in connection with the performance of services for another person under an expense reimbursement or allowance arrangement (accountable plan reimbursement). For a reimbursement or allowance plan to qualify, it must require adequate accounting from the recipient and provide that any excess reimbursements are returned to the payor.

4. **Recreational or social gatherings for employees.** For recreational, social, or similar activities (including facilities) primarily for the benefit of employees (other than highly compensated employees per §414(q)). For example, expenses paid for holiday parties, annual picnics, summer outings, etc. are 100% deductible. The value of these meals is not required to be included in employee wages or other income.

Example 1. Sun Valley CPAs invites all its employees to an end of tax season party in a hotel ballroom that includes a buffet dinner and open bar. The cost of the party, including food and beverage expenses, is 100% deductible because the party is a recreational, social, or similar activity primarily for the benefit of non-highly compensated employees.

Example 2. Assume the facts as above except Sun River excludes rank and file employees and only invites partners to the tax season party. The hotel's invoice lists the costs for food and beverages separately from the cost of the rental of the ballroom and the costs reflect the venue's usual selling price for food or beverages. Because the food and beverages are separately stated they are deductible, but only 50% as the party was only for the highly compensated members. The cost of the ballroom rent is not deductible because the party is entertainment, and it is a facility rented for entertainment.

5. **Food and beverages made available to the public.** For goods, services, and facilities the taxpayer makes available primarily to the public. This exception includes the same type of food or beverages that are provided to employees, if the cost of items consumed by employees is less than 50% of the total food and beverage costs.

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Example 1. Caity is a real estate agent who provides refreshments during an open house for one of her listed properties. Caity's employees, potential buyers of the property, and other real estate agents consume the refreshments. If more than 50% of the refreshments were consumed by potential buyers and other real estate agents (i.e., not employees), 100% of the refreshment costs are deductible.

Example 2. Miguel's Auto is an automobile service center that provides refreshments in its waiting area. Miguel's employees and customers consume the refreshments. The costs of the refreshments are 100% deductible if more than 50% of the refreshments are consumed by customers. Otherwise, only 50% is deductible.

6. **Cost of goods sold.** For goods or services (including the use of facilities) which are sold by the taxpayer in a bona fide transaction for adequate and full consideration are 100% deductible (e.g., restaurant). This includes costs of meals consumed at the worksite by employees who work in the employer's restaurant or catering business.

Example. T Bone operates a restaurant where food and beverages are provided at no cost to food service employees before, during, and after their shifts. The cost of employee meals is 100% deductible (i.e., 100% included in cost of goods sold) because the restaurant sells food and beverages to customers in the ordinary course of its business.

Other meal expense reporting rules (§119; §132). There were other laws that allowed employees to receive meals from their employers on a tax-free basis:

1. Meals for the convenience of the employer (§119) – employees are allowed to exclude from income the value of meals that are provided for the convenience of the employer, but only if the meals are provided on the employer's premises.

2. De minimis fringe benefit (§132(a)(4)) – any property or service the value of which is so small it makes accounting for it unreasonable or administratively impracticable.

OBBBA eliminated deductions for some employee meals (§274(o)). Employer deductions for meals provided to employees for the convenience of the employer (§119(a)), and meals excluded as de minimis fringe benefit meals (§132(e)) are no longer allowed. This change became effective for expenses incurred in 2026. The law change did not impact employers who sell food or beverages in the normal course of business (e.g., restaurants). Restaurants may continue to provide meals for employees and avoid reporting any income for the employees if they meet the de minimis fringe benefit rules.

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Per Diems for Meals, Lodging, and Incidental Expenses

The IRS clarified that a per diem allowance is a payment or reimbursement that is:

1. Paid for ordinary and necessary business expenses that were for lodging, meals, and incidental expenses incurred for travel away from home while performing services as an employee of the employer,

2. Reasonably calculated not to exceed the amount of the expenses or the anticipated expenses, and

3. Paid at or below the applicable federal per diem rate.

When can per diem rates be used (Rev. Proc. 2019-48)? Per diem rates are used by businesses and others to reimburse employees or contractors for travel and other costs. In such cases, the employee/contractor need only substantiate that they are away from home to receive the per diem payment. Once received, the per diem payment is not taxable to the employee/contractor and is fully deductible for the paying entity. Per diems are also used to substantiate the amount of deduction for travel related expenses. But there are strict rules that dictate when the per diem rates may substitute for actual expenses and who can use them:

- **Meal per diems** – Meal per diems may be used by businesses to reimburse employees and contractors who substantiate they are out of town overnight for business related travel. These per diem may also be used by a business owner to calculate the amount of deductible meal expenses while the owner is out of town for business related travel. Note that regardless of the per diem amount, if the per diem is paid or deducted for meals, only 50% is deductible.

- **Lodging per diems** – Lodging per diems may only be used to reimburse employees for out-of-town travel related lodging. They cannot be used for tax free reimbursements for independent contractors, and they may not be used to calculate a deductible amount for owners.

- **Incidental per diem.** Incidental per diems are used by employees and contractors in lieu of deducting fees and tips given to porters, baggage carriers, bellhops, hotel staff, etc.

Per diem amounts. Separate per diem amounts are available for meals, lodging, and incidental expenses. In addition, there are several different meal per diem amounts based on industry type (transportation industry meal per diem is higher than the general meal per diem) and lodging per diems fluctuate based on location. The US Government annually publishes a list of localities and the relative lodging per diem. The published rates are applicable from October 1st through September 30th the following year. If a town or city is not on the list the general lodging per diem is used. Rates are also adjusted if the travel is in the U.S. (CONUS) or outside the U.S. (OCONUS). Taxpayers may choose to adopt the rates on a calendar year basis instead of using the Federal fiscal year. Additionally, taxpayers may choose to use the high-low per diem average rates. In this scenario, all localities in the US are categorized as high or low cost and the appropriate per diem rate is used accordingly.

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Partial day per diems. The full meal and incidental per diem rate is available for a full day of travel (12:01 a.m. to 12:00 midnight). For purposes of determining the per diems for partial days of travel away from home, a payor may use either of the following methods:

1. Prorate the daily per diem using three-fourths of the applicable rate to each partial day of travel; or

2. Prorate using any method that is consistently applied and is consistent with reasonable business practice.

Most Common Current Per Diem Rates (GSA Update)		
Type	**Oct. 2025 – Sept. 2026**	**Oct. 2026 – Sept. 2027**
Meals CONUS – general	$ 68	$68
Meals partial day (75%)	$ 51	$51
Meals OCONUS – general	Varies by Location	Varies by Location
Meals – US transportation	$ 80	$80
Meals – non-US transportation	$ 86	$86
Incidental – Both	$ 5	$5
Lodging – general rate	$110	$113
Lodging – other locations	Varies by Location	Varies by Location

Accountable Plans for Employee Business Expenses

Employers should consider the use of accountable plans (§1.62-2(c)(2)) to reimburse employees for auto expenses, travel, meals, tools, etc. and any other reasonable out of pocket business expense employees are required to pay. An accountable plan is an allowance or reimbursement policy under which amounts are nontaxable to the recipient if the following requirements are met:

- There is a business connection to the expenditure.

- The employee adequately accounts to the employer within a reasonable time (usually 60 days). Advances must be made no more than 30 days before the expense. Receipt required if the expense is for $75 or more (§1.274-5(c)(2)(iii)).

- Excess reimbursements or advances are returned within a reasonable period (120 days) (§1.62-2(g)(2)(i)).

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Accountable Plan	
Type of Reimbursement	**Employer Form W-2 Reporting**
Actual expense reimbursement: Adequate accounting made and excess returned	No amount reported
Actual expense reimbursement: Adequate accounting and return of excess are both required but excess not returned	Report excess amount as wages in Boxes 1, 3 and 5. Report taxes withheld in Boxes 2, 4 and 6.
Per diem or mileage allowance up to the Federal rate: Adequate accounting and excess returned	No amount reported
Per diem or mileage allowance up to the Federal rate: Adequate accounting and return of excess reimbursement both required but excess not returned	Report excess amount as wages in Boxes 1,3 and 5. Report taxes withheld in Boxes 2, 4 and 6. The amount up to the Federal rate is reported only in Box 12, Code L. It is not reported in Boxes 1, 3 and 5.
Per diem or mileage allowance exceeds the Federal rate: Adequate accounting but excess reimbursement over Federal rate not returned	Report excess amount as wages in Boxes 1,3 and 5. Amount up to the Federal rate is reported only in Box 12, Code L. It is not reported in Boxes 1, 3 and 5. Report taxes withheld in Boxes 2, 4 and 6.
Non-Accountable Plan	
Neither accounting nor return of excess is required by plan	Report entire amount as wages in Boxes 1, 3 and 5. Report taxes withheld in Boxes 2, 4, and 6.
NO REIMBURSEMENT PLAN	Report the entire amount as wages in Boxes 1, 3 and 5. Report taxes withheld in Boxes 2, 4 and 6.

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Sample Accountable Plan

<CLIENT>_____

Example Accountable Business Expense Reimbursement Plan

Taxpayer Attorney Review Required

Be it known that employees of the **<CLIENT>** will be reimbursed for ordinary and necessary business-related expenses incurred while performing services as an employee in accordance with the following guidelines:

A. Business Purpose

Business-related expenses covered by this accountable plan must meet the standards of accountability set forth by the Internal Revenue Service (Reg. §1.62-2). All business-related expenses that are ordinary and necessary must have been paid or incurred by the employee while performing services as an employee of **<CLIENT>**. Employees must adequately account for business-related expenses within a reasonable period to receive reimbursement. Excess reimbursements and/or allowances must also be repaid within a reasonable period. This accountable plan remains in effect from January 1 through December 31. **<CLIENT>** at its discretion may make amendments to this accountable plan.

B. Reasonable Period of Time to Request Reimbursement, Advances or Repayment

Any employee seeking reimbursement for qualified business-related expenses must adequately account to **<CLIENT>** within 60 days from the time the expense was either paid or incurred by the employee, or, in the case of an advance, within 30 days of when an expense was paid or incurred.

Any employee that receives reimbursement more than their qualified business-related expenses must return said excess to **<CLIENT>** within one hundred and twenty (120) days after the expense was either paid or incurred.

All employees requesting and receiving business-related expense advances must, upon notification from **<CLIENT>**, adequately account for all outstanding business-related expense advances and/or return excess business-related expense advances within one hundred and twenty (120) days of notification.

C. Reimbursement of Travel Expenses and/or Meal and Entertainment Expenses

Employees will be reimbursed for actual costs incurred for meals and entertainment, travel, and transportation expenses.

D. Reimbursement of Automobile Expense

The current federal standard mileage rate will be used to reimburse employees' ordinary and necessary business-related mileage while conducting business for **<CLIENT>**. Each employee requesting reimbursement will provide the time (dates), place, and business purpose for each business-related expense within a reasonable time (as noted in par.B).

E. Excess Reimbursement

Excess reimbursements and/or allowances must also be repaid within a reasonable period. If the excess reimbursement is not repaid within a reasonable period, then the excess will be considered "Additional income" and will be included in the employees' gross wages and will be subject to withholding and employment taxes.

Any advancement of business-related travel expenses that have not been properly accounted for will be considered "Additional income" and will be included in the employees' gross wages and will be subject to withholding and employment taxes.

F. Payment of Business-Related Expenses

Payment for reimbursement of all other allowable business-related expenses as listed in the allowable expense amount below will be payable to the employee either by a separate check or as a separate entry on their regular paycheck. Failure of the employee to follow the guidelines listed above may render all business-related expenses as non-reimbursable.

_____ _____ _____

Signature Date Title

_____

Print Name

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Employee Business Expenses Qualified for Employer Reimbursement

- Work related education, supplies, and equipment.
- Employer required physical exams and passports for business trips.
- Internet usage to work from home.
- Computers, tablets, and related equipment.
- Local occupational taxes on work income.
- Travel to and from a temporary out-of-town business location.
- Mileage, plus a portion of vehicle licensing and interest costs.
- Secure, regular, and exclusive home office expenses including utilities, insurance, repairs, rent and all normal home office expenses such as those normally deducted by a self-employed person on Form 8829.
- Legal fees related to the job.
- Tax compliance and preparation fees related to the job, such as those arising because of incentive stock options, retirement plans, business travel Schedule K-1s, and planning for use of cafeteria and other fringe benefit plans.
- Cell phones when required by work.
- Malpractice premiums and possibly umbrella insurance premiums.
- Security clearances and TSA pre-check fees for traveling employees.

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2026 Small Business Tax Exceptions

The $32 Million IRC §448(c) Gross Receipts Test | Updated for OBBBA & Rev. Proc. 2025-32

IRC §448 | IRC §263A | IRC §471 | IRC §460 | IRC §163(j)

Overview and Legislative Background

The **Tax Cuts and Jobs Act of 2017 (TCJA)**, P.L. 115-97, enacted the most significant expansion of small business accounting relief in decades. Amending IRC §448(c), the TCJA raised the gross receipts threshold to $25 million (inflation-adjusted), unlocking five separate Code exceptions for qualifying **small business taxpayers.** For tax years beginning in **2026**, that threshold is **$32,000,000 (**Rev. Proc. 2025-32**).** The five exceptions, each dependent on the same §448(c) gross receipts test, are:

- IRC §448 — Exception 1: Cash Method of Accounting
- IRC §263A(i) — Exception 2: Uniform Capitalization (UNICAP) Exemption
- IRC §471(c) — Exception 3: Simplified Inventory Methods
- IRC §460(e) — Exception 4: Long-Term Contract PCM Exemption
- IRC §163(j)(3) — Exception 5: Business Interest Deduction Limitation Exemption

§448(c) Gross Receipts Test — 2026 Mechanics

Under IRC §448(c)(1), a corporation or partnership meets the gross receipts test for any taxable year if its **average annual gross receipts for the three-taxable-year period** ending with the year immediately preceding the current year does not exceed the inflation-adjusted threshold. For individuals and entities not otherwise subject to §448(a), the test is applied *as if* the taxpayer were a corporation or partnership. See IRC §448(c)(3); Treas. Reg. §1.448-2.

Inflation-Adjusted Thresholds — Annual Progression.

Tax Year	§448(c) Threshold	Authority
2022	$27,000,000	Rev. Proc. 2021-45
2023	$29,000,000	Rev. Proc. 2022-38
2024	$30,000,000	Rev. Proc. 2023-34
2025	$31,000,000	Rev. Proc. 2024-40
2026	**$32,000,000**	Rev. Proc. 2025-32

"Gross receipts" means the *total amount of money and fair market value of property received from all sources*, **without reduction** for costs of goods sold or other deductions. See Treas. Reg. §1.448-2(d). Gross receipts include sales proceeds, investment income (interest, dividends, rents, royalties), capital gain proceeds (gross), and tax-exempt income. Amounts received from fellow controlled group members are excluded.

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Preparer note. Even if a taxpayer's average gross receipts fall below $32 million, a **"tax shelter,"** as defined under IRC §448(d)(3), is **ineligible** for any of the five exceptions. A "tax shelter" includes any partnership or other entity (other than a C corporation) if more than **35% of its losses** are allocated to limited partners or limited entrepreneurs (a "syndicate") under Treas. Reg. §1.448-2(b)(2).

Under IRC §448(c)(2) and Treas. Reg. §1.448-2(c), all persons treated as a **single employer** under §52(a) (controlled groups), §52(b) (partnerships/trusts/estates), §414(m) (affiliated service groups), or §414(o) are treated as one person for the gross receipts test. The IRS published FAQs on §448(c)(2) Aggregation Rules to address common scenarios.

Example A — Aggregation Trap. TechCo LLC (a partnership with no C corporation partner) had individual gross receipts averaging $20M. However, TechCo is 100% owned by Holdings Corp (a C corporation), which has average gross receipts of $15M. Holdings Corp is TechCo's sole general partner. Because Holdings Corp is a C corporation that is a partner, aggregation under §52(a) applies. Combined average = $35M > $32M. TechCo is **DISQUALIFIED** from all five exceptions for 2026 – even though its standalone receipts are below the threshold.

Key Takeaway: Always analyze common ownership under §52 and §414 before assuming small business status.

Exception 1 — Cash Method of Accounting (IRC §448)

Under §448(a), C corporations, partnerships with a C corporation partner, and tax shelters are generally **prohibited** from using the cash receipts and disbursements method. §448(b)(3) exempts from this prohibition any corporation or partnership meeting the §448(c) gross receipts test. Qualifying taxpayers may use the cash method *even if they carry inventory – a* major TCJA simplification (§1.448-2).

Benefits of the cash method include:

- Recognize income when received — not when earned under accrual.
- Deduct expenses when actually paid — not when obligated.
- Defer taxable income by collecting receivables after year-end.
- Eliminate the need to track tax-basis accounts receivable/payable separately.

Taxpayers changing from accrual to cash must file Form 3115, Application for Change in Accounting Method, using an automatic change under Rev. Proc. 2025-24. The §481(a) adjustment arising from the change is generally spread over **four years** for a positive adjustment (additional income) or taken entirely in Year 1 for a negative (favorable) adjustment.

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Example – Cash Method Election. Metalworks, Inc. (C corporation) fabricates steel components and averages gross receipts for 2023–2025 of $28.5M. Metalworks used accrual accounting and carried inventory inn years prior to 2026. Metalworks qualifies as a small business taxpayer for 2026 as its average gross receipts are less than $32 million. Metalworks files Form 3115 (automatic change) to switch to the cash method effective January 1, 2026, and excludes a December 2026 receivable of $800,000 from its 2026 income, thereby saving $168,000 of corporate tax ($800,000 x 21%).

Exception 2 — UNICAP Exemption (IRC §263A)

The Uniform Capitalization (UNICAP) rules under §263A generally require capitalizing direct costs *plus* a properly allocable share of indirect costs into inventory or the basis of produced property. "§263A costs" reduce current deductions and increase inventory, which potentially increases taxable income and likely creates substantial administrative burden.

Under §263A(i), a taxpayer (other than a tax shelter) meeting the §448(c) gross receipts test is **fully exempt** from §263A for that year – no UNICAP calculation, no additional capitalization of overhead. See §1.263A-1(b)(14); T.D. 9942 (Final Regs).

Costs now currently deductible (rather than capitalized) under the exemption:

- Purchasing costs — buyers' salaries, freight-in for resale inventory, storage costs.
- Production overhead allocable to manufactured goods.
- General and administrative costs allocable to production activities.
- Interest costs under §263A(f) on self-constructed property

Preparer note. The §263A exemption removes the capitalization burden but does not affect §263(a), which separately governs capitalizing improvements to property. Costs that must be capitalized as improvements — e.g., betterments to a building — remain subject to capitalization even when the taxpayer is exempt from §263A.

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Example – UNICAP Exemption (Wholesale Food Distributor). FreshFoods LLC (S corporation) distributes wholesale food products. Its average gross receipts for 2023 – 2025 were $26M. Under UNICAP, FF would be required to capitalize $340,000 of indirect overhead annually (warehouse supervisors, freight to distribution hub, etc.).

As FF's average annual gross receipts in the prior 3 years is less than $32M, FF qualifies for the §263A(i) exemption. FreshFoods files Form 3115 to adopt the §263A(i) exemption and is allowed to fully deduct the $340,000 of prior year §263A capitalized costs in 2026. Assuming a 37% blended pass-through rate, this generates approximately $125,800 in additional owner-level tax savings.

Caution. If FF were to continue growing so that in a future year it no longer qualifies for the small business exception, it would have to compute a §481(a) adjustment equal to the cumulative capitalized UNICAP costs in ending inventory and recognize the income over four years.

Exception 3 — Simplified Inventory Methods (IRC §471(c))

General inventory rules under §471 require a method that clearly reflects income — typically a complex FIFO, LIFO, or specific identification approach. §471(c) allows qualifying small businesses to choose either of two simplified alternatives:

Method 1 — Non-Incidental Materials and Supplies (NIMS):
Treats all inventory as *non-incidental materials and supplies* under §1.162-3. Inventory costs are deducted when the inventory is *first used or consumed in the taxpayer's business*, potentially accelerating deductions compared to traditional cost-of-goods-sold treatment.

Method 2 — AFS / Books and Records Method:
The taxpayer uses the inventory method reflected in its *applicable financial statement (AFS)* — typically GAAP — or, if no AFS exists, the method used in its books and records. See §1.471-1(b). This aligns tax and book inventory, dramatically simplifying tax-to-GAAP reconciliation.

Preparer note. A taxpayer electing the AFS method (Method 2) eliminates the complexity of maintaining a separate LIFO reserve or lower-of-cost-or-market computation for tax purposes. For taxpayers previously using LIFO for tax, switching to §471(c) AFS treatment also eliminates exposure to LIFO recapture under §1363(d) on any subsequent S election.

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Example D — Simplified Inventory. HomeHardware Co. (HHC) is an S corporation who sells retail hardware. HHC's average gross receipts for 2023 to 2025 were $22M. HHC uses the FIFO inventory method for tax, and it does not have an AFS. As HHC's average gross receipts are less than $32M, if it doesn't account for inventory in its financial statements it may elect to immediately expense inventory items when they are purchased. HHC must file Form 3115 to convert from FIFO to the no inventory accounting method. The elimination of inventory would create a negative §481(a) that would be deducted in full in 2026.

Exception 4 — Long-Term Contract PCM Exemption (IRC §460)

Under IRC §460(a), income from *long-term contracts* must be reported using the Percentage of Completion Method (PCM), which requires recognizing income based on the percentage of the contract completed in each year – often accelerating income before cash is received (§1.460-4(b)).

Under §460(e)(1)(B), a qualifying small business is exempt from PCM for any *construction contract* it reasonably estimates will be completed within 2 years of the contract commencement date. Instead, the taxpayer may use any permissible method – including the Completed Contract Method (CCM), which defers *all* income recognition until contract completion.

Preparer note. The two-year test is determined at the time the contract is entered into, based on a reasonable estimate. If the contract later extends beyond two years, the §460(e) exemption is lost prospectively and PCM must be applied. See Treas. Reg. §1.460-3(b)(1). The exemption applies only to construction contracts — not to manufacturing contracts, which remain subject to §460.

Example – Construction Contractor Elects Completed Contract Method. BestBuild LLC (BB) is a partnership that constructs commercial warehouses. For the years 2023 through 2025, BB's average annual gross receipts were $18M. On March 1, 2026, BB enters a $2.5M contract estimated to be completed by December 2027 (21 months so within the 2 years threshold). As BB's average gross receipts are less than $32M, it qualifies for the §460(e) exception. BB elects to use the Completed Contract Method of accounting and delays reporting the entire $2.5M contract revenue until the job is completed in 2027.

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Exception 5 — Business Interest Deduction Exemption (§163(j))

Since the TCJA, IRC §163(j) limits the business interest deductions to 1) business interest income; plus 2) 30% of *Adjusted Taxable Income (ATI)*; plus 3) floor plan financing interest. Disallowed interest carries forward indefinitely. The OBBBA **restored the EBITDA-based ATI calculation** for tax years beginning after December 31, 2024 – adding back depreciation, amortization, and depletion to ATI – which significantly increases the deductible limit (§1.163(j)-2).

Under §163(j)(3), the §163(j) limitation does **not apply** to any taxpayer that is not a tax shelter and meets the §448(c) gross receipts test. For 2026, any taxpayer with average annual gross receipts of $32 million or less over 2023–2025 may deduct **100% of business interest expense** with no ATI limitation. See IRS Q&As — §163(j). The exemption is an *annual determination* — status may change year-to-year.

Practitioner note. Rev. Proc. 2026-17 allows taxpayers that previously elected under §163(j)(7)(B) (real property trades or businesses), §163(j)(7)(C) (farming businesses), or §1.163(j)-1(b)(15)(iii) (regulated utilities) to withdraw those elections for tax years 2022, 2023, or 2024. Revocations must be made by the earlier of October 15, 2026, or the applicable statute of limitations. The election can be made by filing an amended return or AAR marked "FILED PURSUANT TO REV. PROC. 2026-17." Upon withdrawal, the taxpayer is treated as if the election was never made – any §481 adjustments are required to be accounted for.

Summary — All Five Exceptions at a Glance (2026)

IRC §	Exception	Who Benefits	Key Relief	Key Regulation
§448	Cash Method	C corps; partnerships w/ C corp partner	Use cash method regardless of inventory	Treas. Reg. §1.448-2
§263A	UNICAP Exemption	Producers & resellers of inventory	No capitalization of indirect costs	Treas. Reg. §1.263A-1(b)(14)
§471(c)	Simplified Inventory	Businesses with inventory	NIMS or AFS/books method	Treas. Reg. §1.471-1(b)
§460	Long-Term Contract PCM	Construction contractors	CCM or other method for ≤2-yr contracts	Treas. Reg. §1.460-3(b)
§163(j)	Business Interest	All taxpayers w/ business interest	Full deduction; no ATI limitation	Treas. Reg. §1.163(j)-2(d)

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Special Rules, Traps, and Anti-Abuse Provisions

Tax Shelter / Syndicate Disqualification

Under §448(d)(3), a "tax shelter" includes any entity (other than a C corporation) where **more than 35% of losses** are allocated to limited partners or limited entrepreneurs. Tax shelters are ineligible for **all five exceptions**, regardless of gross receipts. This is the most common trap for real estate entities.

Example – Syndicate / Tax Shelter Trap. RE LP (real estate limited partnership) has average gross receipts of $15M in 2023 through 2025. In 2026 RE generates $500,000 of losses, of which $200,000 (40%) are allocated to limited partners. As more than 35% of RE losses are allocated to passive investors, RE is a tax shelter as defined under §448(d)(3). RE cannot use any of the five exceptions regardless of its gross receipts.

Preparer note. Under §1.448-2(b)(2), active participation in management by a member does not cure syndicate status if the member is a "limited entrepreneur" under the regulations. Only genuine general partners who materially participate at all times are not limited entrepreneurs.

B. Loss of Qualification – Annual Re-Evaluation Required

The §448(c) gross receipts test is determined annually. If a taxpayer's average gross receipts grow to exceed $32 million, it loses all five exceptions and must:

- Switch to accrual method of accounting – file Form 3115 and spread positive §481(a) adjustment over four years. **Must concurrently adopt a UNICAP method** – these two changes cannot be separated.
- Begin capitalizing under UNICAP – compute and adopt a permissible §263A method simultaneously.
- Adopt a permissible §471 inventory method (FIFO, LIFO, etc.).
- Apply PCM to new long-term construction contracts entered after the year of disqualification.
- Become subject to §163(j) beginning the year of disqualification.

Preparer note. The IRS has emphasized in §1.448-2 that a change from cash to accrual **cannot** be made as an automatic change without *concurrently* adopting a permissible UNICAP method. BDO and other practitioners have emphasized that gathering UNICAP data and performing the required calculations can be time-consuming – begin the process early in the year of disqualification.

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C. New Businesses and Short Tax Years

Under §448(c)(3)(B), if a taxpayer was in existence for fewer than three years, average gross receipts is computed over the actual years of existence. For a first-year entity, only current-year (or annualized short-period receipts) receipts are used (§1.448-2(c)(2)). A new business generally qualifies for the small business exceptions in its first tax year regardless of revenue.

Recent Developments — 2025-2026 Guidance, Cases, and Law Changes

A. Rev. Proc. 2025-32 — 2026 Threshold Set at $32,000,000

On October 9, 2025, the IRS published Rev. Proc. 2025-32, setting the inflation-adjusted §448(c) threshold for tax years beginning in 2026 at **$32,000,000,** up from $31 million in 2025. Section 4.30 of Rev. Proc. 2025-32 provides: "For taxable years beginning in 2026, a corporation or partnership meets the gross receipts test of §448(c) for any taxable year if the average annual gross receipts of such entity for the 3-taxable-year period ending with the taxable year which precedes such taxable year does not exceed $32,000,000."

B. One Big Beautiful Bill Act (OBBBA) – Key Changes. The OBBBA made these changes affecting the small business exception framework:

- Restored EBITDA-based ATI for §163(j) — depreciation, amortization, and depletion added back for tax years beginning after December 31, 2024.
- Made 100% bonus depreciation permanent for property acquired after January 19, 2025.
- Permanently extended the 21% corporate tax rate.
- Triggered Rev. Proc. 2026-17 — because §163(j)(7) elections became less advantageous under OBBBA, the IRS provided a limited withdrawal mechanism.

C. Rev. Proc. 2026-17 — §163(j)(7) Election Withdrawal. Issued March 18, 2026, Rev. Proc. 2026-17 provides:

- Withdrawal available for elections made on timely filed returns for tax years beginning in 2022, 2023, or 2024.
- Deadline: earlier of October 15, 2026, or end of applicable assessment limitations period.
- File amended return/Form 1065/AAR marked "FILED PURSUANT TO REV. PROC. 2026-17."
- Upon withdrawal: taxpayer treated as if election was never made; full §481 recalculation required.
- May concurrently make late §168(k)(7) election to opt out of bonus depreciation for affected property classes.

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D. Rev. Proc. 2025-24 — Updated Automatic Method Changes. Rev. Proc. 2025-24 updated the master list of automatic accounting method changes, including:

- Change #25 — Change to cash method by new small business taxpayer (no §481(a) spread required for first year).
- Change #105 — Change to §471(c) AFS inventory method.
- Change #106 — Change to NIMS treatment of inventory.
- Change #28 — Change from UNICAP to §263A(i) exempt treatment.

E. Notable Cases — 2024-2026

In *Larson v. Commissioner*, T.C. Memo 2023-57, the Tax Court reinforced that §52 aggregation requires the ownership tests — common management alone is insufficient. This remains the controlling standard for controlled group determinations in 2026.

In *Olson v. Commissioner*, T.C. Memo 2024-18, the Tax Court examined whether limited LLC members constituted "limited entrepreneurs" for syndicate purposes under §448(d)(3). The court found that members who *materially participated in management* were not limited entrepreneurs — preserving small business exception eligibility. This holding confirms that documenting material participation is critical for LLC members seeking to avoid syndicate characterization.

Example – Comprehensive: Multiple Exceptions in One Year. HomeServices Corp. (HSC), a C corporation, provides landscaping and hardscaping services. HSC's average annual gross receipts for 2023 through 2025 were $27.2M. HSC's gross receipts are less than $32M, so it qualifies as a small business taxpayer for 2026. HSC qualifies:

1. To use the Cash Method of Accounting (§448) – this defers $410,000 of 2026 AR to 2027.
2. Not to use the UNICAP (§263A) – the $180,000 overhead previously capitalized is currently deductible in 2026.
3. Is no longer required to account for inventories (§471(c)) – may use AFS method. If inventory exists, HSC may benefit from writing it off completely in 2026.
4. To ignore §163(j) interest limits – $520,000 business interest fully deductible, no ATI limitation.

All combings, HSC may realize a tax benefit (21% corporate rate) in 2026 of $233,100 (cash method deferral: $410K × 21% = $86,100 + UNICAP exemption $180K × 21% = $37,800 + Interest exemption $520K × 21% = $109,200). Any inventory adjustment would increase the benefit.

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Annual Small Business Exception Planning Checklist

Step	Action Item	Authority
1	Compute 3-year average gross receipts (including all aggregated entities)	IRC §448(c)(1)-(2)
2	Apply aggregation — identify all related parties under §52(a), §52(b), §414(m), §414(o)	IRC §448(c)(2)
3	Confirm not a tax shelter/syndicate — losses to limited partners/entrepreneurs < 35%	IRC §448(d)(3)
4	Compare average to 2026 threshold ($32,000,000)	Rev. Proc. 2025-32, §4.30
5	If qualifying — evaluate cash method election; file Form 3115 if changing	IRC §448; Form 3115
6	Evaluate UNICAP exemption — compute potential §263A costs now deductible	IRC §263A(i)
7	Evaluate §471(c) – determine AFS/books vs. NIMS for inventory	IRC §471(c)
8	Identify all long-term construction contracts - — apply §460(e) two-year test	IRC §460(e)(1)(B)
9	Confirm §163(j) exemption applies — Form 8990 not required	IRC §163(j)(3)
10	Review any prior §163(j)(7) elections for withdrawal (deadline: Oct. 15, 2026)	Rev. Proc. 2026-17

Key Citations and Online Resources

Internal Revenue Code (Cornell University LII):

- IRC §448 — Limitation on Use of Cash Method of Accounting
- IRC §263A — Capitalization and Inclusion in Inventory Costs
- IRC §471 — General Rule for Inventories
- IRC §460 — Special Rules for Long-Term Contracts
- IRC §163(j) — Limitation on Deduction for Business Interest
- IRC §52 — Special Rules (Controlled Groups)

Treasury Regulations (eCFR):

- Treas. Reg. §1.448-2 — Cash Method Limitation
- Treas. Reg. §1.263A-1 — UNICAP Rules
- Treas. Reg. §1.471-1 — Inventory Methods
- Treas. Reg. §1.460-3 — Long-Term Contracts
- Treas. Reg. §1.163(j)-2 — Business Interest Limitation

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IRS Guidance, Revenue Procedures, and Official Sources:

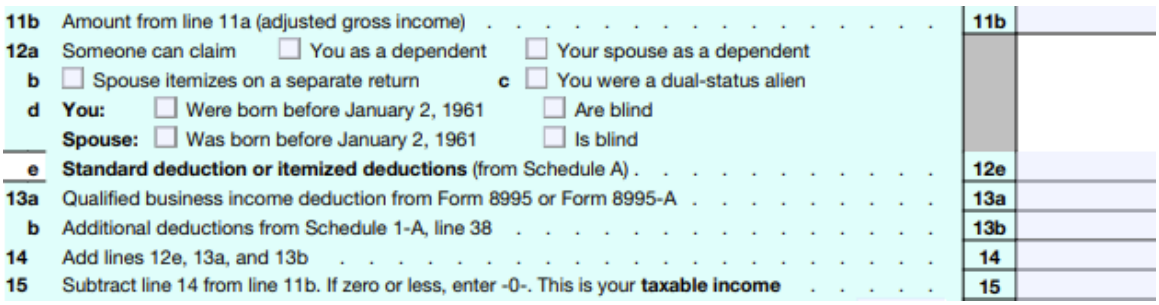
- Rev. Proc. 2025-32 — 2026 Inflation-Adjusted Amounts (I.R.B. 2025-45)
- Rev. Proc. 2026-17 — §163(j) Election Withdrawal (March 18, 2026)
- Rev. Proc. 2025-24 — Automatic Accounting Method Changes (I.R.B. 2025-24)
- IRS FAQs — §448(c)(2) Aggregation Rules and §163(j)
- IRS Q&As — Business Interest Expense Limitation (§163(j))
- Form 3115 — Application for Change in Accounting Method
- Form 8990 Instructions (Rev. December 2025)
- Federal Register: Final Regs §§263A, 448, 460, 471 (T.D. 9942, January 5, 2021)

Qualified Business Deduction Update (§199A)

QBI overview. The QBI deduction (aka: Qualified Business Income or §199A deduction) is a deduction primarily derived from business income, including income from Sch. C, Sch. F, K-1s, and, in some cases, Sch. E. The deduction is equal to the lesser of:

- 20% of net qualified trade or business income deduction (QBI deduction), plus;
- 20% of REIT and Publicly Traded Partnership (PTP) deduction; plus
- Qualified agricultural and horticultural cooperative income deduction.
  Or
- 20% of modified taxable income.

The QBI deduction is only allowed on an individual tax return (Form 1040) or, in some cases, on an estate or trust tax return (Form 1041). Although based on "trade or business" income, the QBI deduction is not allowed on a business tax return (i.e., Form 1120, Form 1120S or Form 1065). The deduction is claimed on Form 1040 as the last item before reaching taxable income.



11b	Amount from line 11a (adjusted gross income)	11b	
12a	Someone can claim ☐ You as a dependent ☐ Your spouse as a dependent		
b	☐ Spouse itemizes on a separate return c ☐ You were a dual-status alien		
d	You: ☐ Were born before January 2, 1961 ☐ Are blind		
	Spouse: ☐ Was born before January 2, 1961 ☐ Is blind		
e	**Standard deduction or itemized deductions** (from Schedule A)	12e	
13a	Qualified business income deduction from Form 8995 or Form 8995-A	13a	
b	Additional deductions from Schedule 1-A, line 38	13b	
14	Add lines 12e, 13a, and 13b	14	
15	Subtract line 14 from line 11b. If zero or less, enter -0-. This is your **taxable income**	15	

Preparer note: The QBI deduction is allowed without regard to basis in a passthrough entity, AGI, or any other limitation on deductions placed at the entity level.

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§199A Part I - 20% of Qualified Trade or Business Income (QBI)

QBI deduction formula defined. In its simplest terms, the QBI deduction equals the lesser of:

1. 20% of qualified business income; or
2. 20% of taxable income without regard to any capital gains of the QBI deduction.

For high income taxpayers (defined below) two additional tests apply: 1) the W-2 wage and business assets test; and 2) the specified service business test (discussed later).

"Low" income versus "high" income taxpayers and QBI. A low-income taxpayer for QBI is defined as a married filing joint taxpayer who has pre-QBI ***taxable income*** of less than $403,500 in 2026 (less than $201,750 for all other filing statuses). Low-income taxpayers are exempt from the W-2 wage test, the specified trade or business test, and the investment in depreciable assets test. **In other words, if the taxpayer's taxable income is less than $403,500 in 2026 (MFJ), or less than $201,750 (2026) for all other filing statuses, the QBI deduction is simply 20% of the lesser of taxable income or qualified business income.**

Example. Chloe is a 50-year-old sole proprietor who operates a tax preparation business. Chloe's 2026 net profit was $100,000. Robert, Chloe's husband, is 59 years old and had retirement income of $70,000. They also had interest income of $20,000. Chloe and Robert's income tax return and their QBI deduction are summarized:

Schedule C income	$100,000
Retirement income	$ 70,000
Interest income	$ 20,000
SE Tax deduction	($ 7,065)
Standard Deduction	($ 32,200)
Taxable income before QBI deduction	$150,735
QBI deduction ($92,935* x 20%)	($ 18,587)
Final taxable income	$132,148

*Chloe's Sch. C income less the SE tax deduction.

Taxable income defined (§199A(a)(2)). For QBI purposes, "taxable income" is defined as taxable income prior to the QBI deduction less net capital gains. Net capital gains are defined as the net of long and short term capital gains plus any qualified dividend income (§1.199A-1(b)(3)).

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Example. Chloe operates a tax preparation business as a sole proprietor which had a profit of $140,000. Robert, Chloe's husband, had retirement income of $20,000 and they jointly earned $10,000 of dividend income, $7,000 of which were qualified dividends. Chloe's income tax return and her QBI deduction are summarized:

Schedule C income	$140,000
Retirement income	$ 20,000
Dividend income	$ 10,000
SE Tax deduction	($ 9,891)
Standard Deduction	($ 32,200)
Taxable income before QBI deduction	$127,909
QBI deduction ($120,909* x 20%)	($ 24,182)
Final taxable income	$103,727

* $127,909 taxable income less $7,000 qualified dividend equals $120,909, which is less than QBI of $130,109 ($140,000 less SE tax of $9,891).

High Income Taxpayers Restrictions (§199A(b); §199A(d)(2); §1.199A-1(d))

Taxpayers whose taxable income (not AGI) exceeds specified thresholds must consider two additional limitations before they can claim QBI deductions:

1. The W-2 and capital investment limitation test; and
2. The specified service business trade or business (SSTB) limitation.

The high-income thresholds are inflation adjusted each year. For taxpayers filing married joint returns in 2026, the high-income taxpayer threshold starts at taxable income of $403,500 and is fully phased in at $553,500 ($150,000 phase-out range). For all other filers, the 2026 threshold starts at taxable income of $201,750 and is fully phased in at $276,750 ($75,000 phase-out range). Prior to 2026, the phase out threshold ranges were $100,000 for MFJ and $50,000 for all others. OBBBA permanently increased the phase out range starting in 2026.

Test #1 – Wage and capital investment limitation (§1.199A-1(d)(iv)). Taxpayers whose taxable income (not AGI) exceeds $553,500 (MFJ), $276,750 (everyone else) are required to limit their QBI deduction to the **greater** of:

1. 50% of W-2 wages paid with respect to the qualified trade or business, or

2. 25% of W-2 wages paid with respect to the qualified trade or business plus 2.5% of the unadjusted basis immediately after acquisition (UBIA) of qualified property used to produce income in the underlying business.

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Example. Harry (a single man) operates his construction business as a sole proprietor and generated QBI of $280,000 in 2026. Harry's business paid payroll of $80,000 and he had equipment with UBIA of $350,000 as of Dec. 31, 2026. Harry's pre-QBI taxable income is $300,332, which exceeds the $201,750 threshold and the entire phase-out range. Harry is subject to the W-2 and/or the UBIA limitations. His QBI deduction is calculated:

a. 20% of Harry's QBI ($265,332* x 20%)		$53,067
b. 50% of W-2 wages ($80,000 x 50%)	$40,000	
or		
c. Sum of 25% of W-2 wages ($20,000) plus 2.5% of qualified basis ($350,000 x 2.5% = $8,750)	$28,750	
d. Greater of b. or c.		$40,000
e. QBI deduction - lesser of a. or e.		$40,000

*$280,000 less $14,668 SE tax deduction.

Preparer note. Wages paid to related parties, including owners, are included for purposes of the wage limitation. Sch. C filers with no employees should consider hiring and paying wages to family members or reorganizing as an S corporation and paying themselves wages.

Example. Josie is an independent contractor sales rep who reports her income on Schedule C. Josie typically reports a profit of $800,000 per year. For 2026 Josie restructures her business as an S corporation and pays herself an annual salary of $240,000 (assumed reasonable).

	S Corp	Sole Proprietor*
S corporation K-1 income /Sch. C Income	$ 560,000	$800,000
W-2 income	$ 240,000	$ - 0 -
Standard deduction	($ 16,100)	($ 16,100)
Taxable income before QBI deduction	$ 783,900	$783,900
QBI deduction	($112,000)	$ - 0 -
Net taxable income	$ 671,900	$783,900

Josie realizes tax savings of approximately $62,680 ($112,000 x 37% income tax plus $560,000 x 3.8% Medicare tax savings).

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Phase in of Wage Limit. The wage limit phases in for taxpayers with pre-QBI taxable income of more than $403,500 (MFJ) and $201,750 (for all others) and is fully phased in at $553,500 and $276,750, respectively. For taxpayers with taxable income between the beginning and fully phased out amounts, the wage limit is determined based on the following formula:

The taxpayer first compares qualified trade or business income to wages paid:

1. 20% of the taxpayer's qualified business income, and
2. 50% of the W2 wages paid by the qualified trade or business.

If #1 is less than #2, no further action is necessary. The amount calculated under #1 is the deductible amount. However, if the amount determined under #2 is less than the amount under #1 the wage limit is binding. The taxpayer is required to compute the QBI deduction by reducing the amount from #1 by the same proportion as the difference between the two amounts as the excess of the taxable income of the taxpayer over the threshold amount bears to $50,000 ($100,000 in the case of a joint return).

Test #2 – Specified service trades or businesses (SSTBs) (§199A(d)(3); §1.199A-5)). Once a high-income taxpayer meets the wage and capital investment test, there is still one last hurdle to clear before the §199A deduction may be claimed. The taxpayer may not be involved in a "specified service trade or business." The IRC and the regulations define the term "specified service trade or business" as those involved in the fields of:

- Health
- Law
- Accounting
- Actuarial science
- Performing arts
- Consulting
- Athletics
- Financial services
- Brokerage services
- Investing or investment management
- Trading in securities, commodities, or partnership interests
- Dealing in securities, commodities, or partnership interests
- Any trade or business where the principal asset of the business is the reputation or skill of the owner or employee(s)

Preparer note. The expanded definitions of the SSTB activities only apply for purposes of §199A. These definitions do not in any way apply to any other Code section. See the expanded definitions in §1.199A-5(b)(2).

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Phase-in of specified service business limitation. The QBI deduction can be limited for "high-income taxpayers whose QBI is from a "specified service business." The "high-income" base threshold are the same as the wage limit: $403,500 MFJ and $201,750 for all others. SSTB taxpayers with taxable income below these thresholds have no limit on the amount of their QBI deduction. Those with pre-QBI taxable income more than the fully phased in amounts ($553,500 MFJ; $276,750 for all others) are not allowed any QBI deduction. And those taxpayers whose taxable income is between the base threshold and the fully phased in amounts are required to perform a separate calculation to determine the amount of specified service business income that may be used to determine the allowable QBI deduction.

Mechanics of the phaseout. For taxpayers in specified service trades or businesses and whose pre-QBI taxable income is between the threshold and the maximum amount, the taxpayer's taxable income "slides" from the threshold amount up through the phase-out range, and the percentage of allowable QBI proportionally "slides" down to zero.

Example. Evan, a single taxpayer, has taxable income of $224,750 in 2026, of which $100,000 is attributable to his work as an attorney. Evan paid wages of $50,000 to employees who worked in his law firm. Evan calculates his applicable percentage:

a. Taxable income above the threshold ($220,300 - $201,750)	$23,000
b. Phase out range for single individual	$75,000
c. % of income more than threshold ($23,000 ÷ $75,000)	31%
d. Applicable % allowable when calculating deduction (100% - 31%)	69%
e. Evan calculates his qualified business income and related wages:	
f. Applicable business income ($100,000 QBI x 69%)	$69,000
g. Applicable wages ($50,000 x 69%)	$34,500
Evan calculates his QBI deduction:	
a. Qualified business income deduction ($69,000 x 20%)	$ 13,800
b. Qualified wage deduction ($34,500 x 50%)	$ 17,250
Evan's 2025 QBI deduction - lesser of a. or b.	$ 13,800

Schedule E Income – Is It a Trade or Business?

The Dilemma - Historically, nobody cared. The Internal Revenue Code does not define what is or is not a trade or business and there is little clarifying regulatory guidance. Historically the lack of guidance has not really mattered when it came to rental real estate activities. Income from rental real estate is not subject to SE tax regardless if the rental activity is a trade or business (§1402(a)(1)). Expenses incurred in rental activities are deductible under §162 if the rental activity is a trade or business and under §212 if the rental is held for the production of income (i.e. an investment).

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Regulations help, right? In the Summary of Comments and Explanation of Revisions section of the §199A regulations, the IRS acknowledged that the rental of a single property may require regular and continuous involvement such that the rental activity is a trade or business. However, the IRS further stated it does not believe that the rental of a single piece of property rises to the level of a trade or business in every case as a matter of law. The IRS says the determination of whether a rental activity is a trade or business depends on the specific facts of each taxpayer and property being rented. In other words, we must use our judgement for now and wait for more guidance later.

IRS FAQs shed some light (QBI FAQs Q56 – Q67). In its FAQs, the IRS offered that rental real estate is treated as a trade or business for purposes of the QBI if it meets ***any*** of the following three tests:

1. The rental real estate rises to the level of a §162 trade or business (discussed below).

2. The rental real estate is a rental real estate enterprise meeting the requirements of the safe harbor provided in Revenue Procedure 2019-38 (and the direct owner of the property chooses to rely on the safe harbor). See discussion below.

3. The rental or licensing of property is to a commonly controlled trade or business operated by an individual or a passthrough entity (i.e., self-rental property).

Can §469 or §1411 help? Practitioners may be tempted to look at other code sections for guidance, such as the passive activity rules (especially the material participation rules) to assist in QBI decisions. This would be a huge mistake. The SCER section of the final QBI regulations states that the passive rules serve a vastly different purpose than the QBI deduction and should not be relied on in any way when making decisions about QBI (SCER II.A.3.a.). Bottom line, tax professionals should avoid any IRC section other than §199A to determine whether a taxpayer activity qualifies as a trade or business.

Preparer note. IRS Q&A #62 specifically states §199A does not have a material participation requirement. Eligible taxpayers with income from a qualified trade or business may be entitled to the QBID regardless of their level of involvement in the trade or business.

What does the IRS say? (§1.199A Regs, Summary of Comments and Explanation of Revisions (SCER) Section II.A.3.b.). In the SCER section of the final QBI regulations the IRS noted that additional factors to be "considered" when determining whether an activity is a trade or business include a) type of property rented; b) number of properties rented; c) level of an owner(s) or agent(s) day-to-day involvement; d) ancillary services provided by lease; and e) the lease term (e.g. long-term vs. short-term). The IRS concluded that further clarification of what is a trade or business is beyond the scope of the QBI regs.

IRS Regulations provide specific guidance in two instances of rental activities.

1. Self-rentals; and
2. Safe harbor rentals.

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1. Self-rentals are a trade or business by default (§1.199A-1(b)(14)). Rent or licensing of tangible or intangible property (rental activity) will be treated as a trade or business for QBI purposes if the property is rented or licensed to a trade or business conducted by the individual or a relevant pass-through entity (RPE) which is commonly controlled (as defined by §1.199A-4(b)(1)(l)).

2. Real estate trade or business safe harbor. The IRS also created a safe harbor to establish that a rental real estate activity is a trade or business (solely for QBI purposes). Individuals and relevant passthrough entities (RPEs) (i.e., S corporations, partnerships, estates, and trusts) may annually choose to use the safe harbor.

Preparer note. This is only a safe harbor. Failure to satisfy the requirements of the safe harbor does not preclude a taxpayer from otherwise establishing that a rental real estate activity is a trade or business for QBI purposes. Taxpayers may always rely on their own facts and circumstances to establish that an activity is a trade or business.

Safe harbor rental real estate activity. Under the safe harbor, a rental real estate activity is defined as an interest in real property held to produce rents and may consist of an interest in multiple properties. The individual or RPE relying on the safe harbor must hold its interest directly or through a disregarded entity.

Multiple rental activities may be combined – consistency required. Taxpayers must treat each rental activity as a separate enterprise or treat all similar rental activities as one single activity. Commercial and residential real estate may not be combined into the same activity. Once a taxpayer combines multiple rental interests into a single activity under the safe harbor, the taxpayer is required to continue to treat interests in all similar properties, including newly acquired properties, as a single rental activity. If a single rental property includes residential and commercial rentals (i.e., mixed-use property) the taxpayer may either treat the entire property as a single rental activity or bifurcate the property into two rental activities.

Specific real estate activities are excluded. Certain rental real estate activities are specifically excluded from this safe harbor, including:

- Real estate used by the taxpayer (including an owner or beneficiary of an RPE) as a residence for any part of the year under §280A; and
- Real estate rented or leased under a triple net lease[4].

Safe harbor requirements. The requirements of the rental real estate safe harbor are:

1. Separate books and records must be maintained to reflect income and expenses for each rental real estate activity (or group of rental activities if activities are combined);

[4]For this purpose, a triple net lease is defined as a lease arrangement that requires the tenant to pay taxes, fees, and insurance, and to be responsible for maintenance of the property, even if the tenant only pays a portion of these items allocable to the portion of the property the tenant rents.

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2. 250 or more hours of "rental services" (defined below) are performed each year with respect to that specific rental activity. The 250-hour test must be met in three of the five consecutive years ending with the year being tested. If a rental has been held for less than five years, the 250-hour test must be met each year the rental is owned.

> **Example.** Barry owns and manages an eight-unit apartment complex. Barry can show more than 250 hours of rental services were provided to the apartment complex in 2026. Assuming all other requirements are met, Barry may treat the apartments as a QBI activity.

3. The taxpayer maintains contemporaneous records (e.g., time reports, logs, etc.) that contain the following:

    a. Hours of all services performed;
    b. Description of all services performed;
    c. Dates on which such services were performed; and
    d. Who performed the services.

"Rental Services" defined (Rev. Proc. 2019-38, Section 3.04). Rental services may be performed by owners, employees, agents, and/or independent contractors and include:

- Advertising to rent or lease real estate;
- Negotiating and executing leases;
- Verifying information contained in tenant applications;
- Rent collection;
- Daily operation, maintenance, and repair of the rental property;
- Management of the real estate;
- Purchase of materials; and
- Supervision of employees and independent contractors.

"Rental services" do **NOT** include:

- Financial or investment management activities (e.g., arranging financing, procuring properties, studying, and reviewing financial statements);
- Planning, managing, or constructing long-term capital improvements; or
- Time spent traveling to and from real estate.

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Example. Siblings Bob, Carol, Ted, and Alice inherited a commercial rental property that includes 12 separate rental spaces and generates annual rental profit of $400,000. The property is held in BCTA, an LLC. The siblings hire Aces Property Management (APM) to manage the rentals. All tenant leases require the tenant to provide their own interior property maintenance. APM finds and vets tenants, negotiates leases, collects and deposits rents, pays all expenses, hires contractors to keep the exterior parking lots and sidewalks maintained, hires experts to provide repairs on exterior portions of the property, and supervises all activities at the property. Based on contemporaneous time logs, APM determined they spent 261 total hours providing these services in 2026. The siblings also spent 35 hours negotiating and obtaining a new loan on the property. All these hours are summarized:

Task	Done By	Total Hours	Qualifying Hours	Non-Qualify'g Hours
Collecting and depositing rents	APM	18	18	
Tenant in/out moves	APM	36	36	
Maintenance and repairs	Contractors	192	192	
Supervise agents	APM	15	15	
Refinance mortgage	Siblings	35		35
Totals		296	261	35

BCTA meets the hours requirement of the rental real estate safe harbor even though the partners didn't have any time invested in the rental real estate. The time documented by APM and its subcontractors counts in the hour total.

Making the rental real estate safe harbor election. Those using the rental real estate safe harbor to claim the QBI deduction are required to attach a statement to their return stating that the safe harbor requirements are met. The statement must also include:

- A description (including address and rental category) of each rental property included in each rental real estate enterprise;
- A description of any rental properties acquired and disposed of during the year.

What if the safe harbor requirements cannot be met? The first thing to ask is "What is the question that needs to be answered?" Most practitioners are determined to decide whether the rental activity is or is not a trade or business. That is **NOT** the question. The real question is whether the rental activity is a trade or business or an investment? Any activity that is engaged in for a profit must be one or the other. Once it's understood there are only two answers, it may be easier to determine that an activity is **NOT an investment**, in which case it **must be a trade or business**. Remembering the real question helps to guide the answer and helps to defend the position with the IRS.

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Example. Terry owns and rents a duplex. During the year, Terry collected 24 rent payments, made monthly mortgage payments that included property taxes and insurance. Terry also made repairs to the rental property during the year which she estimates took 95 hours of her time. Terry doesn't have enough time to qualify for the safe harbor.

Question - is 95 hours enough to make Terry's rental activity a trade or business? Nobody knows for sure. But what if the question were asked in a different way - if you were presented an investment opportunity would you expect to spend 95 hours performing physical labor (almost 8 hours a month) for the year on the "investment"? Probably not. Again, nobody knows for sure - but to quote the Supreme Court, it is a facts and circumstances test. The author believes Terry's duplex would qualify as a trade or business for QBI purposes.

Preparer note. IRS QBI FAQ #62 clearly states that §199A ***does not*** have a material participation requirement. Taxpayers with income from a qualified trade or business may be entitled to the QBID regardless of their level of involvement in the trade or business.

Triple net note. As mentioned above, the rental-related safe-harbor does not apply to triple net leases. This does not, however, mean that triple net leases are always excluded from QBI. The IRS concedes in its QBI FAQ #65 that a single triple net lease treated as a trade or business under §199A is included in QBI. In the BCTA example above, the leases with individual tenants were thought to be triple net. However, there was adequate involvement by the property management company to make a compelling argument that the rental complex was a trade or business.

What do the courts say? (*P. Groetzinger v. Comm.*, 480 US 23, S.Ct. 980, Feb. 24, 1987) In Groetzinger, which is the seminal case in this area, the Supreme Court noted that while the phrase "trade or business" is used frequently in the Code, there is no statutory or regulatory definition. The Court also noted that the determination of whether an activity is carried on as a trade or business must be made for each activity using the specific facts and circumstances of that activity - there is no bright line test. Furthermore, the Supreme Court held that the four most important factors to be decided are whether the activity is pursued:

1. On a full-time basis;
2. With regularity;
3. Continuously; and
4. For making a profit.

While all four of these factors are not required, the more factors that are met the more likely the IRS will accept that an activity is carried on as a trade or business.

Other cases to note:

- *Murtaugh, James B. v. Comm.*, TC Memo 1997-319 where taxpayer who used a property manager to rent two-time share interests was found to be in a trade or business.
- *E.R. Curphey v. Comm.*, 73 TC 766 (1980) Dkt. 10546-78, where the court noted that the rental of "even a single piece of real property for the production of income constitutes a trade or business."

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- *Gilford v. Comm.*, 201 F.2d 735 (2d Cir. 1953) where taxpayers with fractional interests in real estate rentals and were not involved other than hiring a property manager were treated as being in a trade or business. The underlying work of the property manager elevated the activity to the level of a trade or business.
- *Leland Hazzard v. Comm.*, 7 TC 372 (1946) Dkt. #8690 where the taxpayer lived in his residence for nine years and then began renting it. The residence was sold after being rented for 3 years. The Court ruled the rental activity was a trade or business although the taxpayer's involvement in the rental activity was minimal. Hazzard relocated to Pittsburgh and the rental activity was in Kansas City, MO.

But also see where the courts weren't so taxpayer friendly:

- *David Keefe v. Comm.* TC Memo 2018-28 where taxpayer purchased an historical mansion, spent 8 years renovating the mansion in anticipation of renting it, never actually rented it, and then sold it after the renovations were finished.
- *Grier et al. v. U.S.*, 120 F. Supp. 395 (1954) USDC D. Connecticut) where taxpayer inherited single family home, rented it for 12 years to the same tenant, and then sold it. Court ruled that the taxpayer did not have enough activity to make the rental a trade or business.
- *C.A. Foehl, Jr. v. Comm.*, TC Memo 1961-93 where the taxpayers purchased two residential acres with a plan to build their residence on the land. The land included a swimming pool and two bath houses. The Foehls owned the property for 5 years and sold it at a loss which they claimed as a trade or business loss. The Foehls rented the property for one summer to operators of a summer camp. Other than that, the property was never rented. The Court ruled that due to the lack of ongoing rental activity the Foehl's property was not a trade or business and the loss on sale was a capital loss.

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Trade or Business – Related Court Cases Summary					
Case Name	**Year**	**Court**	**Rental Type**	**Ruling**	**Owner Activity**
Keefe	2018	6th Circuit	Single rental	Investment	Yes – not enough
Murtaugh	1997	Tax Court	Time shares	Business	No – agents only
Groetzinger	1987	**Supreme Court**	Gambling	Business	Yes – regular/continuous
Balsamo	1987	Tax Court	Single rental	Investment	Yes – not enough
Curphey	1980	Tax Court	6 rental properties	Business	Yes – continuous
Fegan	1979	Tax Court	Motel rental	Business	No
Foehl	1961	Tax Court	Single rental	Investment	Yes – not enough
Reiner	1955	7th Circuit	Single rental	Business	No
Grier	1955	2nd Circuit	Single rental	Investment	Yes – not enough
Gilford	1953	2nd Circuit	Fractional interest	Business	No – agents only
Hazard	1946	Tax Court	Single rental	Business	No
Fackler	1943	6th Circuit	Long-term lease	Business	Yes - regular

Better prepare 1099s! One last comment - the IRS specifically says on its website (QBI FAQs #64) that trade or businesses and owners who otherwise meet the requirements must file information returns (aka: Forms 1099). §199A and its rules do not change any existing requirement for information reporting as provided under section 6041. Pretty hard to argue you are a trade or business and then argue you are not required to file 1099s. The failure to file 1099s penalty can be over $1,000 per 1099.

Partners and Guaranteed Payments

Items specifically excluded from QBI (§1.199A-3(b)(2)(ii)). The regulations list several specific types of income as excluded form QBI, including:

- Short-term capital gains and losses and long-term capital gains and losses.
- Dividends, income equivalent to dividends, or payments in lieu of dividends, except for patronage dividends (discussed later).
- Interest income, other than interest income which is properly allocable to a trade or business (e.g., finance charges on accounts receivable). Interest income attributable to an investment of working capital, reserves, or similar accounts is not QBI.
- Annuity income.
- Qualified REIT dividends or qualified PTP income (see discussion later).
- Wages including reasonable compensation paid by an S corporation to its shareholder(s).
- ***Guaranteed payments made to partners regardless if the partner is an individual or a relevant passthrough entity (RPE) and regardless if the payment is made for the use of capital or is for services rendered.***

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Example. Chloe and Laina's partnership earns $200,000 (before guaranteed payments). Each partner was allocated $60,000 guaranteed payments and $40,000 pass-through income on Form K-1. Chloe files a joint return with her husband Robert who has a pension of $60,000. Chloe contributes $7,000 to her IRA. Taxable income for Chloe and Robert is calculated:

Guaranteed payment from K-1	$ 60,000
Pass through income from K-1	$ 40,000
Pension income	$ 60,000
IRA contribution (no impact on QBI)	($ 7,000)
SE tax deduction	($ 7,065)
AGI	$145,935
Standard deduction	($ 32,200)
Taxable income before QBI deduction	$113,735
QBI deduction ($37,174* x 20%)	($ 7,435)
Final taxable income	$106,300

* $40,000 K-1 pass through income less $2,826 (SE tax deduction of $7,065 x 40% of SE income).

Are guaranteed payments required? One big difference between an LLC and an S corporation is there is no requirement that an LLC make guaranteed payments or pay partners reasonable compensation. Guaranteed payments are only required where payments made to a partner are:

1. Paid for services or for the use of capital; **AND**

2. Paid without regard to partnership income.

In other words, guaranteed payments will be made regardless of the partnership's ability to make the payments. In the author's experience, guaranteed payments are more often a base pay amount, if there are sufficient profits, and then additional profits are paid as distributable income. Or guaranteed payments are used to pay a partner who provides substantially more services than other partners for those services provided. But, if there is no good reason to classify income as guaranteed payments, all they do is reduce QBO deductions.

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Example. Chloe and Laina's partnership earns $200,000 (before guaranteed payments). Each partner was allocated $0 guaranteed payments and $100,000 pass-through income on Form K-1. Chloe files a joint return with her husband Robert who has a pension of $60,000. Chloe contributes $7,000 to her IRA. Taxable income for Chloe and Robert is calculated:

Guaranteed payment from K-1	$ 0
Pass through income from K-1	$100,000
Pension income	$ 60,000
IRA contribution (no impact on QBI)	($ 7,000)
SE tax deduction	($ 7,065)
AGI	$145,935
Standard deduction	($ 32,200)
Taxable income before QBI deduction	$113,735
QBI deduction ($92,935 x 20%)	($ 18,587)
Final taxable income	$ 95,148*

* Each partner's QBI deduction is increased by $11,152 by eliminating guaranteed payments. If they aren't necessary or required, don't do them.

Preparer note. Question 35 of the IRS §199A FAQs says that taxpayers must "consider" UPE, as well as SE tax deduction, SE health insurance and pension contributions when calculating QBI, even though these items are not reported on the K-1. The FAQ goes on to say these deductions "could" require adjustment to QBI.

"Consider" and "could" don't give us much clarity. The big question is should UPE be offset against guaranteed payments, against K-1 line 1 pass through income, or be prorated between the two? The regulations are silent as to how such items should be treated. In fact, SCER IV.A.5. notes that the IRS was asked to clarify this issue and they declined to do so, stating that such clarification was beyond the scope of the regulations. Prorating the UPE between guaranteed payments and line 1 allocated profit certainly seems reasonable. However, it is the author's opinion that it would also be reasonable to view UPE as incurred in the same way as an employee would incur employee business expenses. UPE are related to a partner's work for the partnership, which is the activity that generates any guaranteed payments. Using this logic, it would seem appropriate to deduct UPE against guaranteed payments first, and if there is UPE more than guaranteed payments the remaining UPE would be deducted against pass through income. The author is taking this position until clear guidance to the contrary is established.

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General Business Topics

Business Loss Deduction (§461(l)OBBBA §70601)

Losses limits. In the case of a noncorporate taxpayer, no deduction is allowed for current year net business losses that are more than a specified amount (in 2025, these amounts are $626,000 for joint filers and $313,000 for all other taxpayers). The specified amounts are adjusted for inflation each year. This limitation on excess business losses was set to expire after 2028 but has now been made permanent.

Modification of the inflation adjusted thresholds. OBBBA also reset the index year to 2024 for inflation adjustments to the business loss limitation. Essentially, the 2024 limits will roll back to the original $500,000 and $250,000 thresholds and then inflation adjustment will begin there in 2026. This makes it highly likely the inflation adjustments made to these amounts since 2019 will be clawed back and the 2026 limits will be lower than the 2025 limits. Any excess business loss is treated as an NOL in the subsequent year and does not have to be retested if carried over. The amendments to the limitation amounts apply for taxable years beginning after December 31, 2025, so there is no impact on the 2025 limits.

Percentage of Completion for Residential Construction (§460(e))

Many small home construction contractors are exempt from the requirement to use the percentage of completion accounting method for home construction projects. OBBBA expanded the exemption to all residential construction contracts for tax years beginning after July 4, 2025. The bill expands the exception to cover contracts up to three years (rather than the previous two years). In addition, no AMT adjustment is required for any residential construction contract.

Huge Change for Marijuana Businesses (§280E)

President Trump's Executive Order requires reclassification of marijuana from Sch. I to Sch. III controlled substance (EO 14370). The U.S. Attorney General published final regulations on April 22, 2026, that placed both FDA-approved medical marijuana products and medical marijuana products regulated by a state medical marijuana license in Schedule III of the CSA. Unlicensed marijuana crops, bulk marijuana, and any marijuana and marijuana extract that have not yet been incorporated into an FDA-approved drug product remain in Schedule I (AG Order #6754-2026).

> **Preparer note.** The DOJ also announced it plans to fully remove marijuana from Schedule I and place it into Schedule III under the Controlled Substances Act, not just medical marijuana. At publishing date for this book, that had not yet happened.

Tax guidance coming (US Treasury Dept NR 4/30/26). Treasury and the IRS expect to issue guidance to address the Federal tax issues stemming from change in marijuana Schedule III classification. Specifically, §280E generally disallows deductions and credits for any amount spent carrying on a business that consists of trafficking in Schedule I or II controlled substances. It currently appears that rescheduling will remove §280E limitations on qualifying businesses.

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Guidance is expected to clarify how businesses with multiple activities (e.g., activities in Schedule I or II and III activities) will apportion related expenses.

Effective date unknown. In its press release, the Treasury noted a transition rule will later be issued that will provide that rescheduling will first apply for a business's full taxable year that includes the effective date of the Final Order (April 22, 2026). While It appears there is no retroactive relief, this area is evolving so stay tuned!

IRS expected to expand FAQs for marijuana related businesses (Cannabis industry FAQs). IRS plans to provide additional insight into marijuana taxation via its FAQs on IRS.gov.

Interest Computation Calculators Available For Form 8697 IR-2026-70)

Overview. Taxpayers with income from certain long-term contracts accounted for under either the percentage of completion method or percentage of completion-capitalized cost method are required, in the year of completion, to allocate the income among the prior taxable years based on actual contract price and costs instead of estimated contract price and costs. Once the underpayment or overpayment of tax that results from this reallocation of income, for each affected prior taxable year, is determined, the taxpayer must either pay look-back interest if the reallocation reveals a deferral of tax liability or is entitled to a refund of interest if the reallocation shows an acceleration of tax liability (§460(b)(1)(B); §1.460-6(a)(1)).

Post-completion revenue and expenses. In addition to the year of completion, look-back applies to any post-completion year for which the taxpayer must adjust the total contract price or total allocable contract costs. For example, if the taxpayer receives additional income due to the settlement of a dispute with regard to a contract in a year after the contract was completed, the taxpayer must compute look-back interest for all prior years that the contract was in process (§1.460-6(c)(1)(ii)). However, the taxpayer may elect not to have look-back method apply in de minimis cases (§460(b)(6)(A); §1.460-6(j))

Form 8697 – reporting the interest owed or due. Form 8697 is used to compute and report look-back interest due or to be refunded. For each filing year, the taxpayer will either owe look-back interest or be entitled to a refund as the "net" result of computing look-back interest on one or more redetermination years. Thus, a current filing year may contain both hypothetical overpayments and underpayments for prior years, but the net result determines whether look-back interest is owed by the taxpayer or should be refunded (§1.460-6(f)(1) and (2)).

IRS provides calculator to assist with Form 8697 calculations (IR-2026-70). The IRS released a new calculator to help businesses working on large, multi-year construction or manufacturing projects more easily figure interest related to those contracts. The Excel-based Percentage-of-Completion Method (PCM) Look-Back Interest Calculator XLSX supports calculations required for Form 8697, Interest Computation Under the Look-Back Method for Completed Long-Term Contracts PDF. Tax professionals working with long-term construction and manufacturing contracts may find the calculator useful when computing look-back interest. The calculators can be found at:

https://www.irs.gov/newsroom/irs-releases-new-look-back-interest-calculator-for-long-term-contracts

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Can't Have a Tax Class in 2026 Without Mentioning AI !

Generative AI – What? Generative AI is software that produces new content – text, images, audio, code – based on patterns it has learned from massive amounts of existing material. The simplest way to think about it is that AI is a very advanced autocomplete. When you start typing a word on your phone and it suggests the next one, that's a basic version of the same process. Generative AI does that on an enormous scale, across billions of words, in a way that can produce coherent paragraphs, complete documents, and detailed explanations. That said, it is important to know that in the AI world, hallucinations can and do occur. A hallucination happens when AI generates content that is factually wrong but sounds completely correct. Bottom line, think before believing AI.

Four main AI platforms. There are a lot of AI tools out there right now. New ones launch constantly, and the existing ones are updating their features at a pace that's hard to keep up with. The four AI products that are most likely to be used in a tax office are:

1. **ChatGPT (OpenAI)** – ChatGPT is the most known AI tool. It was launched in 2022 and is the fastest-growing consumer software product in history. It's likely your team is already using it. It comes in both a free and paid version.

2. **Claude (Anthropic)** – Claude is Anthropic's AI assistant. Claude is generally considered a stronger AI tool for business applications. It also comes in a free and paid version.

3. **Google Gemini** – Gemini is Google's AI platform. It's deeply integrated with Google Workspace, which means it can connect to your Gmail, Drive, Docs, and Calendar if you allow it. That integration is both its main selling point and its main security risk. Gemini is also available in a free and paid version.

4. **Microsoft Copilot** – Copilot is Microsoft's AI product, and it appears in several places depending on what Microsoft products you use. It's built into Windows 11, it's available as a standalone tool at copilot.microsoft.com, and it's integrated into Microsoft 365 applications (e.g., Word, Outlook, and Teams). Like the others, Copilot can be upgraded to a paid version which provides enhanced security features.

AI, Security and Circular 230. When you type a question into a consumer AI, that conversation may be reviewed, analyzed, stored, and used to improve future versions of the AI model. The exact details depend on the platform and how AI is set up. The broad point is this: your input is going into someone else's system, and you don't fully control what happens to it after that.

As we all know, Circular 230 specifically prohibits the unauthorized disclosure or use of tax return information. Tax professionals are required to obtain written client consent before any client information is shared with a third party. The company behind the AI, including their systems, servers, training pipelines, are all third parties. If identifiable client information is shared with AI without written consent, that is a Circular 230 violation.

Effective prompting. The most consistent complaint the author's heard about AI is that it never gets the right answer. To throw back to a very old saying in the tech world, garbage in, garbage out! Those who are most effective using AI are those who take the time to craft their queries well. Letting AI know in advance the context, who you are, who will receive the info and what format you wish to use is invaluable to getting better results. For example, you could ask AI to:

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1. Write a newsletter about Trump accounts – this prompt will get you an answer, but it may be very vague or too detailed, too many or too few words, etc.

A better prompt would be:

2. Write a newsletter from a CPA firm to its clients to explain the rules and processes for Trump Accounts. Include a discussion of the $1,000 government grant and the annual contributions. Do not discuss the employer contribution options. Use no more than 1000 words.

Which prompt will get you something closer to what you want?

Preparer note. In this tax update class, there really is not enough time to cover AI in detail. Taxspeaker has a much more in-depth class – AI Essentials for Tax Offices – that's available either on demand, e-book, or printed manual. It is a one-hour class that I strongly recommend. I've taken it and I loved the info. I don't think there is a more important topic out there today.

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Business Pension Plans

Qualified pension and retirement plans receive favorable Federal tax treatment, including deferral of taxes on contributions and investment earnings until benefits are received at retirement. Congress has provided employer incentives for those who form or maintain pension plans. These pension tax incentives are currently the largest tax expenditure, which include defined contribution, defined benefit, and IRA plans. Yet there remains a growing concern that many millions of working Americans persist largely outside the private pension system.

DOL Reports Latest Pension Plan Statistics (DOL Private Pension Plan Bulletin January 2026)

Highlights from the DOL Bulletin

- While the number of private pension plans has been going up slightly, the number of 401(k) and other employee contribution type plans have been going up much faster. Between 2000 and 2023, employer pension plans (DB and DC) increased from 736,000 to 837,000. During the same period, the number of employer-sponsored defined contribution plans increased from 687,000 to 791,000.

- The number of individuals participating (active or inactive) in any type of employer sponsored plan increased from 103 million in 2000 to 156 million in 2023. All the participant growth was in defined contribution and 401(k) plans. Participation in defined benefit plans shrank from 42 million in 2000 to 29.3 million in 2023.

- Pension plan assets grew from $4.2 trillion in 2000 to $12.4 trillion in 2023.

- Total pension plan distributions in 2023 were $1.044 trillion and total contributions were $846 billion.

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2025 Retirement Savings Account Balances by Age
Source – Vanguard's How America Saves 2026 Report

Age	Average	Median
<25	$7,259	$2,234
25–34	$50,261	$18,732
35–44	$120,742	$46,919
45–54	$214,991	$78,730
55–64	$305,006	$107,269
65+	$330,186	$103,202

Many Retirement Plan Options Available to Employers

At the core, all retirement plans are either defined contribution plans or defined benefit plans. Most private sector retirement plans, especially for small businesses, are defined contribution plans. Options available to small employers looking to implement a retirement program include:

- Payroll deduction IRA
- SEP IRA (§408(k))
- SIMPLE IRA and SIMPLE 401(k)(§408(p); §401(k)(11))
- Profit sharing plans (§415(c))
- 401(k)s, safe harbor 401(k)s (§401(k))
- Defined benefit plans (§415(b))
- Cash balance plans.

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2026 Pension Comparison Summary (Notice 2025-67)				
	Simple IRA	**SEP**	**Solo 401-K**	**401-K**
Highlights	Good choice for small businesses and employers offering a plan for the first time. 97% employee funded.	100% employer funded, but 100% at employer discretion, and 5500 not required. High funding limit for profitable SE businesses.	Higher limits than SIMPLEs but 5500 normally required. 100% employee deferral contributions allowed by owner employees.	Funded by employees & employers but top-heavy rules may apply. Safe harbor plans avoid top-heavy rules.
Max Employee Contribution	$17,000 or $18,100	-0-	$24,500	$24,500
Max Employer Contribution	$17,000 or $18,100	Lesser of 25% of W-2/SE income or $72,000	Lesser of 25% of W-2 or $72,000	Lesser of 25% of W-2 or $72,000
Max Contribution All Sources	$17,000 or $18,100 + 3% of W-2 Before Deferral	$72,000	$72,000	$72,000
Over Age 49 Catch-Up Contr'n	$4,000 or $3,850	N/A	$8,000	$8,000
In 2025, higher catch-up limits for ages 60 - 63	$5,250	$0	$11,250	$11,250
Tax Deduction	Yes	Yes	Yes	Yes
Withdrawals	Taxed	Taxed	Taxed	Taxed
Earnings	Deferred	Deferred	Deferred	Deferred
Penalty Exceptions	Most IRA exceptions	Most IRA exceptions	Many IRA exceptions	Most IRA exceptions
Form By (2026)	10/1/26	Due date + extension	Due date + extension	Due date + extension
Contribute By	Due date + extension	Due date + extension	Due date + extension	Due date + extension
Penalty Issues	25% 1st 2 years, then 10% before 59½	10% before 59½	10% before 59½	10% before 59½
Tests	No other active plan	No other active plan	Family Only, Employer sponsored, other plans okay	Employer sponsored, other plans okay
Distributions required	Usually age 73	Usually age 73	Usually age 73	Later of age 73 or retirement
Bankruptcy Protection	Unlimited	Unlimited	Unlimited	Unlimited
5500 Required	No	No	Normally	Yes
More Information	Publications 560	Publications 560	Publications 560	Publications 560

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Savings Incentive Match Plan for Employees or Small Employers (SIMPLE IRAs) (§408(p); §401(k)(11))

SIMPLE IRAs in general. Many employers, especially small employers, are reluctant to take on the administrative burden and cost of maintaining a retirement plan. To make it more administratively feasible, Congress adopted the Savings Incentive Match Plan for Employees IRAs (SIMPLEs). SIMPLE IRAs are retirement plans where each employee may choose to have their employer make payments to the employee's individual SIMPLE account (over which the employee has 100% control of the investments) or to receive the payment directly in cash. The SIMPLE account is an IRA, but it is a separate and distinct IRA from other types of IRAs (i.e., SEP IRAs, traditional and Roth IRAs).

No fiscal year end for SIMPLE IRAs. All calculations and testing for SIMPLE IRAs must be completed on a calendar year basis. This includes the determination of employer and employee eligibility, as well as contribution timing, matching, etc. The plan sponsor's tax year end is irrelevant.

Deadline for employers to set up SIMPLE IRA plans. A SIMPLE IRA plan may be established on any date between Jan. 1st and Oct. 1st of the year the plan is to take effect, provided the employer hadn't previously maintained a SIMPLE IRA plan. Employers who previously maintained a SIMPLE IRA plan must reestablish a plan only on Jan. 1st of the year the plan is to take effect. New employers that come into existence after Oct. 1st and wish to establish a SIMPLE IRA plan must set up the plan as soon as administratively feasible. A SIMPLE IRA plan cannot have an effective date that is before the date the plan is adopted (Form 5304 or 5305 completed).

SIMPLE IRAs may be combined with traditional and/or Roth IRAs. As with SEPs, contributions to a SIMPLE IRA do not affect the amount an individual can contribute to a Roth or traditional IRA. Individuals may elect to fully fund a SIMPLE IRA and a traditional or Roth IRA if they meet the traditional IRA AGI thresholds for participants in a pension plan.

Form 5304-SIMPLE and Form SIMPLE 5305-SIMPLE. Employers use one of two IRS forms to serve as a model SIMPLE IRA plan document: Form 5304-SIMPLE or Form 5305-SIMPLE. Form 5304-SIMPLE is used when each participant is allowed to choose the financial institution where their SIMPLE account is established. Form 5305-SIMPLE is used when the employer designates the financial institution. The SIMPLE IRA plan is adopted when all appropriate boxes and blanks on the form have been completed and the employer (and the designated financial institution, if any) have signed it. The employer keeps the original form. No forms are required to be filed with the IRS.

Employee notification required. Form 5304/5305 SIMPLE includes a SIMPLE IRA "Model Notification to Eligible Employees", which satisfies the employee notification requirement. If audited, the employer must be able to provide adequate proof of when the SIMPLE IRA plan was established and that employees were notified.

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A Tale of Two SIMPLE IRAs – the Enhanced SIMPLE and the Traditional SIMPLE

SECURE Act and SECURE Act 2.0 made several enhancements to SIMPLE IRAs and created two sets of rules based on the employer's number of employees. To help differentiate between these two sets of SIMPLE IRA rules, the author will refer to them as "Enhanced SIMPLE IRAs" and "Traditional SIMPLE IRAs." Employers with 25 or fewer qualified employees are required to follow the "Enhanced SIMPLE IRA" rules. Employers with 26 or more qualified employees use the "Traditional SIMPLE IRA" rules but are allowed to ***elect*** to use the Enhanced SIMPLE IRA rules. The result is that SIMPLE IRAs are no longer so simple, assuming they ever were! The chart below summarizes the main differences between the two sets of rules.

Description	Enhanced SIMPLE IRA Rules	Traditional SIMPLE IRA Rules
Employer qualifications for the Enhanced or Traditional SIMPLE IRAs	Employers who, in the prior calendar year, had 25 or fewer employees whose W-2 Medicare wages were $5,000 or more are required to follow the Enhanced SIMPLE IRA rules. Employers who had 26 or more qualifying employees may elect to have the enhanced rules apply.	Employers with 26 or more employees who made $5,000 or more in the preceding calendar year are subject to the Traditional SIMPLE IRA rules unless they elect to utilize the enhanced SIMPLE IRA rules.
2026 maximum regular employee elective deferral	$18,100	$17,000
2026 over age 49, but not age 60 – 63, catch-up contribution	$3,850	$4,000
2026 catch-up contribution for those age 60 to 63	$5,250	$5,250
Employer matching contribution	3%, but may elect lower percent in 2 of 5 years. 4% for electing employers.	3% but may elect lower percent in 2 of 5 years.
Employer nonelective contribution	2% for all qualifying employees. 3% for electing employers.	2%
For more information, see Publications 560 or www.irs.gov/retirement-plans/plan-sponsor/simple-ira-plan		

Employee contribution limits. As noted in the chart, the 2026 employee salary reduction contributions to a Traditional SIMPLE IRA are capped at $17,000. Employees who reach aged 50 by December 31st may contribute an additional $4,000. For employers who qualify or elect to utilize the Enhanced SIMPLE IRA rules, the maximum 2026 employee salary reduction contribution is $18,100. Employees who reach aged 50 by December 31st may contribute an additional $3,850. The catch-up contribution for both plan types is $5,250 for employees who are aged 60 to age 63 on December 31, 2026.

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Example 1. Dave's employer, CDB, offers a SIMPLE IRA retirement plan. CDB had 20 employees who made more than $5,000 in 2025. CDB must offer an Enhanced SIMPLE IRA. Dave, who is 55 years old, may contribute $21,950 to his SIMPLE in 2026, calculated:

Enhanced SIMPLE regular contribution	$18,100
Age 50 and above catch-up contribution	$ 3,850
Total employee deferral allowed in 2026	$21,950

Example 2. Assume the same facts as Example 1 except CDB had 30 qualifying employees in 2025 and CDB does not elect to offer the Enhanced SIMPLE IRA. Dave's maximum employee SIMPLE contribution for 2026 is $21,000, calculated:

Traditional SIMPLE regular contribution	$17,000
Age 50 and above catch-up contribution	$ 4,000
Total employee deferral allowed in 2026	$21,000

Note. If CDB had elected to offer the Enhanced SIMPLE to its employees, Dave's maximum employee deferral would have been $21,950, the same as in Example 1.

Example 3. Assume the same facts as Example 1 except Dave turns age 60 in 2026. Dave's maximum employee contribution to his SIMPLE IRA for 2026 is $23,350, calculated:

Traditional SIMPLE regular contribution	$18,100
Age 50 and above catch-up contribution	$ 5,250
Total employee deferral allowed in 2026	$23,350

Multiple plans. If an employee participates in more than one salary deferral plan during the year, the SIMPLE IRA's salary reduction contributions count toward the overall salary deferral annual limit ($24,500 for 2026 plus any catch-up contributions).

Example. Vincent is 30 years old and works for two companies in 2026 – BRC and CRB. BRC offers a SIMPLE IRA and Vincent elects to make 2026 employee contributions of $17,000. CRB offers a 401k. Vincent's maximum employee contribution to the CRB 401k is $24,500 (under age 50). But Vincent must reduce his maximum 401k employee contribution by the $17,000 elective deferrals he made to the BRC SIMPLE IRA. Vincent's maximum contribution to the CRB 401k is $7,500.
.

Preparer note. This rule does not apply to §457 plans. Elective contributions may be maximized to §457 plans and a 401k or SIMPLE IRA plan in the same year. A §457 plan is a non-qualified plan, so contributions have no impact on employee elective deferrals to qualified plan contributions.

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Calculating the 25-employee threshold. The employer looks to the prior calendar year to determine whether it is above or below the 25-employee threshold. Once it's determined the employer meets the 25 or fewer employee rule, the employer must offer the Enhanced SIMPLE IRA that year and for two additional years – the 2-year grace period. This is true unless the increase in the employer's number of employees was due to an acquisition, disposition, or similar transaction involving the eligible employer.

Example. TH Market had 20 employees in 2025 and 28 employees in 2026. TH Market is required to offer the Enhanced SIMPLE IRA to its employees in 2026 as it is a "small" employer because it had 20 employees in the test year (2025). TH Market is also a small employer in 2027 and 2028, as these two years are the grace years. It must continue to offer the Enhanced SIMPLE. Starting in 2029, assuming it no longer qualifies, TH Market has the option to choose whether to offer the Enhanced or Traditional SIMPLE.

Enhanced SIMPLE election formalities. Employers with more than 25 qualified employees who wish to offer an Enhanced SIMPLE must make a formal written election and should maintain documentation that the election was made. Nothing needs to be filed with the IRS. Employers must notify employees of the increased limits allowed by the Enhanced SIMPLE IRA rules. The notice must be included in the annual employer notification that informs employees of the opportunity to enter into a salary reduction agreement or to modify a prior agreement. Employers who are required to make an election must also notify employees of the increased matching contribution or increased nonelective contribution (Notice 2024-2, Q E-4). The employer should also:

1. Notify the SIMPLE IRA plan's or SIMPLE 401(k) plan's financial institution and payroll provider of the increased limits; and
2. Keep records of all actions concerning the increased limits.

The election remains in effect until it is revoked by the employer. Any revocation must also be in writing.

Preparer note. It has been the author's experience that investment advisors and, in some cases, payroll providers don't understand the Enhanced SIMPLE IRA rules and try to limit employee deferrals to the Traditional SIMPLE limits. It may be useful to remind them we handle the tax issues, and they take care of the investments. If everyone stays in their lane, all is well. Just saying!

SIMPLE IRA employer contributions (§408(p)(2)(A)). Employers must calculate their SIMPLE IRA plan contributions under one of two methods:

1. Employer matching contributions; or
2. Nonelective contributions.

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Employer contribution options – matching or nonelective. Employers who've adopted a SIMPLE IRA plan are required to contribute to employee accounts. Employers may annually choose between making matching contributions for employees who are contributing or making nonelective contributions for all eligible employees regardless of how much the employee contributes.

Matching contributions. Employers who elect to match employee contributions are required to contribute on behalf of each eligible employee in an amount equal to the employee's salary reduction contributions, up to a maximum of 3% of the employee's compensation for the calendar year. The employer may elect to reduce the 3% contribution for a calendar year, but only if:

- The match percentage is not reduced below 1%;
- The match percentage is not reduced for more than 2 years out of the 5-year period that ends with (and includes) the year for which the election is effective; and
- Employees are notified of the reduced limit within a reasonable period (usually 30 days before the election period).

Nonelective contributions. As an alternative to making matching contributions, an employer may make nonelective contributions equal to 2% of each eligible employee's compensation for the entire calendar year. The employer's nonelective contributions must be made for each eligible employee regardless of whether the employee elects to make salary reduction contributions for the calendar year. The employer may, but is not required to, limit nonelective contributions to eligible employees who have at least $5,000 (or some lower amount selected by the employer) of compensation for the year. Employers may substitute the 2% nonelective contribution for the matching contribution for a year only if eligible employees are notified that a 2% nonelective contribution will be made instead of a matching contribution and the notice is provided within a reasonable period (generally 30 days) before the election period.

Increased employer contributions required by large employers who elect Enhanced SIMPLE IRA. As mentioned above, employers with 26 or more qualified employees may elect to offer the Enhanced SIMPLE IRA to its employees. However, if the election is made, the large employer must increase its match contribution to 4% or its nonelective contribution to 3%.

> **Example.** Malta, Inc. had 32 employees who made more than $5,000 in 2026. Malta wants to offer its employees the increased contribution limits available under the Enhanced SIMPLE IRA rules in 2027. The result is that Malta must offer its employees either, a 4% match or 3% nonelective contribution for 2027.

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Planning note. The big difference between the matching and nonelective methods is that under the matching method, if an employee doesn't contribute, or contributes less than 3%, the employer only contributes what the employee contributes. Under the nonelective method, the employer must contribute the full 2% for all eligible employees, even if the employee contributes nothing.

Preparer note. Once an employer adopts a contribution method and notifies employees of the method and rate chosen, the employer cannot suspend or modify its choice midyear. The promised contributions must be made on the employees' behalf for the remainder of the calendar year.

Additional *employer* nonelective SIMPLE contributions allowed (§408(p)(2)(A)(iv)). Employers with no more than 25 employees may make ***nonelective employer contributions*** of up to 10% of each employee's compensation. These contributions are ***in addition to the regular SIMPLE employer matching contributions*** and must be made with a uniform percent of compensation (not to exceed 10%). Owner employees may be included. The additional employer contributions cannot exceed the lesser of $5,300 or 10% of the employee's wages.

Preparer note. Employers who offer SIMPLE IRAs may wish to use this new contribution rule for employee bonuses, thus avoiding payroll taxes, workers' compensation premiums, etc.

Example 1 – employer. Chris and Dave own and operate DBC Construction, Inc., which has 12 employees including Chris and Dave. DBC offers a SIMPLE IRA pension plan to which it makes 2% nonelective contributions. DBC has a great year in 2026, and Chris and Dave want to provide bonuses to their employees. All employees made at least $50,000 in 2026. DBC's two options are:

	Wages	**SIMPLE**
Bonus amount ($5,000 x 12 employees)	$60,000	$60,000
Payroll tax, workers comp, other payroll burdens (20%)	$12,000	$ - 0 –
Total cost to DBC	$72,000	$60,000

Complication – Employees often prefer cash instead of a SIMPLE contribution for any bonus they receive. However, if the employee receives a SIMPLE contribution and immediately withdraws it, the tax and penalties are very similar to what the income and payroll tax would be on a wage bonus.

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Example 2 – employee. Assume the same facts as in Example 1 except we will look at this from the employee angle.

	Wages	SIMPLE
Bonus amount ($5,000 x 12 employees)	$ 60,000	$ 60,000
Income and payroll tax (estimated at 22%)	($13,200)	$ - 0 -
Tax and penalties* on SIMPLE withdrawal	$ - 0 -	($15,000)
Employee net	$ 46,800	$ 45,000

*This assumes the employees' SIMPLE IRAs have been in existence for at least two years when the withdrawal took place. Otherwise, the early withdrawal penalty is 25%.

SIMPLE IRAs and Roth Components (§408(p)(12))

SIMPLE IRAs are allowed to accept employee and employer contributions into a Roth account instead of a tax deferred account. This allows employees to choose to have their elective deferrals contributed to Roth accounts. The change also allows employer contributions to be made to Roth SIMPLE accounts. Rules unique to the Roth SIMPLE accounts include:

- Employers are not required to offer Roth SIMPLE accounts but may elect to do so at their own discretion.
- If Roth contributions are elected, the employer must satisfy all the employee notification requirements already in the SIMPLE IRA rules.
- The employee must agree to make contributions made to a Roth account. The employer cannot elect to do so unilaterally.
- A salary reduction contribution made to a Roth IRA is includible in the employee's gross wage income for the taxable year that includes the date on which the employee would otherwise have received the salary reduction contribution as wages. Such amounts are reported in Box 1, 3 and 5 of the W-2 (i.e., taxable, Social Security, and Medicare wages). The elective deferrals are also reported Box 12 with code S (for SIMPLE).
- Employer matching contributions to a Roth IRA are includible in the employee's income in the taxable year that the employer contribution is made to the Roth account. This rule applies even if the employer deducts its contribution in the prior taxable year. Employer contributions are reported on Form 1099-R, Distributions From Pensions, etc. and are treated as a rollover by the employee. This makes the employer contribution subject to tax, but not early withdrawal penalties. Employer contributions are exempt from payroll taxes.

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Additional SIMPLE Information:

- IRS SIMPLE webpage
- SIMPLE Checklist – IRS Pub 4285
- SIMPLE FAQs
- Form 5304-SIMPLE
- Form 5305-SIMPLE
- SIMPLE Fix It Guide

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Qualified Retirement Plans

2026 Retirement Plans Limits (Notice 2025-67)		
Plan Type	**2026**	**2027**
Maximum Defined Contribution Plan Contribution; §415(c)(1)(A)	$ 72,000	
SEP IRA	$ 72,000	
Maximum Annual Benefit for Defined Benefit Plan; §415(b)(1)(A)	$ 290,000	
Annual Compensation Limit: §401(a)(17); §404(j); §408(k)(3)(C)	$ 360,000	
Employee salary reduction maximums: 401(k); 403(b); 457	$ 24,500[1]	
Age 50 and over catch-up contribution: 401(k); 403(b); 457 Plans	$ 8,000	
Age 60 - 63 catch-up contribution: 401(k); 403(b); 457 Plans	$ 11,250	

Catch-up contributions allowed after other deferral contributions maxed out. Additional contributions may be made by an individual who has reached age 50 before the end of the plan year and with respect to whom no other elective deferrals may otherwise be made to the plan for the year because of the application of any limitation of the IRC (e.g., the annual limit on elective deferrals) or of the plan.

Example 1. Cindy is 52 years old and wishes to maximize her 2026 contribution to her 401(k). Cindy's regular deferral is $24,500 from her wages. Her employer contributes $47,500 to her account, giving her $72,000 of total contributions for 2026. Because Cindy is over age 49, she may also make an additional catch-up contribution of $8,000. Her total 2026 contribution is calculated:

Regular deferral	$24,500
Catch-up contribution (age 60)	$ 8,000
Employer contribution	$47,500
Total 2026 contribution	$80,000

Additional catch-up contributions allowed for those age 60 - 63 (§414(v)(2)(B)). Catch-up contributions may, at the employer's discretion, be increased for employees who reached age 60, 61, 62 or 63 by December 31st of the current year. For 2026, the additional 401k catch-up contribution for those whose ages were 60-63 is $11,250 (greater of $10,000 or $7,500 regular catch-up x 150%).

Example 2. Assume the same facts as in Example 1 above except Cindy turned 60 in 2026. Cindy is allowed to use the increased catch-up contribution amount available to those age 60-63 as of December 31st. Cindy's total 2026 contribution is calculated:

Regular deferral	$24,500
Catch-up contribution (age 60)	$11,250
Employer contribution	$47,500
Total 2026 contribution	$83,250

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The catch-up contribution is in excess of the standard $72,000 annual contribution limit.

New Rules for Qualified Plan Direct Rollovers (Notice 2026-49)

Overview. The SEUCRE Act directed Treasury to develop standardized forms, procedures, and protocols to simplify, standardize, facilitate, and expedite direct rollovers to eligible retirement plans and trustee-to-trustee transfers from IRAs. Congress believes the existing direct-rollover regulations, which allow direct-rollovers by simply cutting a check payable to the receiving plan but handing it to the participant to physically deliver, to be error prone at best, and fraud vulnerable at least. A 2024 GAO report found that roughly one-third of participants receiving distributions get paper checks under this mechanism.

Scope. The notice applies to rollovers between employer retirement plans (qualified plans, 403(b), governmental 457(b)) and between a retirement plan and an IRA. It explicitly does not apply to IRA-to-IRA transfers, though the process "may be used" for plan-to-IRA or IRA-to-plan rollovers. The standardized five-step process includes:

1. **Form 1 — Participant's Rollover Request.** The participant initiates the process with the receiving plan, executing a Rollover Request Authorization.

2. **Form 2 — Receiving Plan's Request to Distributing Plan.** The receiving plan forwards the participant's request (with the executed authorization attached) to the distributing plan.

3. **Form 3 — Distributing Plan's Rollover Certification.** After verifying the information on Form 1, the distributing plan certifies account details to the receiving plan and identifies available transfer methods.

4. **Form 4 — Receiving Plan's Rollover Acceptance.** The receiving plan verifies its ability to accept the funds, accepts the rollover, and selects a transfer method from those offered.

5. **Transfer execution.** The distributing plan executes the transfer using the method selected in Step 4.

The notice includes an Appendix containing the four sample forms designed to standardize a five-step plan-to-plan (or plan-to-IRA) direct rollover.

Use of new forms is optional for now. Currently, the use of the sample forms and procedures is entirely optional. Plans remain free to continue existing check-to-participant practices per §1.401(a)(31)-1. But it appears only a matter of time before these new processes become mandatory.

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§401(k) Plans

Overview. The most common retirement plan offered by businesses today is the §401(k) profit sharing plan. In the author's opinion, once a business becomes significantly profitable and it appears those profits will be sustained for a period of time, a §401(k) plan provides an excellent retirement plan option to lower the tax bill, save for retirement, and give employees the opportunity to save substantial retirement money for themselves. All this can be accomplished at a relatively low cost to the employer.

"Starter" §401k deferral-only plans available (§401(k)(16)). Employers who don't sponsor any other retirement plan may offer a deferral-only §401(k) plan (or safe harbor 403(b) plan). A deferral-only §401(k) plan requires all employees to be auto enrolled at a deferral rate of 3% to 15% of compensation. The limit on annual deferrals is $6,000 plus, for those age 50 or older, $1,100 catch-up deferral.

Preparer note. Deferral-only 401k plans are required to file Form 5500 unless otherwise exempt. There is no special exemption for these plans from the annual filing requirements.

Long term part-time workers must be offered §401(k) and §403(b) plan participation §401(k)(2)(D); (NPRM REG-104194-23 – still pending). Historically an employer was able to exclude employees from participating in its 401k/403(b) plan unless the worker performed 1,000 hours of services during the plan year. The new law requires long-term, part-time employees to be made eligible to participate in the employer's 401k/403(b) plan unless the employee is covered by a collectively bargained plan. Employees eligible under these new rules must be age 21 and either:

1. Have completed 1 year where they worked 1,000 hours or more; or

2. Be a part-time worker who worked for the employer for 2 consecutive years and provided at least 500 hours of service each year.

Qualified Roth Contribution Programs Allow Employees to Designate Elective Deferrals (§402A; IRS Designated Roth Account FAQs)

What is a qualified Roth contribution program? Employers may offer employees the option to designate some or all their elective contributions to §401(k), §403(b), or §457 plans to designated Roth accounts. If the employer chooses, eligible participants may also roll over existing plan balances to the designated Roth portion of their accounts. Any amounts contributed to a designated Roth account are included in gross income in the year of the contribution, but eligible distributions from the account (including earnings) are generally tax-free. Employers wishing to establish designated Roth accounts as part of their qualified retirement plan must:

1. Establish a separately designated Roth account for the Roth contributions and the related earnings of each participant;

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2. Maintain separate records for each account;

3. Refrain from allocating to the designated Roth account amounts from non-designated Roth accounts unless such amounts are properly rolled over; and

4. Report designated Roth account contributions separately on employees' W-2s.

Designated Roth account features. There are no AGI limits for contributors to designated Roth accounts (unlike contributors to Roth IRAs). Designated Roth accounts are no longer subject to RMDs when the owner reaches RMD age.

Roth Catch-up Deferrals Only Option for "High Income" Taxpayers (§414(v)(7); §1.414(v))

Preparer note. While this provision was effective for years beginning in 2023, there was significant confusion about the implementation. As a result, the IRS delayed this provision until 2026, which is when it became effective for the first time.

Catch-up contributions may only be made to a designated Roth account for "high income" employees. For this purpose, a "high income" employee in 2026 is one whose 2025 calendar year W-2 wages with the same employer exceeded $150,000. In other words, the catch-up portion of the employee's salary deferral contributions cannot be made on a pre-tax basis if the employee's salary exceeded $150,000 in the prior year. For this purpose, the term "wages" means FICA wages[1].

Wages are not prorated for employees who worked a partial year. For example, Josh was hired in September 2025 at an annual salary of $300,000. Josh earned $100,000 in 2025 because he only worked part of the year. Josh's 2025 FICA wages are less than the $150,000 threshold so the Roth catch-up requirement does not apply to Josh in 2026, even though he earned $300,000. Only the actual wages paid by his current employer in the prior year count. Self-employment income is not wages for this law. The high-income rules do not apply to sole proprietors and partners with SE income.

[1] FICA wages are defined as wages under IRC §3121(a), and subject to tax under IRC §§3101(a) and 3111(a) (§1.414(v)-2(a)(2)). Accordingly, an individual who did not have any FICA wages from the employer sponsoring the plan in the preceding calendar year (e.g., a partner who had only self-employment income, an individual who only had wages under the Railroad Retirement Tax Act rather than FICA, or a State or local government employee whose services were excluded from FICA would not be subject to the Roth catch-up requirement.

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Example 1. Aaron became an employe of DTS CPAs (a partnership) in January 2025, Through October 2025, Aaron earned $156,000 of FICA wages from DTS before becoming a partner in the firm in November 2025. Aaron was allocated $30,000 of partnership income in 2025, all of which was SE income. Aaron was a partner with DTS for all of 2026.

Although Aaron was a partner with DTS for the last two months of 2025 and all of 2026, and thus had no wages in 2026, he had more than $150,000 in FICA wages from DTS in 2025. Aaron may only make any catch-up contributions to a designated Roth account.

Example 2. The facts are the same as in Example 1, except that Aaron became a partner of DTS in May 2025, at which time he had earned FICA wages of $60,000. Aaron was allocated profits from DTS of $155,000 in 2025, all of which was SE income.

Although Aaron had total compensation from DTS of $215,000 in 2025, only $60,000 of that amount was FICA wages. As Aaron didn't have more than $150,000 of FICA wages from DTS in 2025, his catch-up contributions are not required to be made to a designated Roth account.

Final regulations clarify Roth only catch-up rules for high income employees (T.D. 10033). The IRS acknowledged that the original law left many unanswered questions about how to implement the new catch-up contribution Roth requirements and we've been waiting for guidance since the law passed. The IRS issued final regulations that clarify:

A. Employees subject to the high-income mandatory Roth catch-up contribution requirement are deemed to have designated any catch-up contributions as designated Roth contributions (§1.401(k)-1(f)(5)(iii)). This includes the additional catch-up contributions for those age 60 – 63. The employee must be provided with ample opportunity to elect out of deemed election.

B. If an employer plan provides Roth catch-up contribution to a high-income employee, then all catch-up eligible employees must be permitted to make catch-up contributions as designated Roth contributions for the plan year (§1.414(v)-2(a)(5)).

C. A plan that provides for Roth catch-up contribution elections is required to include the Roth catch-up contributions in the participant's gross income. The plan is also required to maintain the catch-up contributions in a designated Roth account.

D. As mentioned earlier, employers are not required to offer designated Roth accounts as part of the employer plans. If an employer plan doesn't include a designated Roth component, then the catch-up limit for participants subject to the Roth catch-up requirement is zero – no catch-up contributions are allowed. In such cases, the employer plan would still allow catch-up contributions for participants who are not subject to the Roth catch-up requirement. This would not violate the anti-discrimination provisions of plan administration (§1.414(v)-2(b)(2)).

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Example. Kai is 52 years old, works at ABC and his annual salary was $160,000 in 2025. ABC has 30 other employees, 8 of whom are 50 or older and none of whom earn more than $150,000 annually. For 2026, Kai wants to max out his elective deferrals to his 401(k) plan, but he is subject to the high-income catch-up rules. ABC decided not to offer a Roth component as part of its 401(k) plan. The result is Kai may only contribute $24,500 to his account. All the other employees aged 50 and over may contribute $32,500 ($24,500 + $8,000) to their respective 401(k) accounts. ABC has not violated any discrimination rules for its 401(k).

E. Designated Roth contributions made prior to reaching the regular deferral limit ($24,500 in 2026) may be allocated to catch-up contributions at the time of contribution rather than waiting until 100% of the regular deferral is met (§1.414(v)-1(c)(3)).

F. This provision only applies to qualified plans. It ***does not apply*** to SEPs and/or SIMPLE plans (§1.414(v)-2(a)(4)).

Preparer note. The final regulations take effect for years beginning after December 31, 2026. However, they also permit plans to implement the Roth catch-up requirement for taxable years beginning before 2027 using any reasonable, good faith interpretation of statutory provisions. In other words, the law will be enforced beginning in 2026.

Employer contributions to pension may be Roth contributions – includes SEPs, SIMPLEs, 401(k)s, 403(b)s and 457 plans (Notice 2024-2). Historically, all plans ***other than SIMPLEs*** were only allowed to accept Roth contributions from the employee deferral portion of pension plans. Employer contributions could only be made on a pretax basis – employer contributions were not allowed Roth treatment. Two changes were made to these rules:

1. SIMPLE IRAs may now accept employee Roth deferral contributions, and

2. Employer contributions to pension plans are no longer required to be pre-tax only. Employer contributions to SEPs, 401(k)s, 403(b)s, and 457 plans may be made on a Roth basis instead of tax deferred.

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Preparer note. Employers who make Roth contributions to employee pensions report the amount contributed on Form 1099-R as a distribution and conversion. This makes the employer's contribution taxable to the employee when made and deductible for the employer in the appropriate plan year. No further reporting is required (i.e., nothing reported in wages or on W-2). The 1099R is issued the year the employer makes the contribution to the Roth account, not the year the employer deducts the contribution. For example, an employer who makes the employer contribution in March 2027 for the 2026 calendar year would issue the employee a 1099-R for 2027 but would deduct the contribution in 2026. Withholding is not required.

Designated Roth contributions. Unlike regular Roth contributions, designated Roth nonelective and matching contributions must be reported on Form 1099-R for the year in which they're allocated to an individual's account. They're reported in boxes 1 and 2a of Form 1099-R, and code "G" is used in box 7. See Notice 2024-2, Questions and Answers L-1 through L-11.

Form W-2 or Form 1099-R Reporting Summary

	Roth IRA under a SEP arrangement or SIMPLE IRA plan	Designated Roth account under an applicable retirement plan
Form W-2 reporting	Include salary reduction contributions in boxes 1, 3, and 5 (or box 14 if railroad retirement taxes apply) of Form W-2. Report them in box 12 using code F (for a SEP) or code S (for a SIMPLE IRA).	Include designated Roth contributions (made in lieu of elective deferrals) in boxes 1, 3, and 5 (or box 14 if railroad retirement taxes apply) of Form W-2. Report them in box 12 using code AA (for a section 401(k) plan), BB (for a section 403(b) plan), or EE (for a governmental section 457(b) plan).
Form 1099-R reporting	Report matching or nonelective contributions in boxes 1 and 2a of Form 1099-R for the year in which the contributions are made to the Roth IRA, using code 2 or 7 in box 7, and the IRA/SEP/SIMPLE checkbox in box 7 checked.	Report designated Roth matching contributions or designated Roth nonelective contributions in boxes 1 and 2a of Form 1099-R for the year in which the contributions are allocated to the individual's account, using code G in box 7.

Preparer note. There is no AGI limit to preclude employees from making contributions to pension plans with a deferral component, regardless of if the contribution is a tax deferred or Roth contribution. The same is true for employer contributions. This change to allow employer Roth contributions will, for the first time, give high-income taxpayers the ability to contribute large sums to Roth accounts, far more than they could ever do with a back door Roth.

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Example. Rashell decides to contribute the maximum to her 401(k) ($24,500 in 2026) in 2026. Rashell elects to contribute $12,250 (50% of the total) to her tax deferred account and $12,500 to her designated Roth account. Her employer agrees to contribute $3,000 (50% of the total) to Rashell's tax deferred account and $3,000 to her designated Roth account. The employer contribution is made on March 15, 2027. Rashell receives the following documents to assist with her tax preparation for the pertinent years.

2026 Form W-2 – taxable wages include her designated Roth contributions of $12,250
2026 Form W-2 – box 3 and 5 (SS and Medicare) include $24,500 (100%) of her deferrals – tax deferred and Roth
2027 – Form 1099R showing a rollover contribution of $3,000 from her traditional 401k to her designated Roth account

Rashell would pay tax on $15,250 ($12,250 in her W-2 and $3,000 in her 1099R. Nothing is reported for the $3,000 contribution made by her employer to the tax deferred 401(k) account.

Unique Plan Catch Up Rules for §403(b) and §457 Plans

§403(b) participants get special $3,000/$15,000 extra catch-up contributions. Employees who are eligible to participate in a §403(b) plan and have worked at least 15 years with the same employer may have access to a separate, $3,000 extra catch-up contribution. This special catch-up deferral is only available to §403(b) participants. The maximum lifetime contribution cannot exceed $15,000. The extra catch-up contribution is allowed regardless of age and is the lesser of:

1. $3,000, or

2. $15,000, reduced by the amount of additional elective deferrals made in prior years because of this rule, or

3. $5,000 times the number of employees' years of service for the organization, minus the total elective deferrals made for earlier years.

§403(b) Catch-ups for employees age 50 or over. Employees who qualify for the special catch-up contribution may elect to defer up to $27,500 ($24,500 + $3,000) for 2026. And if the employee is age 50 or older, the deferral limit is increased to $35,500 ($24,500 + $3,000 + $8,000). Presumably, plan participants age 60 – 63 would also qualify for the extra deferral allowed to them. The 2026 §403(b) deferral limits are summarized:

- Under age 50 and under 15 years of service $24,500
- Under age 50 and 15 or more years of service $27,500
- Age 50 or older, 15 or more years of service $35,500
- Age 60 – 63, 15 or more years of service $38,750

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Note that the employer must elect to apply the extra catch-up contribution. Otherwise, the employee cannot use the extra $3,000.

Example. Assume Stacy, aged 50, worked as a teacher in the Zenith School District for 15 years and she is eligible for the 15 years of service catch-up. Stacy's 2026 eligible wages were $75,000. Stacy's maximum employee and employer contributions to the Zoo School §403(b) plan for 2026 would be $80,000 ($72,000 annual limit + $8,000 age 50 catch-up). Stacy elects to fund $27,500 through salary deferrals – $24,500 basic + $3,000 special catch-up. She didn't contribute anything for the 50 and over catch-up contribution. Stacy has $12,000 of the special catch-up contribution limit left for future years ($15,000 less $3,000 2026 contribution).

Variation. Stacy from the prior example decides she wants to maximize her deferral contributions for 2026. Stacy elects to defer $35,500 ($24,500 basic deferral plus $3,000 special catch-up plus $8,000 50 and over catch-up contribution). As before, Stacy has only $12,000 remaining in her special catch-up contribution.

Preparer note. The IRS has yet to provide any guidance as to how the age 60 – 63 extra catch-up contribution will interact with the other special catch-up contributions. Based on the author's reading of the law, the 60 – 63 extra deferral is simply an add-on to the existing 50 and over catch-up contribution. Therefore, it is the author's opinion that the special would be in addition to the combined limit for those age 60 – 63.

§457 plan participants may double defer for three years prior to retirement (§457). §457 plan participants are allowed to double their salary deferrals in the three years before reaching their normal retirement age. For this purpose, normal retirement age is typically defined in §457(b) plan document. If not, the IRS will accept any age the participant chooses between 65 and 70½. The special catch-up contribution is calculated by deferring the lesser of:

- Twice the basic annual deferral limit, or

- The current year limit plus any unused deferrals from prior years.

This is a true catch-up, meaning the amount is based on the deferrals you did not make in prior years. If you always maximized your contributions, you won't be able to use this special catch-up. The overall limit is based on the total deferral limit for all years during the employee's entire work history, less any actual deferrals the employee made. For an employee who contributed the maximum to the plan each year, the special catch-up contribution is zero – there is nothing to catch up.

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Example. Justine is 67 years old and is still working. Justin's employer offers a §457 plan that includes the special catch-up contribution provision. Justine's normal retirement age is 70. Justine qualifies to make a special catch-up contribution to the §457 plan of:

a.	2026 maximum deferral without catch-up contributions	$ 24,500
b.	Total allowable contributions Justine made to the §457 plan since she was hired in 2020	$128,000*
c.	Contributions she made	($ 65,500)
d.	Balance	$ 62,500
	Catch up allowed in 2026 – lesser of a. or d.	$ 24,500

*Calculated

2020	$ 19,000
2021	$ 19,500
2022	$ 20,500
2023	$ 22,500
2024	$ 23,000
2025	$ 23,500
Total	$128,000

Preparer note. Those who choose to use the §457 plan special catch-up contribution cannot use any other catch-up provisions the same year (e.g., the age 50+ or age 60 – 63 catch-up contributions).

Student Loan Payments as Elective Deferrals

Student loan payments count as employee elective deferrals for matching (§401(m)(4)(A). This provision permits, but does not require, employers to make matching contributions to a 401(k) plan, 403(b) plan, 457(b), or SIMPLE IRA based on an employee's "qualified student loan payments" (QSLPs). Specific rules include:

- A QSLP is a payment made by an employee on an education loan incurred by the employee (employee is legally obligated on the debt) for qualified higher education expenses of the employee, employee's spouse, and employee's dependent(s).

- An employee who co-signs on a qualified loan is considered legally obligated for any payments he or she made.

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- Employees must certify:
  - the amount of the loan payment;
  - the date of the loan payment;
  - that the payment was made by the employee;
  - that the loan being repaid is a qualified education loan and was used to pay for qualified higher education expenses of the employee, the employee's spouse, or the employee's dependent; and
  - that the loan was incurred by the employee.

- Employers may rely on the employee's certification but may also require substantiation if deemed necessary.

- Rules are somewhat relaxed for SIMPLE IRAs as not all the rules are applicable.

Notice 2024-63 covers the QSLP rules in depth. The information contained in the Notice is surprisingly complex and beyond the scope here. At the risk of sounding cynical, the author doubts many employers will adopt this provision, at least in the short term.

Extensive Retirement Plan Resources on IRS Website (Small Business Retirement Plan Resources)

Helping Taxpayers Choose, Maintain and Operate a Plan

- Help with Choosing a Retirement Plan provides resources to help compare retirement plan options.
- Benefits to Starting a Retirement Plan helps find the right retirement plan for retirement security.
- A Plan Sponsor's Responsibilities to learn how to keep retirement plans running smoothly.
- Types of Plans to see what the rules are for SIMPLE IRA, SEP, 401(k) and other plans.
- Pension related videos - Over 30 topics
- IRS Tax Forum Presentations - retirement plan choices and rules

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Depreciation - §168

Basis (IRC §1011)

All depreciation calculations begin with the basis of the asset involved. The basis of property is its cost, plus amounts paid for items such as sales tax, freight charges, and installation and testing fees. The cost includes the amount paid in cash, borrowed money, assumed debt, FMV of old asset allowed on trade-in, or services.

The basis of real property also includes certain fees and charges paid in addition to the purchase price. These generally are shown on the settlement statement and include the following:

- Legal and recording fees.
- Abstract fees.
- Survey charges.
- Cost of an option to purchase property.
- Owner's title insurance.
- Amounts the seller owes that the buyer agrees to pay, such as back taxes or interest, recording or mortgage fees, charges for improvements or repairs, and sales commissions.
- On self-constructed assets, interest incurred during the building phase plus capitalizable Section 263A costs will be added to basis rather than expensed.

Costs incurred to put an asset into service after purchase but before it is usable will also adjust the cost basis. This would include installing special electrical or utility lines, pouring special bases for equipment, zoning, legal and title costs, and receiving rebates. The allocated basis and cost to demolish a building are added to the cost of the land under §280B.

When a taxpayer converts property from personal use to business use, the basis for depreciation is the lesser of the original basis (reduced by any casualty loss deductions or tax credits that reduced the basis of the property) *or fair market value on conversion date*.

If the purchase is not obtained through an arm's-length contract and is not at fair market value, (i.e., a bargain purchase) the basis is, for depreciation purposes, the greater of the purchase price or the seller's adjusted basis in the property, plus any increase under §1015(d) for gift tax paid.

Property received as a gift has a basis equal to the donor's adjusted basis. However, if the donor's adjusted basis exceeds fair market value at the time of the gift, the property has a basis equal to fair market value for purposes of determining loss. Any gift tax paid with respect to the appreciated portion of the property's value is added to determine the basis, but the total basis may not exceed fair market value.

Inherited property has a basis equal to the date of death fair market value of the decedent (or alternate valuation date if elected by the estate).

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Ownership & Qualification

Depreciation may only be deducted on property legally owned by the taxpayer. This may seem basic, but when leasing is involved, it becomes a more difficult question. If you lease property to someone, you generally can depreciate its cost even if the lessee (the person leasing from you) has agreed to preserve, replace, renew, and maintain the property. However, if the lease provides that the lessee is to maintain the property and return to you the same property or its equivalent in value at the expiration of the lease in as good as condition and value as when leased, you cannot depreciate the cost of the property.

More commonly the business owner IS the lessee and must determine if they meet the incidents of ownership rules. If they do, then the lessee can deduct depreciation, even though the contract may be called a lease. Incidents of ownership include:

- The legal title to the property,
- The legal obligation to pay for the property,
- The responsibility to pay maintenance and operating expenses,
- The duty to pay any taxes on the property,
- The risk of loss if the property is destroyed, condemned, or diminished in value through obsolescence or exhaustion.

Generally, if you hold business or investment property as a life tenant, you can depreciate it as if you were the absolute owner of the property.

You cannot depreciate inventory because it is not held for use in the business. Inventory is any property you hold primarily for sale to customers in the ordinary course of business. If you are a rent-to-own dealer you usually depreciate the items over three years.

To be depreciable, the property must have a determinable useful life. The property must eventually wear out, decay, get used up, become obsolete, or lose its value from natural causes. You cannot depreciate property purchased and sold in the same year.

What about land? You cannot depreciate the cost of land because land does not wear out, become obsolete, or get used up. The cost of land generally includes the cost of clearing, grading, planting, and landscaping. Although you cannot depreciate land, you can depreciate certain land preparation costs, such as landscaping costs, incurred in preparing land for business use. These costs must be so strongly associated with other depreciable property that you can determine a life for them along with the life of the associated property.

What about land prep costs? Land preparation costs, however, may be depreciable if they are directly associated with the construction of a depreciable building (Rev. Rul. 65-265. 1965-2 CB 52). Thus, in Rev. Rul. 65-265, costs attributable to excavation, grading, and removing soil necessary to the proper setting of buildings were added to the depreciable basis of the buildings in an industrial complex. The cost of general grading, not directly associated with the construction of the building, however, was added to the basis of the land. See, also, for example, Eastwood Mall Inc., DC Oh., 95-1 USTC ¶50,236 (aff'd, CA-6, unpublished opinion, 59 F3d 170 (1995)), which concludes that the cost of grubbing, blasting, filling, and grading 100 acres of uneven land into an earthen plateau used for the construction of a shopping mall was not depreciable since these improvements were permanent and would not be re-incurred if the mall building was rebuilt or replaced. The IRS did not argue about the depreciation of costs paid to dig spaces and trenches

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for the mall building's foundations, utilities, and the cost of installing utilities, sewers, and paving roads and parking lots.

The cost of clearing, grubbing, cutting, filling, and rough and finish grading necessary to bring land to a suitable grade for the development of a mobile home park was non-depreciable and added to the basis of the land. However, the cost of excavation and backfilling required for the construction of laundry facilities and a storm sewer system that would be destroyed when those assets were replaced was included in the depreciable basis of those assets (Rev. Rul. 80-93, 1980-1 CB 50).

Costs incurred for fill dirt that is used to raise the level of a building construction site are inextricably associated with the land and, therefore, are not depreciable. Costs incurred for fill dirt used to set the foundation of a building are depreciable, as are earth-moving costs incurred for digging spaces and trenches for a building's foundations and utilities (IRS Letter Ruling 200043016, July 14, 2000).

Example. Megan constructed a new building for use in her business and paid for grading, clearing, seeding, and planting bushes and trees. Some bushes and trees were planted right next to the building, while others were planted around the outer border of the lot. If Megan replaces the building, the bushes and trees next to it would be destroyed, giving them the same useful life as the building. Megan can depreciate them. The remaining bushes and trees are added to the other land preparation costs to the basis of the land because they have no determinable life.

Placed in service requirement. Depreciation begins when the underlying property is placed in service for use in a trade or business or to produce income. Depreciation stops when the property cost or basis is either fully recovered or when the property is retired from service, whichever happens first. Property is placed in service when it is ready and available for a specific use, whether in a business activity, an income-producing activity, a tax-exempt activity, or a personal activity. Even if you are not using the property, it is in service when it is ready and available for its specific use.

Example 1. Fred bought a new Massey tractor in December of 2026 for $140,000. He received the tractor on December 23rd but did not receive the special quad wheels needed to use the tractor in the fields until January 11, 2027. The tractor was not “available for its specific use” in 2026, so depreciation will not begin until 2025.

Example 2. Laura bought a rental home in March 2026 for $260,000. The property needed substantial repairs before it could be rented. Laura spent $100,000 to complete the repairs in November of 2026 but did not obtain a “Certificate of Occupancy” from the County until January of 2027. The property will not begin to be depreciated until it is legally able to be occupied, January of 2027.

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Example 3. Deb bought a building and renovated it to accommodate equipment she plans to use for her business. The building renovations were completed on November 1, 2026, but the equipment wasn't installed until January 2027. Deb may begin depreciating the building in November 2026, when she received her certificate of occupancy. It doesn't matter that the equipment wasn't installed until later.

Example 4. Roy buys thirty, three-month old Hereford heifers for $5,000 on July 1st, 2026, to develop breeding stock. Roy expects the heifers to reach breeding age in late March 2027. He will begin depreciating them at that time.

Calculating depreciation – the Big 3. The Federal tax rules of depreciation tell us that depreciation is allowed for property used in a trade or business. Deprecation is calculated using three variable factors:

1. The applicable life (3, 5, 7, 10, 15, 27½, 39 years);
2. The applicable method (200DB, 150DB or straight-line); and
3. The applicable convention (mid-month, mid-quarter, or half-year).

1. Applicable life. §168(c) lists the following life periods:

ADR Class Life	Applicable GDS recovery period	Depr. Life
4 or less	3-year property	3 years
>4, <10	5-year property	5 years
10 – 15	7-year property	7 years
16 – 19	10-year property	10 years
20 – 25	15-year property	15 years
25 or more	20-year property	20 years
Qualified improvement property (QIP)		15 years
Water utility property		25 years
Residential rental property		27½years
Nonresidential real property		39 years
Any railroad grading or tunnel bore		50 years

Most taxpayers choose to depreciate assets the GDS life because it provides for a shorter life for depreciation than the ADS method.

3-year property – bonus mandatory and 179 qualified

- Tractor units for over-the-road use.
- Any racehorse over 2 years old when placed in service.
- Any other horse over 12 years old when placed in service.
- Qualified rent-to-own personal property held by a rent-to-own dealer, but not boats, planes, motor vehicles, trailers, or real estate.

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5-year property – bonus mandatory and 179 qualified

- Automobiles, taxis, buses, and trucks.
- Computers and peripheral equipment.
- Office machinery (such as typewriters, calculators, and copiers).
- Any property used in research and experimentation.
- Breeding cattle and dairy cattle.
- Appliances, carpets, furniture, etc., used in a residential rental real estate activity.
- Certain geothermal, solar, and wind energy properties.
- Agricultural machinery or equipment purchased *new* and placed in service in years beginning after 12/31/2017.

7-year property – bonus mandatory and 179 qualified

- Office furniture and fixtures (such as desks, files, and safes).
- Used agricultural machinery and equipment as well as new or used grain bins and fences purchased after 12/31/2017, or purchased new or used prior to that date,
- Railroad track.
- Any property that does not have a class life and has not been designated by law as being in any other class.
- Certain motorsports entertainment complex property placed in service before January 1, 2026 (2020 CAA Act),

10-year property – bonus mandatory and 179 qualified

- Vessels, barges, tugs, and similar water transportation equipment.
- Single purpose agricultural or horticultural structures.
- Any tree or vine bearing fruits or nuts.

15-year property – bonus mandatory

- Certain improvements made directly to land or added to it (such as shrubbery, fences, roads, sidewalks, parking lots, and bridges).
- Any retail motor fuels outlet such as a convenience store.
- Qualified Improvement Property *(179 Qualified)*

20-year property – bonus mandatory

- Farm buildings

25-year property

- Water utility property

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27.5-year property

- Residential rental property. This is any building or structure, such as a rental home (including a mobile home), if 80% or more of its gross rental income for the tax year is from dwelling units. A dwelling unit is a house or apartment used to provide living accommodations in a building or structure. It does not include a unit in a hotel, motel, or other establishment where more than half the units are used on a transient basis.

39-year property

- Nonresidential real property
- Qualified production property (QPP) – bonus qualified if placed in service between July 5, 2025, and December 31, 2030
- Office in home property unless in a building owned by the taxpayer that is a residential rental building, then use 27.5 years.

2. Applicable methods. MACRS utilizes the following methods for depreciation:

- 200% declining balance applies to assets in the 3-10-year property category. This includes farm equipment placed in service in 2018 and after (was 150% declining balance in prior years).

- 150% declining balance applies, ***by election***, to nonfarm assets in the 3 to 10-year property category.

- 150% declining balance applies to 15 and 20-year life property except qualified real estate improvements, which use straight-line.

- Straight line applies to most other assets and by election.

3. Applicable convention. Taxpayers must use the proper convention when placing property in service. There are three options:

1. **Mid-month convention** – applies to real property and treats all property placed in service or disposed of during a month as placed in service or disposed of at the midpoint of the month. This means that a half month of depreciation is allowed for the month the property is placed in service or disposed of.

2. **Mid-quarter convention** – applies to all other assets when more than 40% of the total current year asset purchases (other than real property) are placed in service in the last 3 months of the year. Under this rule, 1½ months of depreciation is allowed for the quarter where the property was placed in service or disposed of.

3. **Half-year convention** – applies to all other assets, and ½ of one year's expense is allowed in the year placed in service or disposed.

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Notable Depreciable Lives				
Description	**MACRS Life**	**Qualify for 179?**	**Qualify for Bonus**	**Authority**
Asbestos Removal	39 years	No	No	PLR 9240004
Autos & Light trucks	5 years	Yes	Yes	Section 168 (e)(3)
Drainage Tile	15 years	Yes	Yes	IRS Publication 225
Entertainment services equipment (bowling alleys, theaters, concert halls, miniature golf, amusement parks, coin-operated games	7 years	Yes	Yes	Revenue Proc. 87-56
Gas Pump Canopies	5 years	Yes	Yes	Revenue Ruling 2003-54
Golf Course Greens	15 years	No	Yes	Revenue Ruling 2001-60
Gaming furniture & Equipment	7 years	Yes	Yes	Coordinated Issue Paper-Gaming Industry
Home used for adult day care	27½ years	No	No	CCA 201049026
Farm Buildings	20 years	No	Yes	Section 168 (e)(3)
Fences-Agriculture	7 years	Yes	Yes	IRS Publication 225
Heating & HVAC	5-39 years	Yes	Yes	2017 Tax Cuts Act
Improvement-Building Qualified	15 years	Yes	Yes	2020 CARES Act
Lease Termination Payment	39 years	No	No	PLR 9607016
Leasehold Improvements-Qual.	15 years	Yes	Yes	Section 168 (e)(3)
Mobile Homes	27.5-39 years	No	No	IRS Pub 946
Qualified Improvement Property	15 years	Yes	Yes	§168(e)(6)
Qualified Production Property	39 years	No	Yes	Notice 2026-16
Residential Rental Property	27.5 years	No	No	Section 168 (e)(3)
Rental Property Furniture & Appliances	5 years	No	Yes	Announcement 99-82
Rent to Own Property	3 years	Yes	Yes	Section 168 (e)(3)
Retail/Restaurant Real Property	39 years	Yes	Yes	Section 168 (e)(3)
Retail Motor Fuel Outlet	15 years	Yes	Yes	Section 168 (e)(3)
Solar & Wind Energy	5 years	Yes	Yes	Section 168 (e)(3)
Trees & Vines Bearing Fruit & Nuts	10 years	Yes	Yes	Section 168 (e)(3)
Vineyard Irrigation & Wells	20 years	No	Yes	Trentadue v. Comm.
Vineyard Trellises	10 years	Yes	Yes	Trentadue v. Comm.
Wells	15 years	No	Yes	RP87-56

IRS Depreciation Information and Guides

General Depreciation Guidance: IRS Publication 946
Cars: IRS Publication 463
Residential Rental: IRS Publication 527
Home Office: IRS Publication 587
Farm Assets: IRS Publication 225

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Big Changes to 2026 Version of Form 4562 (Draft Form 4562); Form 4562-B Coming.

The 2026 version of Form 4562 has been updated and changed from the 2025 version. The first big change is the form is now titled "Depreciation," no longer Depreciation and Amortization. The other most significant changes include:

- Part II – Special Depreciation Allowance and Other Depreciation has gone from 3 lines to 6 lines. Added lines include info for special depreciation for plants, nuts, reuse and recycle property, and qualified production property. Each of these bonus depreciation asset categories must now be separately reported.

Part II	Special Depreciation Allowance and Other Depreciation (Don't include listed property. See	
14a	Special depreciation allowance for certain qualified property (other than listed property) under section 168(k)	14a
14b	Special depreciation allowance for certain specified plants bearing fruits and nuts under section 168(k)(5)	14b
14c	Special depreciation allowance for qualified reuse and recycle property under section 168(m) . . .	14c
14d	Special depreciation allowance for certain qualified production property under section 168(n) (attach statement)	14d
15	Property subject to section 168(f)(1) election	15
16	Other depreciation (including ACRS)	16

- Part III – MACRS Depreciation added two new lines, one in Section B and C. The new lines provide separate depreciation disclosure – one line for Qualified production property and the other for Railroad grading, tunnel bore or water utility property.

- Part IV – Summary rearranged the existing lines into a different look – cosmetic only.

- Part V – Listed Property, Section A has a new line that asks for additional info on any plane that is being depreciated.

- Part VI – Amortization has been eliminated.

Form 4562-B – Amortization (Form 4562-B)

Form 4562-B is being added in 2026 to account for amortization expenses. The form is an expansion of the former section of Form 4562 for amortization expenses.

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Form **4562-B** (December 2026) Department of the Treasury Internal Revenue Service	**Amortization** Attach to your return. Go to *www.irs.gov/Form4562B* for instructions and the latest information.	OMB No. 1545-0172 Attachment Sequence No. **179A**

Name(s) shown on return	Business or activity to which this form relates	Identification number

1 Amortization of costs that began during your current tax year (see instructions):

(a) Description of costs (see instructions for allowed entries)	(b) Date amortization begins	(c) Amortizable amount	(d) Code section	(e) Amortization period or percentage	(f) Amortization for this year

Section 179 Expensing (§179)

Background. §179 was enacted as part of the Tax Reform Act of 1958 to help small businesses invest in capital assets by allowing them to expense, rather than depreciate, the cost of certain tangible property in the year it was placed in service. Originally §179 allowed a $2,000 immediate expensing limit for small businesses. From 1981–1990s the limits gradually increased under various tax acts. By the early 1990s, the §179 cap reached $10,000.

In 2003's Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) the limit was raised to $100,000 and indexed for inflation. From 2008–2010, the economic stimulus laws temporarily raised the limit to $250,000, then $500,000, and increased the phaseout threshold. In 2015, $500,000 limit was made permanent, as was the indexing for inflation. Off-the-shelf software and certain real property was statutorily added as qualifying property. The TCJA increased the limit to $1 million, with a phaseout starting at $2.5 million, both indexed for inflation. The election to claim §179 is made by completing Part I of Form 4562.

Part I **Election To Expense Certain Property Under Section 179**
Note: If you have any listed property, complete Part V before you complete Part I.

1	Maximum amount (see instructions)	**1**	
2	Total cost of section 179 property placed in service (see instructions)	**2**	
3	Threshold cost of section 179 property before reduction in limitation (see instructions)	**3**	
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	**4**	
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see instructions	**5**	

6	(a) Description of property	(b) Cost (business use only)	(c) Elected cost

7	Listed property. Enter the amount from line 29	**7**	
8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	**8**	
9	Tentative deduction. Enter the **smaller** of line 5 or line 8	**9**	
10	Carryover of disallowed deduction from line 13 of your 2014 Form 4562	**10**	
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)	**11**	
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11	**12**	

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§179 Limits. As mentioned above, the annual limits for 179 expensing and for the purchase of 179 assets are annually adjusted for inflation. The chart below summarizes the current limits.

Year	Max 179 Expense	Max 179 For SUV/Truck*	Max 179 Asset Purchase
2023	$1,160,000	$ 28,900	$2,890,000
2024	$1,220,000	$ 30,500	$3,050,000
2025	$2,500,000	$ 31,300	$4,000,000
2026	$2,560,000	$ 32,000	$4,090,000
2027			

*Unlike §179, there is no limit for bonus depreciation on SUVs and trucks.

§179 rules in general. The §179 deduction is available to individuals and regular corporations, and as a pass-through from S corporations and partnerships, but not ***to estates and trusts*** (§179(d)(4). Married couples who file separate returns can use the same total limit as those filing married jointly. Married filing separate filers allocate the deduction limit 50/50 unless they elect otherwise (§179(b)(4)). Controlled groups of entities are only allowed the same maximum deduction in a year as one entity, and they may allocate that total in any way desired. Other §179 rules to note include:

- The election may be made or revoked on a timely filed amended return (§1.179-5(a)).
- There is no requirement for qualifying property to be new, but it must have been purchased (rather than received by gift or inheritance). Property purchased from a related party does not qualify, including spouses, ancestors, descendants, and entities of which the taxpayer owns more than 50%.
- When property is purchased during the year there is no part-year proration of the expense, the full amount still qualifies if all the other requirements are met. Similarly, short tax years do not require expense pro-ration as the full amount qualifies (§1.179-1(c)).
- The qualifying cost of property does not include the basis of property that is determined by reference to the basis of another property held at any time by the taxpayer.
- Taxpayers are required to treat the trade of any like-kind ***personal property*** as a fully taxable sale of the relinquished property and a new purchase of the replacement property.

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Planning note. As like-kind exchange treatment is no longer allowed for personal property, It is the author's opinion that basis of a personal property asset acquired in a transaction that includes a trade-in of an already owned asset does NOT include any amount determined by reference to the basis of another asset and. The result is §179 is allowed on the entire purchase price of the new asset, including any trade-in allowance.

Example variation. Ice, Inc. trades in a CNC machine with a value of $20,000 and basis of $12,000 for new equipment that costs $100,000, In addition to the old equipment being transferred, Ice writes a check for $80,000. Ice is required to report the sale of its old CNC machine for $20,000 and recognize a gain of $8,000 ($20,000 less basis of $12,000) and cost of the new CNC machine as $100,000. As none of the cost basis of the new machine is determined by reference to the old CNC machine, Ice is allowed to claim §179 expense deduction of the full $100,000 cost of the new CNC machine.

Caution. The current version of IRS Pub. 946, How to Depreciate Property, contains an outdated and confusing example. This author believes the example used in Pub. 946, while may be technically correct, is very misleading.

§179 Qualifying property (§179(d)(1)). Only tangible, depreciable §1245 or qualified real property used *in the United States* in an active trade or business qualifies for §179. Specifically, qualifying property must meet the following requirements ***and not be specifically excluded:***

- Tangible personal property in the 3, 5, or 7-year MACRS class life including machinery, equipment, non-structural property attached to a building such as cabinets and signs, livestock, gas storage tanks and air conditioners or heaters, or
- A single purpose agricultural or horticultural property in the 10-year class, or
- Off-the-shelf computer software, or
- Qualified improvement property, or
- Depreciable tangible personal property used predominantly to furnish lodging, or in connection with furnishing lodging, including any facility where sleeping accommodations are rented (§50(b)(2)).
- Improvements to nonresidential real property placed in service after the date the building was originally placed in service, including:
    - Qualified improvement property (§168(e)(6));
    - Roofs;
    - Heating, ventilation, and air-conditioning property;
    - Fire protection and alarm systems; and
    - Security systems.

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Non-qualifying property includes (§1.179-4(c)(ii)):

- Property used outside the United States,
- Property acquired by gift or inheritance,
- Property acquired from a related party,
- Property in the 15, 20, 27.5 or 39-year life categories *except qualified real estate improvement property, commercial roofs/HVAC and other real property listed above,*
- Rental property (commercial and residential), except for meeting facilities, hotels, motels, and similar transient-rentals (like Airbnb), and certified historic structures,
- Leased property except for corporations (with exceptions),
- Property used by tax-exempt organizations,
- Property used by governmental agencies or foreign entities except with leases < 6 months,
- Land and improvements *except qualified real estate listed above*.
- Property used 50% or less for business purposes. The business use part of property used partially for business and partially for personal use qualifies if the business portion is >50% (§1.179-1(d)).

Preparer note. When taxpayers are allocated §179 from a flow-through entity, the flow-through amount reduces the allowable §179 for the year. If the taxpayer's flow-through amounts (plus any self-employed amounts) exceed the $2,560,000 limit, the excess amount is not deductible, ***does not carry forward, reduces basis, and is lost forever.*** In this situation, reduce any Schedule C or F §179, or contact the flow-through entity to reduce the amount of §179 claimed on the flow-through return.

Qualified improvement property defined – QIP (§168(e)(6)). QIP is defined as any improvement to the interior portion of a building which is nonresidential real property if such improvement is placed in service after the date such building was first placed in service. It does not include enlargements, elevators, escalators, or the interior structural framework. The law requires straight-line depreciation with a 15-year life for all QIP, but QIP qualifies for bonus depreciation and §179.

Improvements to owner occupied QIP qualify if all other requirements are met. For example, the taxpayer self-rental of his or her own building to the taxpayer's 100% owned corporation qualifies as QIP. Large businesses with limitations on the deduction for interest expense that elect out of the business interest limitation must use ADS lives for all real property.

"Internal structural framework" defined. The term "internal structural framework" for QIP purposes has the same definition as the term is defined in the regulations under §48 Qualified Rehabilitated Buildings (§1.168(k)-1(c)(3)(v)). Internal structural framework includes all load-bearing internal walls and any other ***internal structural supports***, such as columns, girders, beams, trusses, spandrels, and all other members that are ***essential to the stability of the building*** (§1.48-12(b)(3)(i)(D)(iii)).

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Preparer note. There is nothing in the QIP definition that precludes non-structural improvements such as plumbing, electrical, security systems, flooring, etc. from being included as QIP. It is the author's opinion that these costs qualify for the tax attributes afforded QIP and we will be treating stated improvements as such until either the courts or authoritative guidance say otherwise.

Example. James spent $10,000,000 to build a 50,000 square foot commercial building shell. The building is completed and approved for occupancy on June 1, 2026. On June 15, 2026, James agrees to rent 20,000 square feet to Brent for his bike shop as his old building is being demolished. James and Brent agreed to split the $500,000 cost of converting the space into a finished bike shop (adding bathrooms, lighting, walls, wiring, etc.). No load-bearing walls were moved or added, and no other structural components were added or changed.

Result. The entire $500,000 James and Brent spend to improve the space is QIP, even though the building was only two weeks old when the improvements began. James and Brent may each claim §179, bonus depreciation and/or 15-year depreciable lives for their share of the expenses ($250,000 each).

Business income limit. §179 is limited to the taxpayer's total business income for the year. For pass-through entities, the business income test is first done at the entity level and then flows through to the owner level for another round of tests. A pass-through entity's elected §179 amount may not exceed the entity's taxable income for the year. For an S corporation, the calculation is based on taxable income at the 1120S level, and for a partnership, at the 1065 level. Then, at the individual level, another income limit applies which adds together income of all trades and businesses. In all three activities, taxable income is adjusted for assorted items, as illustrated below.

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Taxable Income Adjustments for §179 Income Deduction Limit			
	S Corporation	Partnership	Individual
Taxable Income	X	X	X
+Section 1231 gains	X	X	X
+NOL's			X
+½ of SE Tax			X
+Tax Credits	X	X	X
+Tax exempt income	X	X	X
+Guaranteed Payments		X	X
+Wages of shareholder-employees	X		X
+Wages from all other sources			X
+Spouse wages (joint return) from all other sources			X
+ Active income from other activities			X
- Section 1231 losses	X	X	X

Carryovers of §179. A §179 deduction that is limited because of reaching the maximum deduction limit for the year does not carry over. A §179 deduction limited because of reaching the taxable income ceiling carries forward for an unlimited number of years (§1.179-3(a)). Any unused §179 carryovers expire at death of the taxpayer.

Example. Kevin has a $50,000 Sch. C profit from his excavation business before depreciation in 2026. Kevin bought a backhoe for $70,000 in 2026. If Kevin claims §179 expense of $70,000, his 2026 deduction is limited to his $50,000 Sch C profit. The extra $20,000 is carried forward to 2027. Kevin pays no income or SE tax in 2026, and he then deducts the $20,000 excess §179 expense from 2026, saving both ordinary income and SE tax in 2027.

§179 Recapture. To claim §179, the underlying property must be used predominantly for trade or business. This generally means that the underlying asset is used more than 50% of the time for trade or business purposes during its entire MACRS life. If, at any point during an asset's life, it ceases to be used predominantly for trade or business, §179 recapture is required. An asset ceases to be used predominantly for trade or business if:

1. The business use of the asset drops to 50% or less;
2. The property is disposed of in a transaction other than a disposition to which §1245(a) applies (ordinary gain on sale); or

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3. The property is converted from business to personal use.

Recapture is the difference between a) the amount originally expensed under §179, and b) the deprecation that would have been claimed, including bonus depreciation, using the GDS (MACRS) method. The difference between the two calculations is treated as ordinary income and is reported on Part IV of Form 4797 and the form or schedule where the deprecation was originally claimed (e.g., Sch. C., Sch. F, etc.).

Part IV **Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less** (see instructions)

			(a) Section 179	(b) Section 280F(b)(2)
35	Section 179 expense deduction or depreciation allowable in prior years	35		
36	Recomputed depreciation (see instructions)	36		
37	Recapture amount. Subtract line 36 from line 35. See the instructions for where to report	37		

Example. Assume Kevin, from our last example, decides to close his excavation business in May 2028. Kevin owns the 20 acres that surrounds his residence, so he decides to keep the backhoe to use around his home. Unfortunately, Kevin will have to recapture a portion of the §179 expense he claimed on Sch. C for the backhoe. The amount of recapture is the difference between the §179 depreciation he claimed, and the depreciation allowed under MACRS. Assume for this example that Kevin elected out of bonus depreciation. The recapture is calculated:

§179 deprecation claimed		$ 70,000
MACRS depreciation (5-year property)		
- 2026 (20%)	$14,000	
- 2027 (32%)	$22,400	
- 2028 – zero	$ - 0 -	
Total MACRS accumulated depreciation		($36,400)
Net amount – recapture amount		$ 33,600

What about the fact that Kevin carried part of the §179 expense forward? Because Kevin was able to use the entire §179 expense in 2026 and 2027 (i.e., there is no longer any carryforward in 2028), the full recapture applies. However, while not specifically addressed in the regulations, it appears that the recapture included in income would be reduced for any remaining §179 expense still being carried forward.

Preparer note. Autos and other listed property require ADS (mostly straight line) depreciation to be used to calculate the accumulated depreciation instead of MACRS when calculating the recapture amount. The result is a much higher recapture when vehicles are involved.

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§179 Recapture on Asset Sales by Pass-Through Entities – K-1 Reporting

When a passthrough entity disposes of §179 property before its useful life ends, the §179 recapture is not reported on Schedule K, nor on Form 4797. The entity eliminates the net book gain or loss on §179 assets from taxable income and presents it on the entity tax return as a Schedule M-1 adjustment. The information necessary to calculate the tax gain or loss at the owner level will be reported on a Form 1120-S, Schedule K-1, Box 17, Other Information, and designated as Code K – "dispositions of property with §179 deductions." For a partnership, the same information will be reported on Form 1065, Schedule K-1, Box 20, Other Information, designated as Code L. Both Codes K and L will refer to a supporting schedule. Software should provide the necessary information, but if it does not, the shareholder or partner should receive the following information:

- Description of the disposed property.
- Date acquired and placed in service.
- Date of sale or disposition.
- Owner's distributive share of sale price or amount realized.
- Distributive share cost and selling expenses.
- Distributive share of depreciation.
- Distributive share of §179 expense.
- If distribution is due to a casualty or theft, the information necessary to complete Form 4684, Casualties and Thefts.
- Installment sale information, if applicable.

Planning Ideas

#1 – Real Property Improvements. As previously discussed, the following improvements to ***nonresidential*** qualified real property (QRE) and qualified improvement property (QIP) placed in service after the date the building was originally placed in service qualify for §179, including:

1. Qualified improvement property (QIP).
2. Commercial property roofs (QRE).
3. Heating, ventilation, and air-conditioning property (QRE).
4. Fire protection and alarm systems (QRE).
5. Security systems (QRE).

The question poorly answered by the IRS in prior years was whether a new roof was a repair or a replacement. This question is moot for commercial properties as we are allowed to treat a roof replacement as an expense item under §179 if it is replaced on non-residential property.

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Example 1: Lakeland Investments, LLC had several roof leaks on their book warehouse and assembly building in 2026, necessitating several calls to a roof technician, who re-caulked skylights, replaced several shingles, and repaired some vent work. Lakeland spent $7,750 and deducted the full amount in 2026 as a repair because the costs seemed to meet the murky guidance the IRS provided in their repair/capitalization regulations (up to $2,500 per occurrence or item), and because it met the de minimis test that Lakeland had adopted.

In February 2027, Lakeland spent $75,000 to replace the entire roof system – new shingles, skylights, and roof vents. Lakeland used §179 to expense the entire amount in 2027.

#2 – Making the Most of the $2,500 De Minimis Safe Harbor Election. This annual election is made under Notice 2015-82 and allows taxpayers to expense the first $2,500 per invoice *or per item listed separately on the invoice* without argument from the IRS. No other written accounting procedure is required. The election to use this rule or not is made annually. For those who frequently purchase multiple pieces of the same equipment at one time (e.g., computers, tablets, etc.) and who want to maximize current deductions, make sure to apply the $2,500 limit on a per item basis. Taxpayers with an applicable financial statement (generally audited financial statement) may elect to use a per item limit of $5,000.

Election must be made annually. The taxpayer makes the election annually by including a statement with the tax return citing "Section 1.263(a)-1(f) de minimis safe harbor election." The election is made in the year the tangible personal property is placed in service and is allowed in any year of ownership. A written policy is not required for taxpayers who do not have AFS, although the election is still required. If the taxpayer has an AFS, the $5,000 expensing limit must be used on the financial statements as well. The taxpayer can choose a threshold lower than the safe harbor amount in any given year (§1.263(a)-1(f)).

Example. Taxspeaker buys 4 video cameras from B&H Photo for $2,400 each. Taxspeaker does not have an AFS but has elected the de minimis safe harbor amount of $2,500. If the cameras are individually listed on the invoice they may be expensed under the safe harbor rule. If the invoice shows one line item for $9,200, Taxspeaker would be required to capitalize the cameras because the invoice total is over $2,500 and individual items are not listed.

#3 – Avoid Equipment Purchases in Low Income Years. Buying equipment in a small business during lean years is and always has been a questionable decision when examining income tax effects. Mandatory depreciation will be required on the equipment with minimum benefit obtained because of low tax rates in low-income years. Furthermore, for the self-employed with negligible income, the effect is greater because of the lost deduction at the 15.3% self-employment tax rate. A business owner that needs new equipment in a bad year should seriously consider leasing as a short-term solution without negative tax effects.

So, in addition to electing out of bonus and not taking §179, leasing is an option that obtains needed equipment and does not throw away depreciation deductions!

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Bonus Depreciation (§168(k))

Background and getting us up to date. Bonus depreciation is a term created by Congress many years ago to describe an immediate deduction of a percentage of the cost of a qualified asset in the year of purchase. Bonus depreciation has been allowed at various percentages ranging from 20% to 100% of qualified asset cost since its inception decades ago. Bonus depreciation is allowed for new and used assets purchased in the 3, 5, 7, 10, 15 and 20-year life categories.

Bonus qualified property (§168(k)(2); Notice 2026-11). Bonus depreciation applies to:

6. Nearly every asset purchased in the MACRS 20-year or shorter class life,
7. New and used property,
8. Planted and grafted plants bearing fruit or nuts,
9. Computer software (§167(f)(1)),
10. Water utility property,
11. Qualified film, television, and live theatrical productions (§181(d) and (e)). For years ending after July 4, 2025, sound recording productions are also eligible (§181),
12. Certain property with a long production period (§168(k)(2)),
13. Certain noncommercial aircraft (§168(k)(2)(C)),
14. Qualified improvement property, and
15. Qualified reuse and recycling property (subject to 50% limitation).

Preparer note. OBBBA added qualified sound recording production (produced and recorded in the US) to the list of qualified bonus depreciation assets (181(a)(1)). The total per production cannot exceed $150,000. See Notice 2026-11 for additional info.

Non-qualified property (§168(f)). The following is not qualified property for bonus depreciation:

- Property converted from business to personal use in the year of purchase,
- Property bought and sold in the same year,
- Property required to be depreciated using ADS. This includes listed property used less than 50% for business and property financed with tax-exempt bonds,
- Property used in a trade or business that has had floor plan financing indebtedness, unless the taxpayer with such trade or business is not a tax shelter prohibited from using the cash method and is exempt from the business interest limitation rules, and
- Property which is primarily used in the trade or business of the furnishing or sale of (1) electrical energy, water, or sewage disposal services, (2) gas or steam through a local distribution system, or (3) transportation of gas or steam by pipeline, if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by an electric cooperative (public utility property).

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§179, bonus and MACRS ordering rules. Assets that qualify for §179, §168(k) bonus depreciation, and MACRS have an ordering rule for how to claim the various depreciation amounts. The rules require §179 to be applied first, then bonus, then, if there is any remaining basis, MACRS depreciation.

Example. Dolly Inc. bought $5,000,000 of new equipment in 2026. Dolly calculates depreciation:

Equipment cost basis	$ 5,000,000
§179 expense	($2,560,000)
Bonus depreciation	($2,740,000)
MACRS	($ - 0 -)
Net basis	$ - 0 -
Total depreciation claimed	$ 5,000,000

In this example, the full amount of depreciation is allowed, regardless if §179 is maxed out and then bonus is used on the balance. If no §179 was claimed, bonus could be used on 100% of the purchased assets. Either way, the entire basis is entirely written off.

Variation. Assume the same facts as above except Dolly is an S-corporation 100% owned by Willie. Dolly Inc.'s taxable income prior to depreciation is $1,000,000 and Willie has substantial taxable income on his Form 1040 from other sources. In this scenario, Willie's K-1 would look different depending on what depreciation method is used:

	Full §179, then Bonus	**No §179, only Bonus**
Pre-deprecation profit	$ 1,000,000	$ 1,000,000
§179 expensing	($2,560,000)	NA – None
§179 add back due to income limit	$ 1,560,000	NA – None
Bonus depreciation	($2,740,000)	($5,000,000)
Net deductible loss on K-1	($2,740,000)	($4,000,000)

The key here is to remember that bonus depreciation may create a loss whereas §179 is only allowed to the extent of the business profit. By using bonus depreciation instead of §179, assuming he has basis, Willie can offset an additional $1,260,000 of non-K-1 income on his Form 1040.

Recapture rules. Because bonus depreciation is treated just like any other depreciation deduction, if an asset is sold, the normal depreciation recapture rules apply. If bonus depreciation is taken on real property (e.g., leasehold improvements or QIP), it is considered an amount that is faster than straight-line and would be recaptured under §1250 – i.e., recaptured as ordinary income.

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Caution. Unlike §179, bonus depreciation does not include a specific recapture provision if business use of an asset drops to 50% or less. This means that a taxpayer may claim bonus deprecation in the year an asset is purchased and then convert the asset to personal use in a subsequent year and there is no recapture. However, bonus depreciation for passenger automobiles and other listed property is statutorily subject to the recapture provisions of §280F (§168(k)(2)(F)). Essentially this means that any vehicle that has business use drop below 50% is required to calculate recapture under §280F.

Converted property. Property originally purchased by the taxpayer for personal use, and then later converted to business use, qualifies for bonus depreciation without regard to whether it is converted in the year of purchase or later (§1.168(k)-1(b)(3)(ii)(A)). Converted property is treated as if the property was placed in service on the conversion date. Property bought as inventory and then converted to use as an asset also qualifies for bonus (§1.168(k)-1(b)(3)(ii)(B)). The original use date is the date of conversion from inventory to business use.

Example. Chris is working as a carpenter for Rocon Construction, Inc. when he pays $70,000 in 2026 for a new truck that he uses for his job. In 2028 Chris starts his own Schedule C construction business and uses the 2026 truck 100% in the new business. Chris may claim $50,000 (FMV at date of conversion) bonus depreciation on the truck in 2028. The fact that he bought the truck two years earlier doesn't matter. As it was used personally during the two prior years, Chris is still entitled to claim bonus depreciation when the truck is placed in service for depreciation purposes – 2028.

Electing out of bonus. Because bonus depreciation is mandatory, the taxpayer must attach an election to the tax return to elect out. The election is made on a class life basis and applies to all purchases made within that class life. It is not an asset-by-asset election. To make the election, the taxpayer must attach a statement to the return indicating what election is being made and the class of property for which the election is being made.

Election is irrevocable. Once made, an election cannot be revoked without IRS consent. The election must be made by the due date (including extensions) of the return for the tax year in which the bonus depreciation property is placed in service. Taxpayers who file their tax return timely can make the election out or revoke an original election out by filing an amended return within 6 months of the due date of the original return (excluding extensions). Write "Filed pursuant to section 301.9100-2" on the amended return (Form 4562 instructions). If this rule does not apply, the only way to change the election – in or out – is with IRS permission via a letter ruling request (§1.168(k)-1(e)(7)).

Preparer note. Upon disposition of a bonus eligible asset, the "allowed or allowable" rule will apply. This means that a taxpayer who fails to elect out and fails to claim bonus depreciation is still required to claim bonus depreciation as part of the accumulated depreciation (it was "allowable") and pay tax on the amount as recapture income even though no bonus was ever actually claimed. Unfortunately, it appears the bonus depreciation rules specifically preclude filing a Form 3115, Change of Accounting Method, to correct depreciation in the year of sale. Very bad news if mistakes are made on this one!

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Qualified Production Property (QPP) Deduction Added (§168(n); Notice 2026-16)

Preparer note. The IRS issued Notice 2026-16 which contains detailed explanations of the QPP rules and includes numerous examples. The notice also states the IRS intends to issue regulations, but until that happens the guidance in the notice may be relied on. The remaining info in this section relies heavily on the notice.

OBBBA introduced a new and temporary 100% "Qualified Production Property" (QPP) expense provision. Under §168(n), taxpayers may elect to claim bonus depreciation on "qualified production property."

QPP defined. QPP is nonresidential real property that:

1. Qualifies as MACRS property;
2. Is used by the taxpayer as an integral part of a "qualified production activity" (QPA);
3. Is placed in service in the United States or any US possession;
4. The original use commences with the taxpayer (see special rule exception below);
5. The construction of which begins after January 19, 2025, and before January 1, 2029;
6. Is placed in service after July 4, 2025, and before January 1, 2031;
7. The taxpayer designates as QPP and makes the required election;
8. Is not subject to ADS depreciation; and
9. Is not ineligible property (defined below).

"Integral part" requirement. Property, or any portion thereof, is an integral part of a QPA if a QPA takes place within the building. This includes QPAs that take place in a portion of a building. If a QPA is conducted in only a portion of a building, only the portion where the QPA is conducted satisfies the integral part requirement. Other clarifications include:

- **De minimis rule**. If 95% or more of the physical space of a building satisfies the integral part requirement when the property is placed in service, the taxpayer may elect to treat the entire property as satisfying the integral part requirement.

Example. Indy Inc., a calendar-year taxpayer, constructs a 200,000-square-foot factory building for use in its manufacturing trade or business. The factory was completed in November 2028, when it was placed in service. Upon completion, the factory's unadjusted depreciable basis was $60,000,000. The factory includes 190,000 square feet of manufacturing space, 6,000 square feet of office space and 4,000 square feet of other non-manufacturing space. Indy Inc. makes an election to use the de minimis rule. As less than 5% of the total square footage is non-QPP, the factory satisfies the de minimis rule and Indy may treat 100% of the square footage of the factory satisfying the integral part requirement. The entire $60,000,000 basis is QPP and no allocation is necessary.

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- **Property used by a lessee.** In general, property used by a lessee engaged in a QPA is not treated as used by the lessor as an integral part of a QPA – no QPP deduction (§168(n)(2)(A)). But there are two exceptions:

    - **Exception for consolidated groups**. If one company is part of a consolidated tax group and leases property to another company in the same group – intercompany lease – then the whole consolidated group is treated as one single taxpayer. In practical terms, this means the lessor meets the "integral part" requirement if the lessee is doing QPA on that property. In other words, when companies in the same tax family lease property to each other, the test isn't applied lease-by-lease. Instead, the group looks to how the tenant company is using the property.

Example. Roco and Rocon are members of the same controlled group. Roco constructs a building that otherwise qualifies as QPP, but Roco rents the building to Rocon. Under the general rule, Roco cannot use the QPP rules as leasing is not a QPA. However, Rocon, the related tenant, uses the building to engage in a QPA. Because both Roco and Rocon are members of the same tax consolidated group, Roco meets the integral part requirement via Rocon's QPA and is allowed to elect QPP treatment.

    - **Exception for commonly controlled pass-through entities[1].** If a partnership, S corporation, or individual (called a "lessor pass-through entity" or "lessor individual") leases property to another party under common control, two things follow:

        - The lessor isn't treated as a "lessor" of the property for QPP purposes.
        - To decide whether the property counts as an "integral part" of a trade or business, look at what the commonly controlled tenant does with the property, not what the lessor does.

      In short, when property is leased to a related party, the rules look through the lease and evaluate the property based on the tenant's business use, not the landlord's role as landlord.

Example. Brandon constructs a building that qualifies as QPP except Brandon is leasing the building to Rocon, Brandon's 100% owned S corporation that manufactures fly reels. Under the general rule, Brandon cannot use the QPP rules as leasing is not a QPA. However, Rocon, the related tenant, uses the building to manufacture fly reels – a QPA. Because Rocon is a commonly controlled pass-through entity, Brandon meets the integral part requirement via Rocon's QPA and is allowed to elect QPP treatment.

[1] The term commonly controlled person means either: (i) a sole proprietorship, partnership, or corporation of which 50% or more is owned, directly or by attribution under §267(b) or §707(b), by the same person or group of persons that own, directly or by attribution under §267(b) or §707(b), 50% or more of the lessor pass-through entity for a majority of the taxable year in which the property is placed in service, including on the last day of such year, or (ii) a sole proprietorship, partnership, or corporation of which 50% or more is owned, directly or by attribution under §267(b) or §707(b), by the lessor individual or the lessor pass-through entity for a majority of the taxable year in which the property is placed in service, including on the last day of such year.

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Special rule for non-original use property. As stated above, to qualify as QPP, the property's "original use" must be with the taxpayer. There's an exception for used property that meets the following conditions:

1. Nobody used this property in a qualified production activity at any point between January 1, 2021, and May 12, 2025, regardless of whether that use ended up substantially transforming it into a finished qualified product.

2. The taxpayer claiming the benefit never used this property themselves before buying it.

3. The acquisition was the result of a Bonafide purchase as defined under §179(d) and 1.179-4(c) (e.g., cannot be a transfer between related parties or carryover from a corporate reorganization).

4. The cost basis of the property is calculated per §179(d)(3) criteria.

Example. Brandon purchases a warehouse building from an unrelated party in May 2027. Brandon moves his cabinet fly reel manufacturing business into the building. Brandon confirms with the prior owner that the building has been a warehouse since it was originally built in 2015. Because the building was never used for a QPA in the past, and because it meets requirements 1-4 above, the building is QPP and Brandon may elect to apply the expensing rules.

Ineligible property. Ineligible property includes any portion of property used for offices, administrative services, lodging, parking, sales activities, research activities, software development or engineering activities, or other functions unrelated to a QPA. Additionally, any portion of property used to store finished products and certain other items is not used as an integral part of a QPA and is thus ineligible property.

Mixed use property basis allocation. Taxpayers may use any reasonable method to allocate a property's unadjusted depreciable basis between eligible property and ineligible property. The use of square footage, cost segregation data, architectural or engineering plans, process diagrams, or construction invoices to allocate unadjusted depreciable basis to eligible property may be a reasonable method. Taxpayers may use more than one reasonable allocation method for a property if using a single allocation method would not properly allocate basis. Each allocation method must be applied consistently and reflect the property's facts and circumstances. Using employee headcount or employee time spent on QPA activities is not a reasonable method to allocate unadjusted depreciable basis to eligible property.

Example. Harry spends $50,000,000 to construct property that includes 50% of the square footage for a QPA and the remaining portion of the building does not qualify as QPP. Harry may determine the QPP depreciable basis by multiplying the total $50,000,000 basis of the property by 50%.

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Dual-use infrastructure. In the case of property or a portion thereof which contains infrastructure that serves both eligible property and ineligible property (such as a central air conditioning system or a sprinkler system), a taxpayer may allocate the basis of such property between eligible property and ineligible property using any reasonable method. For this purpose, the use of architectural or engineering plans, blueprints, process diagrams, product specifications, or a combination thereof, to allocate unadjusted depreciable basis to eligible property may be a reasonable method if the resulting allocation considers the actual or planned usage of the dual use infrastructure.

Property classes and related elections. QPP is treated as a separate class of property distinct from other §168(k) property classes.

Qualified Production Activities (Notice 2026-16)

Overview. The term qualified production activity (QPA) means the manufacturing, production, or refining of a qualified product. For this purpose, a qualified product is any tangible personal property other than any food or beverage prepared in the same building as a retail establishment in which the meal or beverage is sold (e.g., restaurant). A trade or business activity of a taxpayer does not constitute manufacturing, production, or refining of a qualified product unless the activity results in a substantial transformation of the property comprising the qualified product. A manufacturing, production, or refining activity that does not create a substantial transformation of property may nevertheless be included in QPA or will not cause a taxpayer to fail to have QPA, if the activity meets certain requirements discussed below. Qualifying activities are further defined:

- **Production.** The term production is centered in two primary areas: agricultural production and chemical production.
    - **Agricultural production.** In general, the term agricultural production means the process of cultivating the ground, typically in fields or large acreage, and includes:
        - Preparing the soil;
        - Planting seeds;
        - Raising, cultivating, irrigating, and harvesting crops for sale, rent, or lease to customers; and
        - Breeding, rearing, feeding, and managing livestock for sale, rent, or lease to customers. For this purpose, livestock incudes cattle, hogs, horses, mules, donkeys, sheep, goats, captive fur-bearing animals, chickens, turkeys, pigeons, and other poultry.
    - **Exclusions.** The term agricultural production does not include:
        - The raising of animals that are not livestock; or
        - Activities that benefit people engaged in agriculture when these activities are not agricultural production, such as food marketing.
    - **Chemical production.** The term chemical production means a chemical process whereby a product is formulated from organic and inorganic raw materials, including preparing raw materials for reaction, combining materials in a reactor to form a new substance, isolating the final product from byproducts, intermediates, and other substances, and purifying the final product. Examples of chemical production include:

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  - Basic inorganic chemical manufacturing, such as petrochemical manufacturing, industrial gas manufacturing, and synthetic dye and pigment manufacturing;
  - Basic organic chemical manufacturing, such as ethyl alcohol manufacturing and cyclic crude, intermediate, and gum and wood chemical manufacturing;
  - Manufacturing synthetic resins, plastics materials, and non-vulcanizable elastomers and mixing and blending resins on a custom basis;
  - Manufacturing nitrogenous or phosphatic materials and mixing with other ingredients into fertilizers;
  - Manufacturing pharmaceutical products intended for internal and external consumption in such forms as ampoules, tablets, capsules, vials, ointments, powders, solutions, and suspensions;
  - Manufacturing adhesives, glues, and caulking compounds; and
  - Manufacturing soaps, detergents, polishes, surface active agents, textile and leather finishing agents, and other sanitation goods.

- **Manufacturing.** The term manufacturing means to materially change the form or function of tangible personal property, including parts and components, to create a new item of tangible personal property that is held for rent, lease, or sale to customers in the ordinary course of a trade or business. The form or function of the raw materials, elements, parts, components, or other tangible personal property used as inputs is considered to be materially changed if, at the completion of the processes giving rise to the new item of tangible personal property, the materials, elements, parts, components or other inputs have been transformed such that they are distinguishable from, and cannot readily be returned to, their original state. In no event will a change in form or function resulting solely from packaging, repackaging, labeling, minor assembly operations, or a combination thereof, be considered a material change to the form or function of tangible personal property.

- **Refining.** The term refining means to purify a substance into a useful and higher-value product. Examples of refining include:
  - Removing free fatty acids and other impurities from animal fats by degumming, decolorization, deacidification, and deodorization;
  - Processing petroleum, liquid hydrocarbons, and other products from crude oil by using fractionation, straight distillation of crude oil, and/or cracking;
  - Purifying nonferrous metals (except aluminum) by electrolytic methods or other processes;
  - Processing vegetable oils from plant material by removing free fatty acids, phospholipids, pigments, off-flavors, and other impurities;
  - Processing vegetable, oilseed, and tree nut oils from purchased oils, such as by degumming and neutralization;
  - Wet corn milling;
  - Processing cane or beet sugar from raw cane or beet sugar;
  - Removing remaining impurities and moisture from animal fat, bones, and meat scraps through techniques like filtration and bleaching;
  - Processing tar paving, roofing, and saturated materials from crude petroleum and manufacturing asphalt;
  - Extracting alumina (aluminum oxide) generally from bauxite ore;
  - Processing liquified natural gas or chemical feedstocks from natural gas;
  - Recovering copper or copper alloys from scrap; and

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- Recovering nonferrous metals (except copper and aluminum) from scrap.

Essential activities. A QPA includes a qualified product if the activity is essential to the completion of the QPA. A manufacturing, production, or refining activity is essential to the completion of a QPA if:

- The activity occurs within the same property or the same integrated facility in which the substantial transformation of the property comprising the qualified product occurs;

- The activity does not occur within ineligible property; and

- Without the activity, the substantial transformation of the property comprising the qualified product:

    - Cannot occur,
    - Would result in a product that is different in quality than the intended qualified product, or
    - Would result in a quantity of qualified products that is different from the intended quantity.

Storage activities:

- Storage of raw materials. The receiving and storage of raw materials to be used or consumed during a QPA are activities essential to the QPA if they are within the same property or integrated facility as the QPA.

- Storage of other items. Any other storage, such as the storage of finished products, is not an activity essential to a QPA.

Related activities. A trade or business activity will not fail to be a QPA if the individuals performing or supervising the manufacturing, production, or refining activities also perform, or are otherwise involved in, activities related to the QPA if:

1. The related activity occurs within the same property, or within the same integrated facility where substantial transformation of the property comprising the qualified product occurs, and

2. The related activity does not occur within ineligible property. For example, the following activities likely would be QPA:

    - Oversight and direction of the manufacturing, production, or refining activities that result in the substantial transformation of the property comprising a qualified product;
    - Material selection, vendor selection, or control of the raw materials or work-in-process that are substantially transformed into a qualified product;
    - Management of manufacturing, production, or refining costs or capacities attributable to the manufacturing, production, or refining activities that result in a substantial transformation of the property comprising a qualified product (for example, cost reduction or efficiency initiatives associated with the manufacturing,

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production, or refining activities that result in a substantial transformation of the property comprising a qualified product); or

- Developing or directing the use or development of, product design and design specifications, as well as trade secrets, technology, or other intellectual property used in conducting a manufacturing, production, or refining activity that results in a substantial transformation of the property comprising the qualified product.

Comprehensive example. Del Mar owns a factory building that it uses to process tomatoes and other vegetables into jarred tomato sauce that is sold in grocery stores. The jarred sauce is a qualified product, and the sauce ingredients are the property comprising the qualified product. The physical space of Del Mar's factory is divided up into the following areas:

- **Ingredient receiving.** A loading bay used to receive the sauce ingredients;
- **Ingredient storage.** A section used to store the sauce ingredients received at the loading bay;
- **Ingredient preparation.** A section used to, as applicable to each ingredient, inspect, sort, clean, blanch, peel, chop, mince, and/or otherwise prepare the sauce ingredients for further processing;
- **Sauce processing and jarring.** A manufacturing space in which the prepared ingredients are combined, blended, cooked, cooled, preserved, and sealed in labeled jars.; and
- **Sauce storage.** A section used to store the jarred sauce prior to shipping it to customers.

Ingredient receiving and ingredient storage. Individuals working in the ingredient receiving and storage sections exclusively engage in receiving and storage related activities. The form or function of any sauce ingredient is not materially changed from its original state into a new item of tangible personal property through the activities conducted in the loading bay and ingredient storage sections. The ingredient receiving activities at the loading bay and the ingredient storage activities relate to raw materials to be consumed in the QPA and are conducted in the same property as the QPA. The ingredient receiving and ingredient storage activities are essential activities and are thus included in Del Mar's QPA. The space is QPP.

Ingredient preparation. During the ingredient preparation stage, the forms of the sauce ingredients are materially changed from their original state such that new items of tangible personal property result (prepared ingredients), but further processing is required beyond the ingredient preparation stage to arrive at a final, complete, and distinct item of property (jarred sauce) that is fundamentally different from the original inputs. However, without this ingredient preparation stage, the sauce processing stage would result in a product that is different in quality or quantity from the intended qualified product. In addition to performing the inspecting, sorting, cleaning, blanching, peeling, chopping, mincing, and other preparation activities, the individuals working in ingredient preparation also perform tests to ensure that the prepared ingredients are of the appropriate quality before they are further processed as a part of the sauce processing and jarring activities. The ingredient preparation space is QPP.

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Sauce processing and sauce jarring. During the sauce processing and sauce jarring stage, the forms of the prepared ingredients are further materially changed into the final, complete, and distinct item of property (jarred sauce). The individuals working in sauce processing and sauce jarring also perform oversight activities to ensure the manufacturing process occurs as intended. The sauce processing and jarring space is QPP.

Sauce storage. Individuals working in sauce storage exclusively engage in storage related activities of the jarred sauce. The form or function of the jarred sauce is not further materially changed through the activities conducted in this section of factory. The storage of finished products is not an essential activity. Accordingly, the portion of factory used to conduct the sauce storage is ineligible property.

Summary Del Mar's QPA. The scope of the QPA conducted in, or taking place within, Del Mar's factory includes the ingredient receiving and storage stage, the ingredient preparation stage, and the sauce processing and jarring stages, including the quality testing and oversight activities. Only the area devoted to finished goods storage is excluded.

QPP Depreciation and Recapture

Future depreciation recapture is §1245 recapture. There are two recapture rules that create the biggest drawbacks to claiming bonus depreciation on QPP:

1. If, at any time within the 10 calendar-year period beginning the date the QPP is placed in service, there is a change of use so the property ceases to be QPP, the taxpayer must treat the QPP property as being disposed of and recognize the entire amount of bonus depreciation claimed as income. The result is §1245 income recapture, all of which is subject to ordinary income tax rates.

2. After the initial 10-year period expires, any recaptured QPP bonus depreciation is still subject to §1245 recapture – ordinary income tax rates.

This means that the tax rate on recapture will be up to 37% instead of the 25% rate normally associated with sales of nonresidential buildings.

Basis of asset after recapture. Depreciation for disqualified QPP is determined in the year of change and all subsequent taxable years by treating the disqualified property as a new separate asset placed in service on the first day of the year of change. As the disqualified property is nonresidential real property, the depreciation allowance is calculated using the 39-year straight-line life.

Example. Aldo, Inc. is a calendar-year taxpayer that places a 50,000 square-foot factory in service on January 1, 2027, and elects to designate the entire $10,000,000 basis as QPP. Aldo's special depreciation allowance for the 2027 is $10,000,000, and its adjusted basis in the QPP is $0 as of January 1, 2028. From January 1, 2027, to December 19, 2032, Aldo uses the QPP as an integral part of a QPA. However, at the end of 2032, Aldo stops using the property as QPP and begins using it for a non-qualified use.

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Result. Aldo's building underwent a QPP change in 2032 and became disqualified property. Aldo is treated as disposing of the QPP and recognizes a gain of $10,000,000 in the 2032 taxable year. The entire $10,000,000 gain is treated as ordinary income. Aldo's adjusted basis in the building is increased by $10,000,000 as of January 1, 2032. Aldo starts depreciating the building in January 2023 using the 39-year life and the straight line method, giving it a depreciation deduction if $245,726 in 2032 – ($10,000,000 basis ÷ 39 years) ÷ 12 months x 11.5 months.

QPP and like-kind exchanges. Another trap for those who choose to use the new QPP accelerated deduction is that if a taxpayer decides to exchange QPP (relinquished §1245 real property) for a standard commercial building (§1250 property), §1245 recapture will be triggered. §1245 can only be deferred in a like-kind exchange if it is replaced with §1245 property. There appears to be two methods available to tax advantage of the like-kind exchange rules to defer the §1245 recapture gain:

1. QPP is sold and is then replaced with new QPP of equal or greater value. If all other §1031 rules are met, it appears this would allow the taxpayer to avoid tax on the exchange.

Caution. As of today, QPP expires for buildings placed in service after 2030. Accordingly, there won't be any replacement 1245 property via purchase of new QPP starting in 2031.

2. Assuming the 10-year recapture (see above) is not applicable, the taxpayer may prepare cost segregation study on new property acquired via a §1031 exchange with the goal of maximizing its §1245 asset class allocation to absorb as much of §1245 recapture as possible.

Example. Echo Inc. constructed and placed in service a QPP building in 2027. The original $5,000,000 basis was fully written off as QPP in 2027. In 2038 Echo decides to move its operations to a new state, where it purchases a new building for $15,000,000. Echo performs a cost segregation analysis and determines that $6,000,000 of the $15,000,000 new building purchase price is allocable to §1245 assets. Echo used §1031 to exchange the QPP property into the $6,000,000 of §1245 property in the new building to avoid immediately paying tax on the recapture gain.

Other Notable QPP Rules and Definitions

Contract manufacturing. Whether the taxpayer is the owner of the qualified product resulting from the QPA is not considered to determine whether the taxpayer's trade or business activity is a QPA. For example, Cysco Inc. entered into contract manufacturing arrangement to manufacture qualified products for its customers, but Cysco does not own the resulting product. Cysco is engaged in a QPA if the activity otherwise meets the relevant rules and definitions. It may claim the QPP deduction for property that otherwise qualifies.

Tangible personal property. The term tangible personal property has the same meaning as in §1.48-1(c). The fact that the property is held to be tangible personal property under local law is not controlling. Only the regulation definition matters.

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Making the election

Preparer note. It is important to remember that bonus depreciation is mandatory – it is the default position taken on the tax return. If a taxpayer doesn't want to claim bonus depreciation, an election out must be attached to the return for all asset classes for which bonus is not desired. However, for QPP it is the opposite. Taxpayers must make the election described below to classify their real estate assets as QPP.

Timing. A taxpayer elects to treat property as QPP by making the election by the due date, including extensions, of the taxpayer's original Federal income tax return for the taxable year in which the eligible property is placed in service by the taxpayer.

Manner of making election and designation. A taxpayer makes the designation and election by attaching a statement to its Federal income tax return for the taxable year in which the eligible property is placed in service. The statement, entitled "STATEMENT PURSUANT TO SECTION 7 OF NOTICE 2026-16", must include the following information:

1. The name and taxpayer identification number of the taxpayer making the election;

2. For each property placed in service in the taxable year for which an election under this section 7 is being made:
    a. The street address, city, state, zip code, and a description of the property;
    b. The total unadjusted depreciable basis of the property;
    c. If the eligible property is less than the entire property, the dollar amount of unadjusted depreciable basis allocable to the eligible property, and a description that identifies the eligible property; and
    d. The dollar amount of the unadjusted depreciable basis of eligible property the taxpayer is designating as QPP (or a statement that the taxpayer is designating the entire unadjusted depreciable basis of the eligible property as QPP);

3. If the taxpayer is applying the de minimis rule, a declaration that the taxpayer is applying the de minimis rule described in Notice 2026-16 and identification of each eligible property to which the de minimis rule is applied; and

4. If the taxpayer is using the automatic one-year extension of the placed-in-service-date requirement (disaster related auto- extension) a declaration that:

    a. The taxpayer is using the automatic one-year extension of the placed-in-service-date requirement as described in Notice 2026-16; and
    b. Each property for which the taxpayer is using the automatic one-year extension was in a disaster area for all or a portion of 2030; and
    c. Identification of each eligible property for which the taxpayer is using the automatic one-year extension and identification of the federally declared disaster.

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Revocation. Any QPP election and any designation contained in such election may be revoked only by filing a request for a private letter ruling and obtaining the written consent of the IRS. The IRS will provide consent only in extraordinary circumstances. If the request for revocation would allow a taxpayer to use hindsight, the extraordinary circumstances standard is not met.

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Bonus Qualifying Assets		
Description	**Class Life**	**Other Requirements**
Semi Tractors	3 Year	None
Rent to Own Property	3 Year	None
Vehicles	5 Year	None
Computer Equipment	5 Year	None
Office Equipment	5 Year	None
Appliances & furniture in residential rentals	5 Year	None
Farm equipment	5 Year	None
Office furniture	7 Year	None
Single purpose ag structure	10 Year	None
Trees & vines	10 Year	None
Convenience store selling gas at retail	15 Year	< 1,400 square feet, ≥50% of gross from fuel sales and ≥50% of property square footage for fuel sales
Land improvements	15 Year	None
Qualified improvement property (QIP)	15 Year	None-retroactively changed after 12/31/17 with 2020's CARES Act
Farm buildings	20 Year	None
Qualified production property (QPP)	39 Year	Buildings used for production, manufacturing and refining only

Class Life is the Question – ATG Has the Answer (Cost Segregation ATG)

The newly updated IRS Audit Technique Guide for Cost Segregation studies includes a detailed description of the essential elements of an acceptable cost segregation study, acceptable methodologies for completing a study, and the supporting documentation necessary to support the study's findings. Additionally, the ATG provides in-depth analysis of:

- Specific industries including:
  - Casinos,
  - Restaurants,
  - Retail businesses,
  - Pharmaceutical/Biotechnology,
  - Auto Dealerships, and
  - Auto Manufacturing.

- Proper procedures for analyzing Electrical Distribution Systems and Open-Air

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Luxury Automobile Deprecation (§280F)

Annual depreciation is limited for "luxury" automobiles. For this purpose, a "luxury automobile" is defined as "*any 4-wheeled vehicle manufactured for use on public roads which is rated at 6,000 pounds unloaded gross vehicle weight (curb weight) or less*". For trucks, vans, or SUVs the definition uses *gross vehicle weight rating (GVRW)* (maximum loaded weight including passengers, fuel, etc.) (§280F(d)(5)(A)). Most full-size pickups, vans and SUVs are over the 6,000-pound limit and not subject to the luxury auto depreciation limits. In addition, the term "luxury automobile" does not include vehicles that, by design, do lend themselves to personal use. Such vehicles include clearly marked police vehicles, cargo trucks with GVRW over 14,000 pounds, ambulances, hearses, bucket trucks, cement mixers, delivery trucks with only one seat, dump trucks, flatbed trucks, refrigerated trucks, vehicles used by the taxpayer in the trade or business of transporting persons or property for hire, etc. (§1.274-5(k)). Luxury auto limits are:

Luxury Auto Deprecation Limitations (Rev. Proc. 2026-15)			
	2025	**2026**	**2027**
Year 1	$12,200*	$12,300*	
Year 2	$19,600	$19,800	
Year 3	$11,800	$11,900	
Year 4 and after	$ 7,060	$ 7,160	
*Luxury autos placed in service are allowed an additional $8,000 of bonus depreciation.			

Example. Dennis, a real estate agent, purchases a new BMW sedan for $98,000 in June of 2026. Assuming he uses the sedan 100% for business, Dennis expects to claim a depreciation deduction of $19,600 under the regular MACRS rules ($98,000 x 20%). However, the luxury auto rules limit Dennis's deprecation deduction (ignoring bonus depreciation) to $12,300. His car will not be fully depreciated until 2036 - 10 years after he buys it!

2026	$12,300
2027	$19,800
2028	$11,900
2029 – 2035	$ 7,160
2036	$ 3,880

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Listed Property Rules (§274)

IRC §274 defines certain disallowed deductions related to entertainment, recreation, travel, and fringe benefits and provides additional substantiation requirements for property that lends itself to personal use including vehicles. Specifically, §274(d) provides that no deduction is allowed for any listed property unless the taxpayer substantiates with adequate records or sufficient corroborating evidence including:

a) the amount of such expense,
b) the time and place of the travel or use,
c) the business purpose of the expense, and
d) the business relationship to the taxpayer of the person receiving the benefit.

With respect to vehicles, many incorrectly believe that only vehicles that also meet the definition of a luxury auto under §280F are subject to these substantiation requirements. The enhanced substantiation requirements of §274(d) apply to *any pickup truck or van, unless the truck or van was specially modified with the result that it is not likely to be used more than a de minimis amount for personal purposes*. For example, removing a pickup bed and installing a flatbed. Merely painting a sign on the door of the truck or van is not enough! Almost all pickups and vans are subject to these rules.

Depreciation and Reporting Requirement Summary			
	<6,000 lbs. Luxury Auto	**6,000 – 14,000 lbs. truck or van**	**>14,000 lbs. truck or van**
Listed property?	Yes	Yes	No
Logbook required?	Yes	Yes	No
Depreciation limited	Yes	No	No
Bonus depreciation allowed?	Yes – limited	Yes	Yes
§179 allowed?	Yes – limited	Yes – SUVs limited	Yes
Mileage method allowed?	Yes	Yes	No

Business purpose supported. An adequate record of business purpose must be in the form of a written statement. However, the amount of detail necessary to establish a business purpose depends on the facts and circumstances of each case. A written explanation of the business purpose will not be required if the purpose can be determined from the surrounding facts and circumstances. For example, a salesperson visiting customers on an established sales route will not normally need a written explanation of the business purpose of his or her travel.

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Business use supported. An adequate record contains enough information on each element of every business or investment use. The amount of detail required to support the use depends on the facts and circumstances. For example, a taxpayer who uses a truck for both business and personal purposes and whose only business use of the truck is to make customer deliveries on an established route can satisfy the requirement by recording the length of the route, including the total number of miles driven during the tax year and the date of each trip at or near the time of the trips.

Although you must prepare an adequate written record, you can prepare a record of the business use of listed property in a computer memory device that uses a logging program.

Business use does not include the use of property for pay of any 5% owner or related party. It does include the use of property included in the W-2 of unrelated, non-owner employees. Business use also does not include property used for investment purposes, except for depreciation.

Substantial compliance. If you have not fully supported an element of an expenditure or use but have complied with the adequate records requirement for the expenditure or use to the satisfaction of the IRS director for your area, you can establish this element by any evidence the IRS director for your area deems adequate.

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Fixing The Error – How Do We Solve Depreciation Mistakes?

Depreciation errors are corrected by either filing an amended return or filing a change in accounting method form. Depreciation errors that are NOT subject to the accounting method change filing requirements require amended returns and include:

Amended Returns

- You claimed the incorrect amount because of a mathematical error made in any year.
- You claimed the incorrect amount because of a posting error made in any year.
- You claimed the incorrect amount on property placed in service by you in tax years ending before the statute of limitations expired.
- You are changing the amount of Section §179 claimed or not claimed.
- Election to apply the $2,500/$5,000 de minimis safe harbor rules (within its own time requirements of return due date plus extension).
- Election not to claim bonus depreciation under 168k (within its own time requirements of return due date plus extension).

Amending returns only corrects depreciation errors that occurred in the last three years. Errors that occurred before cannot be “caught up” on current or amended returns and are only “caught up” when the asset is sold using Form 3115 and Code 107 as discussed below.

Change in Accounting Method Form 3115

Form 3115, Change in Accounting Method, is used to correct most other depreciation errors, including the omission of depreciation. If you forget to take depreciation on an asset, the IRS treats this as the adoption of an incorrect method of accounting, which may only be corrected by filing Form 3115. ***When changing methods of accounting from not taking depreciation (incorrect method) to taking depreciation (correct method) use Code 7 on Form 3115 if the asset is still in use, code 107 if disposed.***

The IRS's automatic consent procedures for taxpayers who have adopted an impermissible method of accounting for depreciation (or amortization) and have either claimed no allowable depreciation, less depreciation than allowable, or more depreciation than allowable is provided in the guidance at Rev. Proc. 2015-13 and 2018-31.

Generally, Form 3115 must be attached to the taxpayer's tax return for the year of change by the original due date (including extensions). A copy must also be filed with the IRS no later than when the original is filed with the taxpayer's return.

Taxpayers who qualify under the automatic procedure are permitted to change to a method of accounting under which the allowable amount of depreciation is claimed. The unclaimed depreciation from years prior to the year of change is considered as a net negative (taxpayer favorable) adjustment in the year of change, generally effective for tax years ending on or after December 31, 2001, and are deducted ***in full on the return for the year of change***.

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Changes that result in a change in accounting method are:

- Changing from not taking depreciation to taking depreciation. ***(Because this is a change from an impermissible method to a permissible method use Code 7 on Form 3115)***

- Changes in methods or conventions, ***(Because this is a change from one permitted method to another, use Code 8 or 200 if MACRS on Form 3115)***

- Changes to or from a required life, ***(Because this is a change from one permitted method to another, use Code 8 on Form 3115)***

- Correcting depreciation on leasehold improvements from using the incorrect life of the lease term to the correct life of the asset (generally 39 years). ***(Use Code 199 on Form 3115)***

Rev. Proc. 2015-13 is also used to correct depreciation after an asset has been sold and the 12/30/03 regulation changes correct other depreciation errors. The Procedure's additional primary value is to recover depreciation deductions mistakenly overlooked, for which, under the "allowed or allowable" rule the taxpayer had to reduce basis in the asset. ***This Revenue Procedure effectively makes the "allowed or allowable" penalty disappear! Code 107 on Form 3115 is used to "catch up" omitted depreciation on an asset when it is sold.***

Changes that do not require Form 3115 because they are not changes in an accounting method, and which may only be made on an amended return, include:

1. A change in computing depreciation because of a change in the use by the same taxpayer,

2. Changes in placed-in-service dates.

3. A change in useful lives,

4. Making a late depreciation election or revoking a timely valid depreciation election (including the election not to deduct bonus depreciation). If you elect not to claim any bonus, a change from not claiming to claiming bonus is a revocation of the election and is not an accounting method change. You must get IRS approval to make a late depreciation election or revoke a depreciation election. You must submit a request for a letter ruling to make a late election or revoke an election.

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Other depreciation corrections still qualify for the automatic change provisions of Rev. Proc. 2015-13.

- Rev. Proc. 2015-13 allows the use of one Form 3115 to correct mistakes on more than one asset.

Explanation of the 2-year rule.

The use of an incorrect method of depreciation, which would include taking no depreciation, is an incorrect accounting method. Once an incorrect accounting method is used for two years, a Form 3115 is required to change accounting methods back to a correct method, or in this case, since not taking depreciation is incorrect, to begin taking depreciation a Change in Method form must be filed. To change to the correct method, meaning to take the overlooked or correct depreciation requires the filing of the change in accounting method form, Rev. Proc. 2015-13 in most cases. (Instructions to Form 3115)

If no depreciation is taken and only one year has passed the return may be corrected via amendment because the incorrect method had only been used for one year.

Examples of depreciation change in accounting methods:

a. Using an incorrect method (or no method, which is also impermissible!),

b. Changing a method or convention, (like 200DB to S/L)

c. Change to or from a recovery period assigned by the Code,

d. Changing from non-depreciable to depreciable, or vice-versa.

Form 3115 will have to be filed, with the entire amount of incorrect or overlooked depreciation deducted in full in the year of correction via Form 3115. The total depreciation adjustment is called a Section 481(a) adjustment, which***, if negative may be deducted in full in the year of change.***

If positive, it is added ratably over 4 years, or if positive but less than $50,000 in total the taxpayer may elect to add it in to income in full in the year of change.

The form may be filed at any time for any year, and if for a prior year sale, is accompanied by an amended tax return.

- Code 7 is used as the Code number of change on Page 1 of Form 3115 if correcting an error while the asset is still owned by the taxpayer.

- Form 3115 will use Code 107 as the Code number of change on Page 1 of Form 3115 if the asset has been sold and Rev. Proc. 2007-16 applies.

Rev. Proc. 2015-13 requires that a signed copy of Form 3115 be filed to the IRS office. No advance IRS approval is required to correct the error, as this is an automatic approval change in most cases. There is no user fee.

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An original of the Form 3115 should be included with the tax return filed for the year of change. The original must be filed by the due date of the return, plus extension. There is a 6-month automatic extension of this due date providing the return was timely filed, and an amended return (with this change) is filed within 6 months.

When filing Form 3115, the additional statements listed below must be attached:

- A detailed description of the former and new methods of accounting,
- A statement describing the taxpayer's business or income-producing activities,
- A statement of the facts and law supporting the new method of accounting, new classification of the item of property, and new asset class,
- A statement identifying the year in which the item of property was placed in service.

Example. Taylor James is a new client who inherited a house when her mother died on January 1, 2021, when the house was valued $275,000, not counting land of $50,000. Taylor rented the house in January 2021, but when she asks you for help with her 2026 tax return you discover she's never claimed depreciation on the rental home. The unclaimed depreciation is $50,000 ($275,000 ÷ 27½ = $10,000 x 5 years = $50,000).

Form 3115 must be filed for the 2026 tax year to calculate the §481(a) negative adjustment at $50,000 and a copy must be attached to Taylor's 2026 tax return. The §481(a) adjustment will be listed as a separate expense item on Taylor's 2026 Schedule E, subject to normal deduction and passive activity rules.

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Payroll, Payroll Related Tax and Fringe Benefits

Form 1099 Reporting Changes

Overview. A payment settlement entity (PSE) is required to file Form 1099-K for payments made in settlement of reportable payment transactions for each calendar year. A PSE makes a payment in settlement of a reportable payment transaction, that is, any payment card or third-party network transaction. This includes payments received via apps, online merchants, and other third-party online processers (credit card processers). The 1099-K covers transactions anywhere else one may receive online payments via credit card (E-Bay, Etsy, Craigs List, etc.).

1099-K reporting threshold changes – Yes, again! (OBBBA 70432(a)(2)). When originally adopted, §6050W set the Form 1099-K annual filing threshold at $20,000 and 200 transactions. Since then, the filing threshold has been a political hot potato. The 2021 American Rescue Plan reduced the filing threshold to $600, regardless of the number of transactions. That threshold was set to be effective in 2022, but it was repeatedly postponed. Afte the delays, the $600 threshold was to be phased in, starting at $5,000 in 2024 regardless of the number of transactions. OBBBA retroactively and permanently changed the law back to the original thresholds – $20,000 ***and*** 200 transactions. If both thresholds aren't met, there is no reporting required by the PSE.

What to do if personal or other non-taxable income is reported on a 1099-K (IRS 1099-K FAQs). The IRS recommends that taxpayers who receive an incorrect Form 1099-K first reach out to the issuer and ask for a corrected copy. Good luck with that! Assuming that doesn't work, the IRS recommends the income be reported as "Other Income" on Form 1040, Schedule 1, Line 8z, and then also reported as an "Other Adjustment" on Line 24z. The description for each entry should be "Form 1099-K received in error."

1099 Filing Thresholds Increased for the First Time in Decades (§6041(a);

The threshold for filing Forms 1099-NEC and 1099-MISC has been $600 for decades. OBBBA changed the filing threshold to $2,000 for payments made after 2025. The $600 threshold remains in effect for 2025 1099s. Additionally, the threshold amount will be adjusted for inflation for years after 2026. It's about time!

IRS Made Multiple Changes to Info Returns to Accommodate OBBBA Related Changes (Form 1099-MISC; Form 1099-NEC; W-2, etc.)

Reporting changes on info forms in 2026. For tax years 2026 and later years, employers and other payers are required to separately report qualified overtime compensation. Forms W-2, 1099-NEC, and 1099-MISC have been updated to allow employers and other payers to provide separate reporting of an individual's qualified overtime compensation. The updated forms also include additional tip deduction related fields, including Treasury Tipped Occupation Code.

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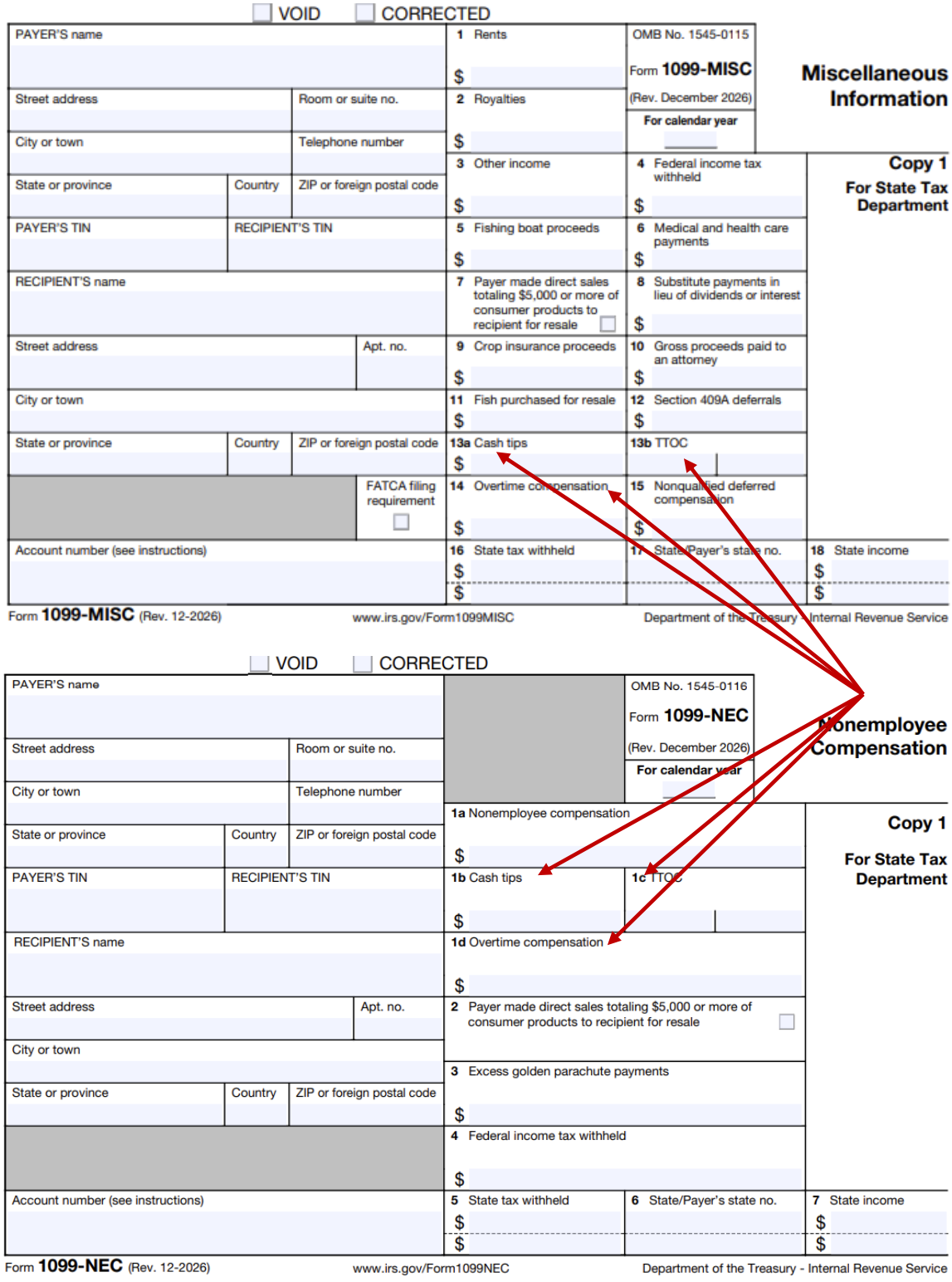
Form 1099-MISC revised for 2026.



☐ VOID ☐ CORRECTED

PAYER'S name	1 Rents $	OMB No. 1545-0115 Form 1099-MISC (Rev. December 2026) For calendar year	Miscellaneous Information
Street address / Room or suite no.	2 Royalties $		
City or town / Telephone number	3 Other income $	4 Federal income tax withheld $	Copy 1 For State Tax Department
State or province / Country / ZIP or foreign postal code	5 Fishing boat proceeds $	6 Medical and health care payments $	
PAYER'S TIN / RECIPIENT'S TIN	7 Payer made direct sales totaling $5,000 or more of consumer products to recipient for resale ☐	8 Substitute payments in lieu of dividends or interest $	
RECIPIENT'S name	9 Crop insurance proceeds $	10 Gross proceeds paid to an attorney $	
Street address / Apt. no.	11 Fish purchased for resale $	12 Section 409A deferrals $	
City or town	13a Cash tips $	13b TTOC	
State or province / Country / ZIP or foreign postal code	14 Overtime compensation $	15 Nonqualified deferred compensation $	
FATCA filing requirement ☐	16 State tax withheld $ $	17 State/Payer's state no.	18 State income $ $
Account number (see instructions)			

Form **1099-MISC** (Rev. 12-2026) www.irs.gov/Form1099MISC Department of the Treasury - Internal Revenue Service

☐ VOID ☐ CORRECTED

PAYER'S name	OMB No. 1545-0116 Form 1099-NEC (Rev. December 2026) For calendar year	Nonemployee Compensation
Street address / Room or suite no.		
City or town / Telephone number	1a Nonemployee compensation $	Copy 1 For State Tax Department
State or province / Country / ZIP or foreign postal code		
PAYER'S TIN / RECIPIENT'S TIN	1b Cash tips $	1c TTOC
RECIPIENT'S name	1d Overtime compensation $	
Street address / Apt. no.	2 Payer made direct sales totaling $5,000 or more of consumer products to recipient for resale ☐	
City or town	3 Excess golden parachute payments $	
State or province / Country / ZIP or foreign postal code		
	4 Federal income tax withheld $	
Account number (see instructions)	5 State tax withheld $ $	6 State/Payer's state no. / 7 State income $ $

Form **1099-NEC** (Rev. 12-2026) www.irs.gov/Form1099NEC Department of the Treasury - Internal Revenue Service

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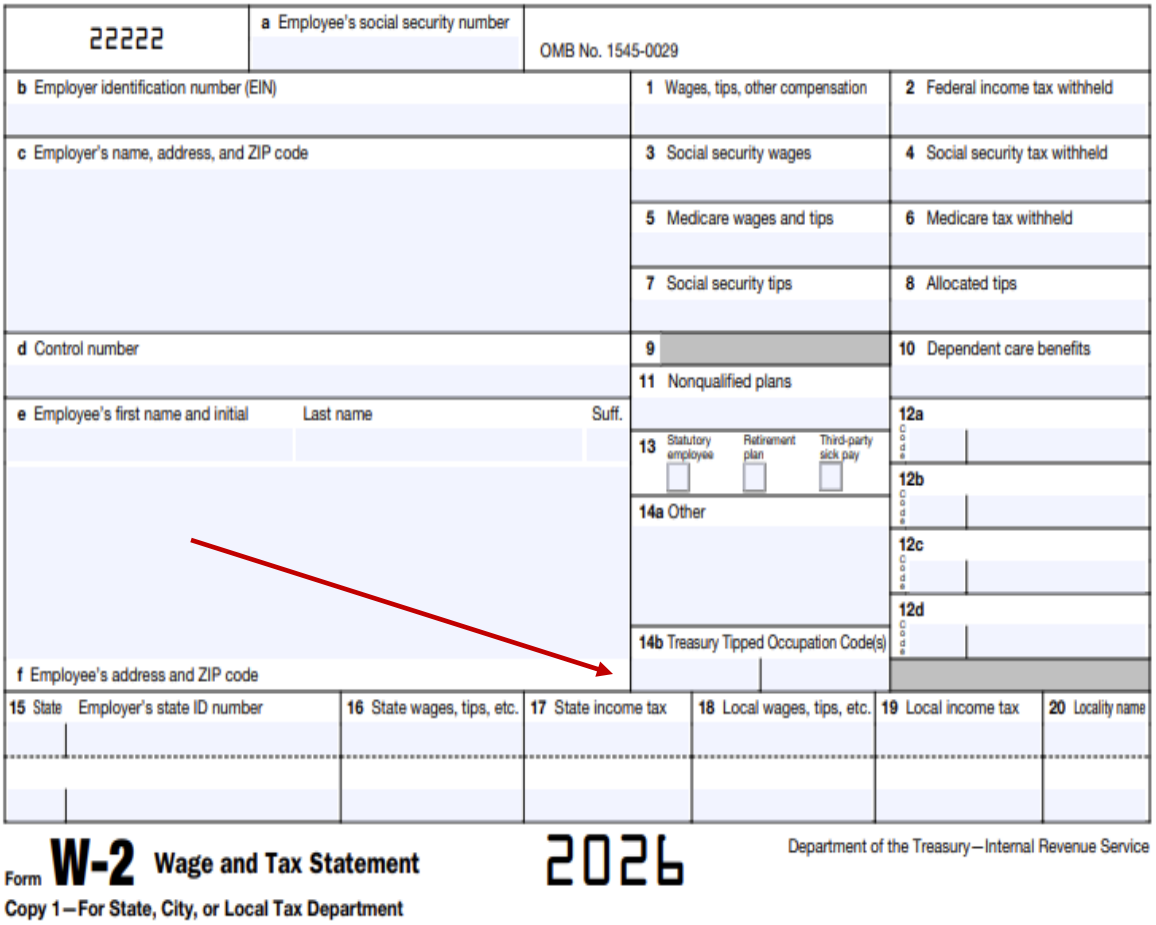

22222	a Employee's social security number	OMB No. 1545-0029	
b Employer identification number (EIN)		1 Wages, tips, other compensation	2 Federal income tax withheld
c Employer's name, address, and ZIP code		3 Social security wages	4 Social security tax withheld
		5 Medicare wages and tips	6 Medicare tax withheld
		7 Social security tips	8 Allocated tips
d Control number		9	10 Dependent care benefits
		11 Nonqualified plans	
e Employee's first name and initial / Last name / Suff.		13 Statutory employee / Retirement plan / Third-party sick pay	12a Code
		14a Other	12b Code
			12c Code
		14b Treasury Tipped Occupation Code(s)	12d Code
f Employee's address and ZIP code			

15 State / Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name

Form **W-2** Wage and Tax Statement 2026 Department of the Treasury—Internal Revenue Service

Copy 1—For State, City, or Local Tax Department

New codes for Form W-2. Box 12 will have some new codes available in 2026, including:

- TA – employer contributions to Trump accounts.
- TP – total amount of qualified tips for the tip deduction.
- TT – total amount of qualified overtime compensation for the overtime deduction.

Treasury released list of tipped professions that qualify for the tip deduction (Treasury Tipped Occupations Detailed List). The Treasury Department detailed its initial list of professions that customarily and regularly receive tips. Updates are expected to the list as time goes on, but this at least gives us a starting point. The list is divided into 8 broad categories that include 68 occupations:

1. **Beverage and food service** – e.g., wait staff, bartenders, non-restaurant food servers (e.g., Door Dash); chefs and cooks, food prep workers, fast food workers, dishwashers, host staff, bakers.

2. **Entertainment and events** – gambling (dealers, change and booth cashiers, cage workers, sports book writers and runners, dancers, musicians and singers, disc jockeys (except radio), entertainers and performers, digital content creators, ushers, ticket takers, and locker, coat and dressing room attendants.

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3. **Hospitality and guest services** – baggage porters and bell hops, concierges, hotel and resort desk clerks, maids and housekeeping cleaners.

4. **Home services** – home maintenance and repair workers, landscaping and groundskeeping workers, electricians, plumbers, HVAC and home appliance workers, home cleaning service workers, locksmiths, roadside assistance workers.

5. **Personal services** – care workers, private event planners, photographers, and videographers, event officiants, pet caretakers, tutors, nannies and babysitters.

6. **Personal appearance and wellness** – skincare, massage, barbers, hairstylists and hairdressers, cosmetologists, shampooers, nail care technicians, eyebrow care, waxing technicians, makeup artists, trainers, group fitness instructors, tattoo artists and piercers, tailors, and shoe and leather workers.

7. **Recreation** – golf caddies, self-enrichment teachers, recreational tour pilots, tour guides, travel guides, and sports and recreation instructors.

8. **Transportation and delivery** – valets, taxi and rideshare drivers, shittle drivers, goods delivery, auto detailers, private and charter bus drivers, water taxi and charter boat operators, pedicab and rickshaw drivers, and home movers – final regs added gas pump attendants.

Preparer note. Workers may only take the deductions for qualified tips and qualified overtime included on Form W-2, Form 1099-NEC, Form 1099-MISC, Form 1099-K, or reported by the worker on Form 4137. If the tips or overtime are not reported, they are not deductible.

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Qualified Employer Fringe Benefits

The goal of the tax professional or business owner in providing fringe benefits is simple-they want to provide benefits to employees and themselves, deduct those benefits on the business return, and receive the same benefits tax-free.

All payments provided by employers to employees, both direct compensation and indirect payments for the benefit of employees, are taxable by default. **Qualified fringe benefits** are those that Congress has decided **are excludible from income** under Federal law and usually not even reportable for Federal withholding, FICA, or FUTA purposes. **Non-qualified fringe benefits are taxable wages.**

Here is the list of most of the Congressionally established fringe benefits:

§74 – Achievement awards
§79 – Group term life insurance
§104 – Compensation by employer for injury or sickness
§105 – Benefits received through employer health or accident insurance
§106 – Health insurance premiums paid by employer (includes QSEHRAs)
§117(d) – Qualified tuition reductions
§119 – Meals or lodging for employer's convenience
§125 – Cafeteria plans
§127 – Educational assistance program
§128 – Trump Account contributions
§129 – Dependent care assistance program
§132(b) – No additional-cost service
§132(c) – Qualified employee discounts
§132(d) – Working condition fringe benefits
§132(e) – De minimis benefit
§132(f) – Qualified transportation expenses
§132(j)(4) – On-premises athletic facilities
§132(m) – Qualified planning services
§132(n) – Qualified military base realignment and closure fringe
§137 – Adoption assistance programs
§139 – Disaster relief payments

Selective benefits are discussed in the pages that follow.

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Treatment Under Employment Taxes			
Type of fringe benefit	**Income tax withholding**	**Social Security and Medicare (including Additional Medicare Tax when wages are paid in excess of $200,000)[1]**	**Federal unemployment (FUTA)**
Accident and health benefits	Exempt (except 2% shareholder-employees of S corporations).	Exempt	Exempt
Achievement awards	Exempt[2] up to $1,600 for qualified plan awards ($400 for nonqualified awards).		
Adoption assistance	Exempt[2 3]	Taxable	Taxable
Athletic facilities	Exempt if substantially all use during the calendar year is by employees, their spouses, and their dependent children, and the facility is operated by the employer on premises owned or leased by the employer.		
De minimis (minimal) benefits	Exempt	Exempt	Exempt
Dependent care assistance	Exempt[3] up to certain limits, $7,500 ($3,750 for married employee filing separate return).		
Educational assistance	Exempt up to $5,250 of benefits each year. (See *Educational Assistance*, later in this section.)		
Employee discounts	Exempt[3] up to certain limits. (See *Employee Discounts*, later in this section.)		
Employee stock options	See *Employee Stock Options*, later in this section.		
Employer-provided cell phones	Exempt if provided primarily for noncompensatory business purposes.		
Group-term life insurance coverage	Exempt	Exempt[2 4 6] up to cost of $50,000 of coverage. (Special rules apply to former employees.)	Exempt
Health savings accounts (HSAs)	Exempt for qualified individuals up to the HSA contribution limits. (See *Health Savings Accounts*, later in this section.)		
Lodging on your business premises	Exempt[2] if furnished on your business premises, for your convenience, and as a condition of employment.		
Meals	Exempt[2] if furnished on your business premises for your convenience.		
	Exempt if de minimis.		
No-additional-cost services	Exempt[3]	Exempt[3]	Exempt[3]
Retirement planning services	Exempt[5]	Exempt[5]	Exempt[5]
Transportation (commuting) benefits	Exempt[2] up to certain limits if for rides in a commuter highway vehicle and/or transit passes ($340) or qualified parking ($340). (See *Transportation (Commuting) Benefits*, later in this section.)		
	Exempt if de minimis.		
Tuition reduction	Exempt[3] if for undergraduate education (or graduate education if the employee performs teaching or research activities).		
Working condition benefits	Exempt	Exempt	Exempt

[1] Or other railroad retirement taxes, if applicable.
[2] Exemption doesn't apply to S corporation employees who are 2% shareholders.
[3] Exemption doesn't apply to certain highly compensated employees under a program that favors those employees.
[4] Exemption doesn't apply to certain key employees under a plan that favors those employees.
[5] Exemption doesn't apply to services for tax preparation, accounting, legal, or brokerage services.
[6] You must include in your employee's wages the cost of group-term life insurance beyond $50,000 worth of coverage, reduced by the amount the employee paid toward the insurance. Report it as wages in boxes 1, 3, and 5 of the employee's Form W-2. Also, show it in box 12 with code C. The amount is subject to social security and Medicare taxes, and you may, at your option, withhold federal income tax.

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Achievement Awards (§74)

Achievement Awards. Generally, gross income of all amounts received as prizes and awards, including those received by employees from their employer, are taxable income when received (§74(a)). This includes amounts received from:

- Radio and television giveaway shows;
- Door prizes;
- Awards in contests of all types;
- Prizes and awards from an employer to an employee in recognition of some achievement in connection with his or her employment; and
- Any award of cash, cash equivalents, gift certificates/cards, or other intangible property such as vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, other securities, and similar items.

Some employer achievement awards are an exception to the general rule (§74(c)). Prizes or awards given by an employer to an employee in recognition of some achievement in connection with employment may be excluded from gross income if:

A. The cost of the award to a specific employee was no more than $400 and, for qualified plan awards, the average cost of all the employee achievement awards given during the tax year was no more than $400.

B. Such prizes or awards were made primarily in recognition of the recipient's past achievements in religious, charitable, scientific, educational, artistic, literary, or civic fields.

C. The recipient was selected without any action on his or her part to enter the contest or proceedings.

D. The recipient is not required to render substantial future services as a condition to receiving the prize or award.

Qualifying award criteria. Qualifying achievement awards meet the following requirements:

1. Given to an employee for length of service or safety achievement;

2. Awarded as part of a meaningful presentation and awarded under conditions and circumstances that do not create a significant likelihood of disguised pay.

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Qualifying award examples. The following provides some examples of allowable non-taxable employee awards:

1. Length-of-service award may be awarded tax-free as long as:
    a. The employee receives the award after his or her first 5 years of employment; and
    b. The employee did not receive another length-of-service award (other than one of very small value) during the same year or in any of the prior 4 years.

2. Safety achievement award may be awarded tax-free as long as:

    a. It is given to a manager, administrator, clerical employee, or other professional employee; and
    b. During the tax year, more than 10% of the employees, excluding those listed in 2a above, have already received a safety achievement award (other than one of very small value).

Deduction limit. The deduction for the cost of employee achievement awards given to any one employee during the tax year is limited to:

1. $400 for awards that are not qualified plan awards,
2. $1,600 for all awards, whether or not qualified plan awards,
3. A prize or award of nominal value and provided infrequently (e.g., plaques, flowers, holiday turkey, gift certificate to Jelly of the Month Club, etc.) is excludable from employee wages.

Passthrough owners. Benefits provided for 2% S corporation shareholders under this section are added to Box 1 of Form W-2 wages and deducted as employee wages on the corporate tax return. The benefits are not subject to FICA or Medicare tax. Benefits provided to partners or LLC members are added to guaranteed payments of the specific partner and deducted as such on Form 1065.

Group Term Life Insurance (§79)

Overview. The cost of employer-provided group term life insurance coverage up to $50,000 is excludable from an employee's gross income. Coverage more than $50,000 generates imputed income to the employee, calculated using the IRS's Table I rates rather than the actual premium cost.

Preparer note. It is critical to note that the employer's actual cost is not used to calculate any taxable group term life benefit. The taxable amount is always determined by the IRS statutory table, which can be found in IRS Pub 15-B. The Table amounts increase as the employee ages. For example, the amount of imputed income for an employee age 40 and an employee age 60 who both have $25,000 of excess life insurance coverage would be materially different due to their age difference.

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Calculating imputed income for insurance over $50,000. The cost of life insurance coverage that exceeds $50,000 is included in the W-2 wage income of the affected employee. The amount of imputed income is calculated:

1. Determine total coverage amount.
2. Subtract $50,000.
3. Divide the excess by 1,000.
4. Multiply by the applicable Table I monthly rate (based on the employee's age as of year-end).
5. Multiply by 12 (or the number of months of coverage).
6. Subtract any after-tax contributions the employee made toward the coverage.

Example. Terry, age 40, and Bill, age 60, are both employees of JLLC and both have $100,000 of group term life insurance. The amount of their imputed income is calculated:

	Terry	Bill
Total coverage amount	$100,000	$100,000
Less tax-exempt coverage amount	($50,000)	($50,000)
Excess coverage amount	$ 50,000	$ 50,000
Divide by $1,000	÷ $ 1,000	÷ $ 1,000
	50	50
Applicable table monthly rate	x $ .10	x $ .66
	$ 5	$ 33
Months applicable	x 12	x 12
Amount added to Wages	$ 60	$ 396

Reporting mechanics. The imputed cost is included in Box 1, 3, and 5 as applicable, but Federal income tax withholding is optional at the employer's discretion. The taxable amount is also separately identified in Box 12 using Code C.

Other notables. Note key exceptions and traps:

- **Discrimination testing** – if the plan discriminates in favor of key employees those key employees lose the $50,000 exclusion entirely. The full cost of coverage becomes taxable, not just the excess. Non-key employees remain unaffected even under a discriminatory plan.

- **Employer as beneficiary** – if the employer, rather than a named beneficiary, is directly or indirectly the beneficiary, the entire premium is nondeductible, and the exclusion does not apply.

- **Retiree coverage** – continued coverage post-retirement still triggers Table I imputed income calculations, often missed when payroll systems are decommissioned for terminated employees. The former employee pays her or his share of the FICA tax, and the employer pays its share.

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- **Permanent benefit combinations** – where GTLI is bundled with a permanent (cash value) component, only the term portion qualifies for §79 treatment. The permanent benefit piece is taxed separately under different rules.

Employer Compensation for Injury or Sickness (§104)

These rules exempt worker's compensation payments made by the employer or through insurance exempt from income tax. It also exempts payments for personal physical injuries or sickness, disability income from terrorist or military actions, payments to dependent survivors of public safety officers dying in the line of duty.

Other Health Related Benefits (§104; §105; §106; §125; §223)

Owner benefits and related entities. The best entity for providing fringe benefits to owners is the C corporation. The worst entity to provide owner fringe benefits is the sole proprietor, followed closely by the partnership or LLC. Most fringes provided to owners are taxable for both regular and self-employment tax purposes.

The owner of the S corporation is somewhere in between the C corporation and the sole proprietor in terms of tax-free fringe benefits.

- The 2% S corporation shareholder is an individual who owns, directly or through attribution, **more than 2%** of the outstanding stock of the corporation. This 2% rule requires certain fringe benefits to be added to the shareholder's Form W-2 as compensation and deducted by the S corporation as wages.

- For purposes of the 2% test, any individual who on any day of the year owns (directly or indirectly) > 2% of the outstanding stock or who owns stock with > 2% of the combined total voting power is considered a > 2% shareholder under §1372(a). The attribution rules at §318 apply this same treatment (add to Form W-2) for the individual's spouse, children, grandchildren, and parents. Such an individual also qualifies for the same deductions because they are considered to own the stock [§318(A)(1)(A)].

- The 2% rule requires certain fringe benefits to be added to the shareholder's Form W-2 which applies when the specific fringe benefit is to be treated "as if paid for a partner in a partnership," which is IRS's roundabout way of saying treat the fringe benefits as taxable guaranteed payments deductible by the S corporation (Rev. Rul. 91-26).

    a. The problem is that guaranteed payments do not exist in an S corporation, so the fringe benefit is added to Form W-2 Box 1.

    b. Health insurance is exempt from FICA/Medicare with a written plan.

    c. The shareholder is then taxed on the amount received as if he or she received it in cash and then used it to pay for the amount involved. Meaning if the shareholder had paid it directly and qualified for a personal deduction on Form 1040, then the shareholder retains the deduction on the Form 1040 as if he or she had paid it. Remember, the shareholder received a cash wage and used it to buy the fringe. Thus,

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the following fringes are added to the 2% shareholder's Form W-2 as income and qualify for a personal deduction on the Form 1040 of the shareholder:

1. Self-employed health insurance deduction
2. Health Savings Account (HSA) deduction
3. Medical expense deduction
4. Adoption credit

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Healthcare Fringe Benefits					
	§106 Health	§105(b) HRA	§106(g) QSEHRA	§125 FSA	§223 HSA
Major Provisions	Allows the employer to pay health insurance for employees. Must meet ACA rules for qualified plans	Allows the employer to reimburse other medical expenses of employees **excluding** health insurance	Allows the small employer to reimburse medical expenses of employee **including** health insurance	Allows the employer to reimburse other medical expenses of employee pre-tax or post-tax if elected	Allows the employer to deposit a specific amount to an employee's health savings account
Employer Payments	Deductible	Deductible	Deductible	Deductible	Deductible
Employee Effects	Non-taxable	Non-taxable	Non-taxable	Non-taxable	Non-taxable
Funded By	Employer	Employer	Employer	Employee Pre-Tax & Post-Tax	Employer and/or Employee, Employee may be pre- or post-tax
2025 Contribution Limits	None-Plan established	None-Plan established	$6,350 Single, $12,800 family	$3,300 per person annually	$4,300 Self Only, $8,550 Family Plus >55 Catch Up
Carryover Unused Amounts?	No	Unlimited - plan established	Plan established	2 ½ months if plan allows	Savings balance carries over
Portability	None	Plan decides	None	None except COBRA	100%
Discrimination Allowed	Yes	No	No	No	Limited
Funding	Pay As You Go	Pay As You Go	Pay As You Go	Pay As You Go	Pay As You Go
Admin	None	Employer	Employer	Employer	None

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Preparer note. Whenever a Schedule K-1 from a partnership or LLC is received that reflects "Guaranteed Payments," an inquiry should be made as to whether the guaranteed payments include amounts paid by the partnership for health insurance or similar benefits.

Why? Because if the guaranteed payment amount includes such payments, the partner or shareholder may qualify for the self-employed health insurance deduction on the front of Form 1040 or deductions elsewhere for other inclusion amounts.

Business Owners' Health Insurance Treatment

Type of Employee or Taxpayer	Where Deducted	How to deduct	Social Security Savings?	Qualify for SE Health Deduction?	Deduct in Loss Years?	Special Tax Treatment
Sole proprietor	1040	SE Health	None	Yes	No	None
Spouse employee of sole proprietor	Schedule C	Sch C Line 14	Full Deduction	N/A	Yes	Treated as deductible, tax-free fringe
Partner or LLC member	1065	Form 1065 Line 10	None	Yes	No	Add to guaranteed payments with SE tax
Spouse employee of partner or LLC	1065	Form 1065 Line 19	Full Deduction	N/A	Yes	Treated as deductible, tax-free fringe
S corp >2% S/H	1120-S	Form 1120-S Line 7	Fully Exempt	Yes	No – if no wages	Add to Box 1 of W-2, No FICA or Medicare
Spouse employee of 2% S Corp S/H	1120-S	Form 1120-S Line 8	Fully Exempt	Yes	No – if no wages	Add to Box 1 of W-2, No FICA or Medicare
Family employee of >2% S/H	1120-S	Form 1120-S Line 8	Fully Exempt	Yes	No – if no wages	Add to Box 1 of W-2, No FICA or Medicare
C corp S/H	1120	Form 1120 Line 24	Full Deduction	N/A	Yes	Treated as deductible, tax-free fringe
Spouse employee of C corp S/H	1120	Form 1120 Line 24	Full Deduction	N/A	Yes	Treated as deductible, tax-free fringe

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Qualified Small Employer HRA (QSEHRA) (§106(g))

Overview. Employers are allowed to reimburse up to $13,100 family, $6,450 individual (2026) in annual costs for employee health insurance and/or medical care under a QSEHRA. One glaring disadvantage is the inability for partners and >2% S corporation shareholders to participate in QSEHRAs, but that is offset by their ability to deduct their own premiums as self-employed health insurance on their personal Form 1040. Because of attribution rules, spouses and family members of 2% S corporation shareholders also may not participate.

QSEHRA Annual Limits		
Plan Type	**2026**	**2027**
Single	$ 6,450	
Family	$13,100	

A QSEHRA is not a group health plan, and as a result, is not subject to the group health plan requirements applicable under the IRC or ERISA. Payments from a QSEHRA to reimburse an eligible employee's medical expenses are not includible in the employee's gross income if the employee has coverage that provides minimum essential coverage (qualified health care coverage).

QSEHRA requirements. To provide the QSEHRA only two requirements apply:

1. The employer must be a small employer. A small business is defined as an employer with fewer than 50 FTEs in the prior calendar year.

2. The employer may not offer any qualified group health plan, other HRA, FSA, or excepted benefit such as dental, vision, etc.

The QSEHRA must be funded by the employer, not with employee pre-tax amounts. The employee must provide the employer with proof of qualified health insurance coverage. Most 3rd party providers recommend employees provide a signed statement and a copy of an insurance card, receipt, or policy.

Establishing a QSEHRA. The steps to establish a QSEHRA include:

1. Develop a written, non-discriminatory plan for eligible employees. Although a third-party administrator (TPA) is not technically required, because of plan compliance, reporting, ERISA, etc. most employers should consider using a TPA.

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a. Plan reimbursements may not exceed annual limits – $6,450 for single coverage, $13,100 (2026) for family coverage. The limits are annually adjusted for inflation.

b. The plan may be as narrow or as wide as the employer desires, meaning it may reimburse only one or two types of expenses (as long as non-discriminatory) or any qualified medical expenses. The employer may also reimburse or make health savings account deposits as a fringe benefit for the employee.

c. The plan may reimburse employee's health insurance premiums, even for coverage obtained by the employee on the Marketplace or Medicare premiums, or premiums paid by a non-employee spouse, as long as non-discriminatory.

d. If the employer is part of a controlled group, no member of the group may offer qualified health insurance.

2. Obtain from the employees' annual written proof of qualified health insurance coverage.

3. Reimburse employees for qualified expenses. Using a TPA makes this requirement simple because the TPA (e.g., TASC) provides the employees with a credit card that only pays allowable medical expenses and then withdraws the amount from the employer's account.

4. Provide written notice of the existence of the plan to the employees.

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Model Attestation for Initial Proof of MEC

Instruction – Complete the following to provide information on your current health coverage.
I am attesting to the following:
I, _____(insert name) am covered under the following health coverage: (insert name of the health coverage)_____.

The coverage began on (insert date coverage began) _____.

The coverage is minimum essential coverage (MEC).
Instruction – Also complete the following if a family member's expenses can be reimbursed from the QSEHRA.

The following family member _____(insert name), is covered under the following health coverage: (insert name of the health coverage)_____.
The coverage began on (insert date coverage began) _____.
The coverage is MEC.
I hereby affirm that the above information is true and accurate.

Signed: _____
Date: _____

Eligible employees. Eligible employees are full-time employees with at least 90 days of employment, who are over age 24 by the beginning of the plan year, and non-unionized. Thus, part-timers (<25 weekly hours), seasonal employees (<7 months), employees under age 25, employees covered by a collective bargaining agreement if health benefits were the subject of good-faith bargaining, and nonresident alien employees with no U.S. source income may be excluded. The QSEHRA may not be provided to retirees, former employees, or non-employees.

Reimbursement timing. The QSEHRA may reimburse for medical expenses incurred no earlier than the first day of the month the plan was established, but it may reimburse for insurance premiums back to the beginning of the year if the employee was eligible. Medical expenses are incurred when treatment is provided, not when the bill is paid. Any amount paid to an employee-spouse under the QSEHRA does not qualify for the self-employed health insurance deduction.

QSEHRA reporting. Employers must report the amount of payments and reimbursements each employee was entitled to receive from the QSEHRA for the calendar year in Box 12 of Form W-2 using Code FF. The reporting is without regard to the amount of payments or reimbursements received. **No Form 1095-B, Health Coverage, is required.**

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Cafeteria Plans (§125)

A. A cafeteria plan, including an FSA, is a written plan that allows employees to choose between receiving cash or taxable benefits instead of certain qualified benefits for which the law provides an exclusion from wages. Dependent care benefits are limited to $7,500 (2026) and health care benefits (other than HSA contributions and health insurance premiums which are still unlimited) are limited to $3,400 (2026).

1. Employers *may amend their plans* to permit employees to include a 2 ½ month carryover period after the end of the year to use cafeteria plan benefits (Notice 2005-42).

2. During this period, qualified benefits may be paid or reimbursed from money left at the end of the prior year.

3. Unused benefits after the expiration of the grace period may not be received in cash, converted to another benefit, or carried to future.

4. Employers are allowed to amend §125 cafeteria plans to carry over up to $680 (2026) of unused amounts remaining in a health FSA at the end of the plan year (Notice 2013-71).

   The $680 carryover does not limit an employee's ability to elect the maximum in salary reduction contributions under §125(i), which limits employee salary reduction contributions.

B. If an employee chooses to receive a qualified benefit under the plan, the fact that the employee could have received cash or a taxable benefit instead will not make the qualified benefit taxable.

C. Generally, a cafeteria plan does not include any plan that offers a benefit that defers pay. However, a cafeteria plan can include a qualified §401(k) plan as a benefit. Also, certain life insurance plans maintained by educational institutions can be offered as a benefit even though they defer pay.

D. Eligible employers meeting contribution requirements and eligibility and participation requirements can establish a simple cafeteria plan. Simple cafeteria plans are treated as meeting the nondiscrimination requirements of a cafeteria plan and certain benefits under a cafeteria plan.

   1. An eligible employer employs an average of 100 or fewer employees during either of the 2 preceding years. If the employer was not in existence throughout the preceding year, it is eligible if the employer reasonably expect to employ an average of 100 or fewer employees in the current year. If the employer establishes a simple cafeteria plan in a year that it employs an average of 100 or fewer employees, it is considered an eligible employer for any subsequent year as long as the employer does not employ an average of 200 or more employees in a subsequent year.

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2. These requirements are met if all employees who had at least 1,000 hours of service for the preceding plan year are eligible to participate and each employee eligible to participate in the plan may elect any benefit available under the plan. The employer may elect to exclude from the plan employees who:

    a. Are under age 21 before the close of the plan year.

    b. Have less than 1 year of service with you as of any day during the plan year.

    c. Are covered under a collective bargaining agreement if there is evidence that the benefits covered under the cafeteria plan were the subject of good faith bargaining.

    d. Are nonresident aliens working outside the U.S. whose income did not come from a U.S. source.

3. The employer must make a contribution to provide qualified benefits on behalf of each qualified employee in an amount equal to:

    a. A uniform percentage (not less than 2%) of the employee's compensation for the plan year, or

    b. An amount which is at least 6% of the employee's compensation for the plan year or twice the amount of the salary reduction contributions of each qualified employee, whichever is less.

    If the contribution requirements are met using option (b) above, the rate of contribution to any salary reduction contribution of a highly compensated or key employee cannot be greater than the rate of contribution to any other employee.

E. Qualified benefits

1. Accident & health plans and HSAs (but not MSAs or long-term care insurance)

2. Adoption assistance

3. Dependent care assistance effective January 1, 2026, the annual contribution limit for dependent care FSAs increased from $5,000 to $7,500 because of OBBBA.

4. Group term-life insurance.

5. Health savings accounts (HSAs) (Distributions from an HSA may be used to pay eligible long-term care insurance premiums or qualified long-term care services.)

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Benefits that may not be offered through §125 Plan

1. MSAs
2. Athletic facilities
3. Educational benefits
4. Meals, moving and on-premise lodging
5. Transportation or commuting fringes
6. Tuition reduction plans
7. Retirement planning services
8. Working condition benefits

F. Health FSA. A health FSA is usually provided as part of an overall employer-provided cafeteria plan. These plans require a written plan document that requires a salary reduction by the amount of the FSA contribution which is limited to $3,400 annually. If a plan does not comply with the §125 requirements, the benefit is added to wage income of the recipient.

1. The definition of medical expenses for health FSAs, HRAs, HSAs, and MSAs include insurance copayments and deductibles and only qualified prescription drugs, insulin, and medical devices; thus, over the counter remedies do not qualify.

2. The annual limit is *per employee* not per taxpayer so that 1 employee with several dependents is still limited to a maximum $3,400 deferral for 2026 and thereafter. In the case of a plan providing a grace period (which may be up to 2 months and 15 days), unused salary reduction contributions to the health FSA that are carried over into the grace period for that plan year will not count against the limit for the next plan year.

The limit does not apply to a cafeteria plan that is used to fund the employee's share of health insurance premiums or health savings accounts.

Example. Employer EX offers a calendar-year cafeteria plan including a health FSA with a grace period of two months and 15 days. Effective for the 2026 plan year, the written plan provides that employee salary reduction contributions for the health FSA are limited to $3,400. Some employees have unused amounts from their 2025 health FSA salary reduction contributions that remain available during the grace period in the first 2 months and 15 days of 2026.

The availability during the grace period of amounts attributable to 2025 health FSA salary reduction contributions does not cause Employer EX's cafeteria plan to fail to satisfy the $3,400 limit.

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3. If each of two spouses is eligible to elect salary reduction contributions to an FSA, each spouse may elect to make salary reduction contributions of up to $3,400 to his or her health FSA, even if both participate in the same health FSA sponsored by the same employer.

Example. Trent and Alicia both work for Rugged, Inc. The company offers an employer sponsored health FSA. Trent and Alicia may each designate up to $3,400 annually to salary reduction for the health FSA.

4. An employee employed by two or more employers that are not members of the same controlled group may elect up to $3,400 (as indexed for inflation) under each employer's health FSA. If an employee participates in multiple cafeteria plans offering health FSAs maintained by members of a controlled group or affiliated service group, the employee's total health FSA salary reduction contributions under all the cafeteria plans are limited to $3,400 (as indexed for inflation).

Example 3: Trent works for Rugged, Inc. The company offers an employer sponsored health FSA. Trent may designate up to $3,400 annually to salary reduction for the health FSA.

Trent also works part-time for Northside, Inc., an unrelated employer. Northside Inc. also offers a health FSA. Trent may also designate up to $3,400 to salary reduction under Northside's health FSA.

5. The statute imposes the annual limit only on salary reduction contributions to a health FSA in a cafeteria plan and does not limit the amount permitted for reimbursement under other employer-provided coverage, such as employee salary reduction contributions to an FSA for dependent care assistance or adoption care assistance.

Example. Trent works for Rugged, Inc., which offers an employer sponsored health FSA as part of an overall cafeteria plan under §125. Trent may designate up to $3,400 annually to salary reduction for the health FSA.

Trent may also utilize the other allowed elements of his employer's cafeteria plan over and above the health portion FSA limit. Therefore, Trent participates in a $7,500 dependent care assistance program in addition to the health FSA.

6. The limit also does not apply to salary reduction contributions to a cafeteria plan that are used to pay an employee's share of health coverage premiums, nor does it apply to salary reduction or any other contributions to an HSA or to amounts made available by an employer under an HRA.

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Health FSA Savings			
No FSA-		**With FSA –**	
Pay IRS then Doc		**Pay Doc then IRS**	
1. Gross income	$ 65,000	1. Gross income	$ 65,000
2. Less 30% tax	(19,500)	2. Less FSA	(3,400)
3. Cash left	$ 45,500	3. Taxable Inc	$ 61,600
4. Less Doctor	(3,400)	4. Less 30% Tax	(18,480)
5. Cash Left	$ 42,100	5. Cash Left	$ 43,120

The FSA provides a savings of $1,020 to the employer ($43,120 - $42,100).

G. Benefits provided for 2% S corporation shareholders

1. Add the benefit to Box 1 of Form W-2 wages and deduct the gross amount as employee wages on the corporate tax return.

2. Add the benefit amount to Boxes 3 (FICA wages) and 5 (Medicare wages) of Form W-2 as the benefits are subject to FICA or Medicare tax as non-qualified fringe benefits. S corporation shareholders are not permitted to participate in FSAs, so any benefits are taxed as wages.

3. Benefits provided to partners or LLC members are added to guaranteed payments of the specific partner and deduct as guaranteed payments on Form 1065 and the individual will pay SE tax on the full amount.

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Education Assistance Programs and Scholarships (§127)

Overview. The employer may provide up to $5,250 per year in tax-free reimbursements for undergraduate and graduate tuition, books, equipment, fees, and supplies.

1. It does not apply to education for sports, games, or hobbies unless as part of a degree program or work-related.

2. Tools and supplies that the employee is allowed to keep at the end of the program (other than books) do not qualify, nor do meals, lodging, or transportation.

3. An exclusion of up to $5,250 from an employee's gross income is allowed if an employer paid principal or interest on an employee's "Qualified education loan" [Section 2206 of the CARES Act]. The Consolidated Appropriations Act, 2021 (CAA) extended this provision of the law through December 31, 2025.

4. OBBBA permanently extended the tax-free status of employer-provided educational assistance for student loan repayment (up to $5,250 annually) beyond 2025. Starting in 2027, this $5,250 maximum limit will be indexed for inflation. Additionally, the Act expands qualified expenses for §529 plans to include licensing, certifications, and certain high school dual-enrollment courses.

Non-discrimination required. The plan must be written and may not favor highly compensated employees.

- No more than 5% of the benefits may be provided to shareholders, spouses or dependents or other owners.

- Employees must be provided with notice of the plan's existence.

- Employees may not receive cash instead of the benefit.

- The plan may be provided through direct payment or reimbursement.

Preparer note. This provision applies to all employers and employees, including sole proprietors, partners, 2% shareholders and leased employees.

Preparer note 2. Benefits provided to an adult child (an over age 20, non-dependent) of the owner, who owns less than 5% of the business qualify for this exclusion. The attribution rules do not apply in this situation.

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Scholarships and grants excludable under §117(a). Scholarships and grants received under 117(a) may also be excluded from income. To qualify:

1. The recipient must be a degree candidate at a qualified education institution and use the funds for tuition, fees, books, supplies, and equipment required for instruction.

2. If an employer pays for an employee's study or research, and those amounts represent payments for past, present or future employment services, the employee must include them in his or her income (§1.117-4(c)).

3. Employers have some leeway as to the type of recipient; they may establish scholarships for employees, their spouses and children or even others not associated with the company, such as residents of the community where the company is located.

Feature	§127 Qualified Educational Assistance	§132(d) Working Condition Fringe	§117(d) Qualified Tuition Reductio
Written Plan Required	Yes	No	No
Undergraduate Courses Covered	Yes	Yes	Yes
Graduate Courses Covered	Yes	Yes	No*
Must Be Job Related	No	Yes	No
Courses Qualifying Employee for New Trade or	Yes	No	Yes
Courses Needed to Meet Minimum Job Requirements Covered	Yes	No	Yes
Can Discriminate in Favor of Highly Compensated	No	Yes	No
Dollar Limitation	Yes-$5,250	No	No
Expiration date	None	None	None
Definition of Employee Includes:			
Current Employees	Yes	Yes	Yes
Family Members	No	No	Yes
Laid-Off Employees	Yes	No	No
Employees Retired or on Disability	Yes	No	Yes
Independent Contractors	No	Yes	No
Educational Expenses Covered:			
Tuition, Books, Supplies, Equipment	Yes	Yes	Tuition Only
Tools or Supplies, for class use only	No	No	No
Education Involving Sports, Games	No**	No**	Yes
Meals, Lodging or Transportation	No	Yes	No

**Unless has a reasonable relationship to the business or is required as a part of a degree program.

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OBBBA makes changes to education assistance programs. Student loan payments are now included as qualified expenses that employers may reimburse tax free to employees under §127. This allows employers to pay up to $5,250 annually towards an employee's student loans, including principal or interest payments on qualified loans (per §221(d)(1)). The loan payments can be made directly to a third party such as an educational provider or loan servicer or directly to the employee, and ***it does not matter when the qualified education loan was incurred.*** The employer is allowed to fully deduct the payment, and the employee receives a tax-free fringe benefit. This provision is now permanent. Starting in 2027 the $5,250 annual limit will be inflation adjusted annually.

Preparer note. An educational assistance program must be provided for the exclusive benefit of employees. A program that provides benefits to the spouse or dependents of an employee is not a §127 educational assistance program unless the spouse or dependents are themselves employees.

Final note. The IRS recently published Fact Sheet-2026-10, which includes FAQs about employer provided educational assistance programs.

Sample Educational Assistance Plan
Taxpayer Attorney Review Required

The purpose of the _____ Educational Assistance Plan is to provide non-taxable educational assistance of up to $5,250 per calendar year to eligible employees. All full-time, regular employees who have completed one full year of service are eligible to participate in the plan.

Tuition, registration fees, required fees such as labs and library fees, and required books for a business-related undergraduate or graduate course at an accredited college or university to the maximum of $5,250 per calendar year for successfully completed courses will be reimbursed when the employee provides proof of a grade of at least "B" in the course. (Employees will receive 1/2 of the requested amount initially and the other 1/2 upon submission of documentation of completing a course with a grade of "B" or higher).

An employee who receives advance tuition payments or tuition reimbursement must sign a legally binding agreement that if he/she does not remain employed with the company for at least one year following the completion of the course(s), he/she will be obligated to repay the assistance either through payroll deductions or other legal means.

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Trump Account Contributions May Be Made by Employers (§128; 530A; Notice 2025-68; PR §1.128-1, et al.)

Preparer note. The rules for employer contributions to employee Trump Accounts (TAs) were clarified by the proposed regulations NPRM-REG-101355-26, which were issued August 11, 2026. While these regulations are only proposed at the time this book was published, the regs may be relied on for plan years beginning before the date any final regulations are published.

Overview. §128 permits employers to make and deduct annual contributions of up to $2,500 per employee (not per dependent) to Trump Accounts. Employees with multiple qualifying dependents may allocate the $2,500 amount between his or her dependents any way they choose. Contributions by employers are not taxed until the beneficiary withdraws the employer's contribution. Employer contributions are included in the $5,000 overall Trump account contribution limit per qualifying individual. Contributions of more than $2,500 are taxable wages for the employee.

Making employer contributions (§1.128-2). Employer contributions may be made directly by the employer to the account of a qualifying employee (e.g., under age 18) or the employee's dependent. Contributions may also be paid via a §125 cafeteria plan. Contributions are excluded from employee income but are taxable to the beneficiary when withdrawn. The $2,500 annual employer contribution limit will be adjusted for inflation beginning in 2028. Contributions made prior to July 4, 2026, do not qualify.

Contributing through §125 plan (§1.128-2(d)(7)). Trump account contribution programs may be offered via salary reduction under a §125 cafeteria plan but ***only if the contribution*** is made to a Trump account of the dependent of an employee. Salary reduction contributions via a §125 plan cannot be made to a Trump account of an employee.

Dependent defined. For this purpose, a dependent is an individual who, for the calendar year in which the contribution is made, the employee anticipates will be a dependent of the employee under §152 (i.e., a qualifying child or qualifying relative). For divorced taxpayers, the child may qualify for the non-custodial parent if there is a signed Form 8332. Employers may rely on an employee's certification that the dependent is qualified.

Preparer note. The proposed regs clarify that self-employed individuals, including partners in partnerships, sole proprietors, directors, and 2% S corporation shareholders, ***may not participate*** in this program or receive excludable contributions.

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Example 1. Jerry's employer, Acme, offers a §128 Trump account contribution program of up to $2,500 per employee. Jerry has two dependents. Jerry may allocate the §128 contribution among the Trump accounts for his two dependents, but the total amount allocated cannot exceed $2,500 for 2027.

Example 2. Niko and Samantha, who are married and file jointly, have one dependent, Josh. Niko and Samantha's employers each offer §128 Trump account contribution programs of up to $2,500 per employee. Niko and Samantha may each allocate their respective $2,500 §128 contribution benefit to Josh's Trump account. Josh receives total employer contributions of $5,000 to his Trump account in 2027. No other contributions may be made to Josh's Trump account in 2027 as the $5,000 limit has been reached.

Example 2 - continued. Assume the same facts as Example 2 except Niko and Samantha both work for the same employer. Each parent remains entitled to their respective $2,500 benefit under §128, and both elect to fund Josh's Trump account with their benefit. The program complies with the annual $5,000 limit requirement. This is true even if the §128 contributions were made via salary reductions.

Example 3. Sara is Jerry's only dependent and she is a qualifying individual for purposes of a Trump account. Jerry works for two unrelated employers, Acme and Wile e, each of which offers §128 contributions of $2,500. Jerry allocates the $2,500 §128 contribution under each program for Sara's benefit. Neither Acme nor Wile e is required to provide any corrective notice solely because of the other employer's contribution. However, Jerry must include the $2,500 excess contribution in his gross income on his 2027 income tax return. This would be the case if the contributions were made via salary reduction.

Example 4. Jerry works for Acme, which offers a §128 contribution program. Jerry has one qualifying dependent, his daughter Sara. Acme makes a $2,500 contribution to Sara's Trump account in 2027. Acme also contributes an additional $1,000 to Sara's Trump account that does not qualify under §128. Acme must report on Jerry's W-2 the $2,500 contribution under the §128 plan and the additional $1,000 as gross wages.

§128 plan administration duties. Employers offering benefits under §128 must:

1. Have a formal, written, non-discriminatory plan;
2. Not open the account - the employee, or the parents or a close relative must open the account.
3. Notify employees of the existence of the plan and provide an annual written statement by the following January 31st of the following year which shows the amounts paid.
4. Employer contributions are reported to the employee on Form W-2, Box 14, Code TA.

Anti-discrimination provisions (§128(c)). Employers offering benefits under §128 must ensure that the plan does not primarily benefit highly compensated employees (HCEs). §128 apply the nondiscrimination rules of §129(d)(2), (3), (6), (7), and (8). The main components of these rules are (PR §1.128-3):

1. **Contributions and benefits.** Terms cannot discriminate in favor of HCEs or their dependents. The same terms must be available to all eligible employees.

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2. **Eligibility.** The program must benefit employees who qualify under an eligibility classification established by the employer that is reasonably based on objective business criteria (e.g., hourly/salaried, division, location, etc.). Nondiscrimination is satisfied by either a facts-and-circumstances test or by a numerical safe harbor found in PR 1.183-3(b)(3)(iii).

3. **Average benefits test.** The average benefits provided to NHCEs must be at least 55% of the average provided to HCEs, computed using only employees with a benefit greater than zero.

The nondiscrimination testing is performed on the last day of the plan year.

Example. Acme has 15 HCEs and 15 NHCEs in 2027. Acme offers a Trump account contribution program funded solely via §125 plan salary reductions. All 30 employees are eligible to make salary reduction elections under the plan on the same terms. Eleven of the HCEs elect benefits under the plan of $2,500 each; one of the NHCEs elects benefits of $2,500; three of the NHCEs elect benefits of $1,500; one of the NHCEs elects benefits of $1,000; and two of the NHCEs elect benefits of $500, for a collective $9,000 in benefits provided to seven NHCEs. The average benefit provided to NHCEs is $1,286 ($9,000/7). The average benefit provided to the HCEs is $2,500 ($27,500/11). The average benefit provided to the NHCEs is 51.4% ($1,286/$2,500) of the average benefits provided to the HCEs so the 55% is not satisfied.

Example - continued. Continuing the example, assume that before timely furnishing the Form W-2s for 2027, Acme treats $500 of the benefits elected by each of the HCEs as gross income and wages, reducing the benefits provided to the 11 HCEs to $22,000. This reduces the average benefit to HCEs to $2,000 ($22,000/11) and makes the average benefits provided to the NHCEs 64.3% of the average benefits provided to the HCEs ($1,286/$2,000). The required 55 % threshold is satisfied.

Other items of note. Some other notable rules included in the proposed regulations include:

- **Excludable employees (PR§1.128-3(e)**). Certain employees may be excluded by the employer from participation in the 128 plan, including employees:
  - Who are under age 21
  - Have less than one year of service, and
  - Who are part of a collectively-bargained employee group.

- **Pilot-match safe harbor (PR§1.128-3(d))**. Employer contributions that match the government's $1,000 pilot deposit (for children born 2025–2028) are disregarded in both the contributions/benefits test and the average benefits test, provided the match is offered on the same terms to all non-excluded employees.

- **Effect of failure (PR§1.128-3(g)).** If an employer §128 plan discriminates in favor of an HCE, the failure does not disqualify the program for NHCEs – only HCEs lose the exclusion.

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- **Self-correction mechanism (PR§1.128-3(c)(5))**. If the 55% test fails as of the last day of the plan year, the employer can cure it by including the "excess benefit amount" in the affected HCEs' wages on Form W-2 (Box 12, code "TA"), by the normal W-2 filing deadline, plus a corrective notice to the trustee within a 21-day safe-harbor window.

- **Employer contributions are tax-exempt for income tax only.** Qualifying employer contributions are excluded from an employee's gross income for Federal income tax, but contributions are subject to Social Security, Medicare, and Additional Medicare (FICA) taxes, FUTA tax, and Railroad Retirement Tax Act (RRTA) tax unless another exclusion applies.

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Dependent Care Assistance Programs (§129)

Employers may offer employees with childcare needs an option to exclude a portion of their wage income that is paid directly or indirectly to the employee under a dependent care assistance program. The care services must be for a qualifying person's care and provided to allow the employee to work. The plan must be in writing (§129 (d)(1)) and provided to employees in a non-discriminatory manner. The plan must provide, by January 31st of the following year, a written summary of amounts paid by the employer for dependent care assistance to or for the employee. This is typically accomplished by reporting the amount paid on Form W-2, Box 10.

Qualified reimbursable amounts include care:

- At a day care center that complies with all appropriate state and local regulations;
- By a housekeeper, whose duties include dependent care;
- By a relative who cares for the employee's dependents, so long as the relative is not another one of the employee's dependents or a child under 19. For example, an employee cannot be reimbursed for paying the employee's 16-year-old child to care for the member's 2-year-old child;
- For an elderly or incapacitated spouse or dependent, either in the employee's home or outside of the employee's home. If the employee is claiming reimbursement for care outside of his or her home, the dependent must spend 8 hours each day in the employee's care;
- At a day camp to which the employee sends his or her school aged child during school vacations for work related dependent care expenses.

Maximum benefit (§129(a)(2)). The maximum excludable benefit in 2026 and beyond is $7,500 (was $5,000 in prior years), $3,750 MFS. Married employees are limited to $7,500 even if both spouses have access to a §129 plan at their respective jobs. If a married couple's joint benefit exceeds $7,500, the couple is required to report the excess as additional income on their Form 1040 to ensure the maximum benefit does not exceed $7,500. The entire excluded amount is exempt from income and FICA taxes. This amount is not indexed for inflation.

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Other Fringe Benefits Excluded from Employee Gross Income (§132)

The IRC includes multiple fringe benefits that an employer may provide to employees on a tax-free basis. Whether these benefits are offered to employees is at the sole discretion of the employer – there is no way for an employee to opt in to any benefit without employer adopting the benefit first. Employers who choose to offer any benefit under §132 must make the benefit available to all employees or a reasonable employee classification on substantially the same terms to maintain tax-free status for highly compensated employees. The more useful benefits are listed below.

A. **No additional-cost service (§132(b)).** "No-additional-cost service" means a service provided by an employer to an employee if:

- The service is offered for sale to customers in the ordinary course of business of the employer, and
- The employer incurs no substantial additional cost (including forgone revenue) to provide the service to the employee.

No-additional-cost services occur frequently in industries with excess capacity services. Examples include transportation tickets, hotel rooms, entertainment facilities and so on; they may also occur with governmental facilities (for example, a municipal golf course or recreation (§1.132-2(a)(2)).

Reciprocal agreements. No-additional-cost services provided to employees by an unrelated employer may qualify as a no-additional-cost service if all the following apply:

- There is a written reciprocal agreement between the employers under which a group of employees of each employer, all of whom perform substantial services in the same line of business, may receive no-additional-cost services from the other employer.
- The service is the same type of service generally provided to customers in both the line of business in which the employee works and the line of business in which the service is provided.
- Neither employer incurs any substantial cost either in providing the service or because of the written agreement (§1.132-2(b)).

B. **Qualified employee discounts (§132(c)).** An employee discount allows employees to obtain property or services from their employer at a price below that available to the public. To be excludable, the discounted property or service must be offered to the public in the ordinary course of business. The amount of the discount cannot exceed:

- For merchandise or other property, the employer's gross profit percentage times the price charged to the public for the property (i.e., cannot discount below cost).
- For services, no more than 20% of the price charged to the public.

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The exclusion for a qualified employee discount applies whether the property or service is provided at no charge (in which case, only a portion will be excludable as a qualified employee discount) or at a reduced price. This exclusion ***is not available*** for discounts on real property or personal property of a kind commonly held for investment.

C. **Working condition fringe benefits (§132(d)).** Working condition fringe benefits include property or services that, if the employee had paid for the property or service, the cost would have been allowable as a business expense deduction to the employee. That is, if the cost of an item is an allowable business expense deduction for the employee, it may be excludable from the employee's wages as a working condition fringe benefit if provided by the employer. This did not change because of the TCJA's suspension or the OBBBA's repeal of Miscellaneous Itemized Deductions. The law is based on whether the expense is a legitimate business expense for the employee, not on the deduction status on Schedule A. To be excludable as a working condition fringe benefit:

- The benefit must relate to the employer's business,
- The expense would have been an allowable business expense deduction to the employee if the expense had been paid personally, and
- Business use must be substantiated with records.

Working condition fringe benefits include:

- Business use of a company vehicle,
- Job-related education,
- Professional dues or subscriptions,
- Employer provided cell phones,
- Job related travel costs, etc.

D. **De minimis benefit (§132(e)).** De minimis fringe benefits include any property or service provided to an employee, the value of which is so small that accounting for it is unreasonable or administratively impracticable. The value of the benefit is determined by the frequency it's provided or, if this is not administratively practical, by the frequency provided by the employer to the workforce (§1.132-6(b)). Examples of de minimis benefits include:

- Personal use of photocopiers (no more than 15% personal use)
- Flowers for special occasions
- Traditional birthday or holiday gifts
- Personal use of employer provided cell phone, etc.

De minimis fringes do not include cash or cash equivalents, use of employer boat or home, golf, or country club memberships, etc. As discussed in the employer meal section, OBBBA eliminated the deduction of meals as a de minimis fringe benefit.

E. **Qualified transportation expenses (§132(f)).** Commuting expenses generally are not allowed as a deduction for employees. However, qualified transportation expenses paid by employers are allowed to be excluded from an employee's taxable income. Employers may reimburse or pay directly for commuting related transportation expenses for employees. This benefit applies to:

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- **Commuter transportation in a commuter highway vehicle** – a commuter highway vehicle is a highway vehicle that seats at least six adults (not including the driver). In addition, it is reasonably expected that at least 80% of the vehicle mileage will be for transporting employees to and from work. Employees must occupy at least one-half the vehicle's seats;

- **Transit passes** – any pass, token, farecard, voucher, or similar item entitling a person to ride, free of charge or at a reduced rate, on mass transit, a vehicle that seats at least six adults (not including the driver). Mass transit may be publicly or privately operated and includes buses, rail, or ferry; and

- **Qualified parking** – employer provided parking to employees on or near its business premises. Includes parking on or near the location from which employees commute to work using mass transit, commuter highway vehicles, or carpools. It doesn't include parking at or near an employee's home.

Employer payments are subject to limits. Employers may provide an employee with any one or more of these benefits at the same time. These employer-provided benefits, subject to annual limits, are exempt from withholding and payment of employment taxes, are not reported as taxable wages on the employee's Form W-2 and are not included in the employee's gross income. The 2026 limits are $340 per month ($4,080 annually) for each applicable category.

Preparer note. The TCJA temporarily repealed employer deductions for the qualified transportation fringe benefits (§274(a)(4) and §274(l)). While employees may receive the benefits tax free, the employer gets no deduction. ***OBBBA made this change permanent.***

F. **Adoption assistance programs (§137).** An adoption assistance program is a plan separately written by an employer that meets all the following requirements:
   - It benefits employees who qualify under rules that don't favor highly compensated employees or their dependents.
   - It doesn't pay more than 5% of its payments during the year for shareholders or owners (or their spouses or dependents). A shareholder or owner is someone who owns (on any day of the tax year) more than 5% of the stock or capital or profit interest of the business.
   - Reasonable notice of the plan is given to eligible employees.
   - Employees provide reasonable substantiation that payments or reimbursements are for qualifying expenses.

Tax exclusion. Employers exclude all qualified adoption assistance program related payments from employees' wages subject to Federal income tax withholding. Adoption related payments are, however, subject to Social Security, Medicare, and FUTA taxes.

Reporting requirements. Employers must report all qualifying adoption expenses paid or reimbursed under its adoption assistance program in box 12 of the employee's Form W-2, regardless of amounts. Code T is used to identify the payment as an adoption related payment.

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G. **Disaster related relief payments (§139).** IRC §139 was enacted in 2001 in response to the September 11th terrorist attacks. The intended purpose is to provide tax relief for individuals affected by Federally Declared Disasters. Under this provision, employers may make qualified payments to employees that are excludable from the employee(s)' gross income – meaning recipients do not owe federal income tax on qualifying disaster relief payments. The exclusion applies to payments received by individuals for ***reasonable and necessary expenses*** resulting from a qualified disaster.

- **Qualified disaster relief payments** – Reimbursement or payment to employees of any reasonable disaster related expense is excludible, including:
  - Personal, family, living, or funeral expenses due to a qualified disaster.
  - Repair or rehabilitation of a personal residence or its contents (furniture, appliances, etc.) damaged by the disaster.
  - Payments from federal, state, or local governments, charitable organizations, or employers, provided they are to help individuals cope with disaster-related expenses.

- **Non-qualified expenses** would include:
  - Payments for expenses otherwise covered by insurance.
  - Wage replacement payments (e.g., unemployment compensation or paid sick leave).
  - Any payment that represents compensation for services.

- **Qualified disaster** – A qualified disaster must be declared by the Federal government under the Stafford Act, or events determined by Federal law (e.g., 9/11, COVID-19 pandemic). This includes natural disasters (hurricanes, wildfires, floods, pandemics, etc.) and certain terrorist or catastrophic events.

- **Reporting requirements** – Employers are not required to report or otherwise include qualified payments on any forms. Payments are not subject to income, FICA, FUTA or any other tax, thus no W-2 or Form 1099 reporting is required.

Employer-Provided Cell Phones (Notice 2011-72)

The value of an employer-provided cell phone, provided primarily for non-compensatory business reasons, is excludable from an employee's income as a working condition fringe benefit. Personal use of an employer-provided cell phone, provided primarily for non-compensatory business reasons, is excludable from an employee's income as a de minimis fringe benefit.

A. A cell phone is provided primarily for non-compensatory business purposes if there are substantial business reasons for providing the cell phone. Examples of substantial business reasons include an employer's:

- Need to contact the employee at all times for work-related emergencies.

- Requirement that the employee be available to speak with clients at times when the employee is away from the office.

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- Need to speak with clients located in other time zones at times outside the employee's normal workday.

B. Cell phones provided to promote goodwill, boost morale, or attract prospective employees are not excludible from an employee's wages.

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Other Payroll and Related Tax Developments

Social Security Rates and Limits			
Year	**2025**	**2026**	**2027**
Social Security Wage Limit	$176,100	$184,500	
Medicare Wage Limit	None	None	None
Social Security Rate	6.2%	6.2%	6.2%
Medicare Rate	1.45%	1.45%	1.45%
Medicare for earned income over $200k, $250k (MFJ)	2.35%	2.35%	2.35%
Quarter of Coverage	$1,810 ($7,240 for 4 quarters)	$1,890 ($7,560 for 4 quarters)	

Early Retirement Social Security Earnings Limit			
Year	**2025**	**2026**	**2027**
Earned income limit age 62 to year before FRA	$23,400	$24,480	
Earned income limit year of FRA	$62,160	$65,160	
Earned income limit after reaching FRA	None	None	None

Social Security Overpayments Due to Excess Earned Income

Social Security recipients who are under their full retirement age (FRA) are subject to the earnings caps listed in the above table. Recipients who haven't reached FRA and have earned more income than the limits must pay some or all the Social Security benefits back. The amount paid back is equal to:

- For those years prior to reaching full retirement age, $1 for every $2 over of earned income more than the limit.
- For those who've reached the year of their FRA, but they haven't reached the month of their FRA, they must pay back $1 for every $3 or earned income more than the limit.

For those who are required to pay back benefits due to the earnings limit, the Social Security Administration (SSA) withholds 100% of the beneficiary's Social Security income until the repayment is completed.

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Example. Jen started collecting SS benefits of $2,000 per month when she was 63 years old. In 2026, her first full year of retirement, Jen took a part-time job where she earned $44,480. The Social Security Administration (SSA) notified Jen in July 2027 that she had $20,000 of earnings more than the 2026 limit. Jen owed $10,000 ($20,000 x 50% (2 for 1)) back to SSA. The SSA notified Jen that they were going to withhold her checks starting in August 2027 until the $10,000 was repaid.

Shark Attack Medicare Tax – IRMAA (Income-Related Monthly Adjustment Amount)[1]

IRMAA stands for "Income-Related Monthly Adjustment Amount." IRMAA requires "high-income" taxpayers to pay Medicare Part B and D premiums more than the base premiums paid by most taxpayers. Roughly 5.1 million Medicare participants (7.5% of the total) were subject to IRMAA in 2025. The amount of the IRMAA tax is based on a taxpayer's modified AGI (AGI per tax return plus tax-exempt interest) from the most recent tax information the IRS can provide, which is generally two years prior to when the premiums are paid. For example, 2026 IRMAA premium adjustments are normally calculated based on a taxpayer's 2024 tax return AGI. Those subject to IRMAA will receive a letter from the Social Security Administration notifying them they are subject to IRMAA and how much the adjustment will be. These letters are normally sent to taxpayers in the year prior to the year the adjustment takes effect.

[1] Per SSA Program Operations Manual, Section HI 01101.010.

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IRMA Amounts are subject to annual inflation adjustments (CMS Fact Sheet 11/2024). The chart below shows the base Medicare Part B and D premiums, as well as the 2025 IRMAA adjustments.

2024 Modified Adjusted Gross Income		2026 Premiums (based on 2024 MAGI)	
Single	**MFJ**	**Part B**	**Part D**
≤$109,000;	**≤$218,000 MFJ**	$202.90	None*
>$109,000, ≤$137,000;	**>$218,000, ≤$274,000 MFJ**	$284.10	$14.50
>$137,000, ≤$171,000;	**>$274,000, ≤$342,000 MFJ**	$405.80	$37.50
>$171,000, ≤$205,000;	**>$342,000, ≤$410,000 MFJ**	$527.50	$60.40
>$205,000, <$500,000;	**>$410,000, <$750,000 MFJ**	$649.20	$83.30
≥$500,000;	**≥$750,000 MFJ**	$689.90	$91.00
*The Part D surcharge is in addition to whatever premiums are paid to the private insurance company.			

IRMAA exception – the "Life Changing Event." The IRMAA calculation is normally very objective – if MAGI exceeds the relevant threshold, the taxpayer pays IRMAA. However, if a taxpayer had a "life-changing event" (LCE) that reduced household income in a subsequent year, they may request the Social Security Administration to reconsider the IRMAA adjustment. Life-changing events may include events such as marriage, divorce, the death of a spouse, loss of income, retirement, an employer settlement payment, etc. The taxpayer must file Form SSA-44 directly with the Social Security Administration to appeal an IRMAA determination.

Preparer note. Large capital gains are specifically excluded from the list of LCEs.

Preparer note. Taxpayers who've filed an amended return on which income was reduced may contact the SSA directly to ask for an adjustment to IRMAA. This is done by calling 800.772.1213 and explaining the reason for the amendment and the income impact.

Planning note. IRMAA is often overlooked in the tax planning process and, I can tell you from personal experience, taxpayers are not happy to find out two years later they owe additional tax. Our systems and procedures must be updated to ensure IRMAA is addressed in any tax planning engagement. Just my two cents!

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Employee v. Independent Contractor – IRS v. DOL

Making the determination of whether a worker is an employee or an independent contractor is critical for business owners as misclassifying workers may result in significant penalties. Historically this has been a very confusing area for business owners. Contributing to the confusion is the fact that different Federal and state agencies may use different criteria to classify workers. For example, the Dept. of Labor (DOL) and the IRS each have their own standards for classifying workers. In 2024, the DOL withdrew its 2021 guidance and released new final regulations in March 2024.

DOL Independent Contractor regulations finalized (RIN 1235-AA43). The DOL rescinded its 2021 proposed two-factor (weighted) test it was using to determine worker status. Instead, the DOL backtracked to its pre-2021 equally weighted multi-factor standards. The DOL conceded the pre-2021 rules more properly aligned with the history of the law and the definitions used by multiple courts, including the Supreme Court, in dozens of court cases over many years.

DOL independent contractor v. employee rules. Under the final regulations, the DOL considers the following factors:

- The opportunity for profit or loss depends on managerial skill.
- Investments made by the worker and potential employer, if any.
- The degree of permanence of the work relationship.
- Nature and degree of control over the worker's duties.
- The extent to which the work performed is an integral part of the potential employee's business.
- The degree of skill and initiative involved in the work.

IRS independent contractor v. employee rules. The IRS rules use three broad categories, and the related sub-categories, of a worker's tasks to determine if they are an employee or a contractor. These categories are:

- **Behavioral control** – does the business:
  - Dictate how, when, or where the worker works?
  - Tell the worker what tools or equipment to use and does the business provide those tools?
  - Direct the worker who to hire and how to manage employees?
  - Tell the worker where to buy tools, supplies, and/or services?
  - Provide training for the worker?

Businesses have the right to direct ***what*** gets done, and for employees, ***how*** tasks get done. Independent contractors decide for themselves ***how*** tasks get done as long as they get done.

- **Financial control** – does the business:
  - Make significant investments in their work or is it the worker's responsibility?
  - Reimburse workers for their out-pocket expenses?
  - Enjoy any profits made from the worker's work or do profits go to the worker?
  - Allow the worker to incur a loss?

Emphasized above is the worker's ability to earn a profit or incur a loss. If neither of those possibilities exist, it is highly likely the worker is an employee. It's hard to argue that a worker is independent when they cannot earn a profit or absorb a loss.

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- **Relationship dynamics.** If behavioral and financial control are unclear, the next step is to look at the nature of the relationship between the worker and the business. It should be noted:
  - Independent contractors do not receive work benefits (insurance, paid leave, retirement, etc.).
  - Any work contract between the business and the worker should reflect what kind of relationship the two intend.

DOL FAQs for worker classification #6. Does this final rule affect the analysis for determining worker classification under other laws?

No. The final rule only revises the Department's interpretation under the FLSA**. It has no effect on other laws – Federal, state, or local – that use different standards for employee classification.** For example, the IRC and the NLRA have different statutory language and judicial precedent governing the distinction between employees and independent contractors, and those laws are interpreted and enforced by different Federal agencies. Similarly, this rule has no effect on state wage-and-hour laws which use an "ABC" test, such as California or New Jersey. The FLSA does not preempt any other laws that protect workers, so businesses must comply with all Federal, state, and local laws that apply and ensure that they are meeting whichever standard provides workers with the greatest protections.

Preparer note. You might ask – why are DOL rules in our manual if the IRS uses their own? We put it here to assist in the event you have a client who is assessed worker classification related penalties. In most cases, the only defense with the IRS for worker classification issues is reasonable cause. It seems to the author, if multiple Federal agencies cannot consistently define who is and who is not an employee, it is reasonable we might make classification mistakes as the area is very confusing. And if it's that hard, then we would seem to always have a reasonable cause argument.

Congress enacts Act §530 to provide employer relief (IRS Act Section 530 Relief). Congress recognized decades ago that worker classification is a very complex area of the law and penalties associated with worker misclassification were drastic. After failing to find a solution to the confusion, Congress passed the Revenue Act of 1978 (commonly referred to as Act Section 530) to provide employers with relief from penalties if the misclassification was the result of a reasonable mistake. Act Section 530 was originally a temporary provision but was made permanent by TEFRA in 1982. Subsequently, Act §530(d) added amended by TRA of 1986 (limited relief for certain technically skilled workers); Act §530(e) was added by SMJPA of 1996 (which broadened the application of the provision. Act §530 has not been substantively changed since 1996 – almost 30 years ago.

Act Section 530 relief. If a business meets the requirements of Act §530, the employer is relieved of any taxes or penalties associated with misclassification of workers. This relief does not apply to the worker, just to the employer. The relief applies to FICA, Federal unemployment tax, Federal income tax withholding (FIT), Railroad Retirement Tax Act taxes, and any related interest or penalties attributable to the liability for employment tax (Rev. Proc. 85-189).

IRS Training 3320-102 (10-96) spells out the rules (IRS Training 3320-102). The IRS training manual states:

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"IRS policy requires its employees to exercise strict impartiality in the conduct of their duties. Thus, you must approach the issue of worker classification in a fair and impartial manner and actively consider section 530 relief at the beginning of an examination. **This includes furnishing taxpayers with a summary of section 530 at the beginning of an examination.** Additionally, you may need to assist taxpayers in identifying facts which establish either worker classification."

IRS advance notice if worker classification is being audited (Act §530(e)(1); Rev. Proc. 2025-10 Section 3.04) Publication 1976). The IRS is required to give a taxpayer written notice of Act §530 relief prior to initiating an employment tax audit. The IRS is also required to assess whether a taxpayer satisfies the requirements of Act §530 before analyzing whether the taxpayer's workers are employees (Rev. Proc. 2025-10). The IRS satisfies its notification requirement by providing taxpayers IRS Pub 1976, Do you "Qualify for Relief under Section 530?" Once notice is given, the IRS is required to determine if the business meets the requirements for Act §530 relief before beginning the development of the reclassification issue. If Act §530 applies, the business is exempt from any worker misclassification tax and/or penalties and any further analysis if moot.

Act §530 qualifications. Act §530 applies if an employer meets three statutory requirements – two consistency requirements and one reasonable cause:

1. **Reporting consistency** – The taxpayer must have timely filed Forms 1099 consistent with its treatment of the worker as a non-employee. For example, if the taxpayer claims the worker is an independent contractor, Forms 1099-NEC must have been filed for the taxable years at issue. If no information return requirement exists, relief may still be allowed, but it is much more difficult. For example, if the taxpayer claims the worker was a volunteer, no information returns would be required (Rev. Proc. 85-18, 3.03(B); Rev. Rul. 81-224).

2. **Substantive consistency** – If the taxpayer or predecessor treated the worker, or any worker holding a substantially similar position, as an employee the taxpayer will not be eligible for relief (See §530(e)(6); Rev. Proc. 85-18; Rev. Rul. 83-16, Rev. Rul. 84-161). This is a facts and circumstances determination. A review of the day-to-day services performed, and comparison of the job functions must be made. The mere fact of similar job titles or categories alone are not sufficient.

3. **Reasonable basis** – The taxpayer must have reasonably relied on one of the following three "safe harbors" or on the "any other reasonable basis standard":

    a. Prior audit – Since Dec. 31, 1996, the prior audit must have included an examination for employment tax purposes of the status of the class of workers at issue or a substantially similar class of workers.

    b. Judicial precedent –The facts in the case must be like the situation of the taxpayer at hand. The judicial precedent or published ruling must have been in existence at the time the taxpayer began treating workers as non-employees. One case is sufficient to establish a precedent that creates a safe haven. This is true even if case law can be found to support either side of the non-employee/employee issue.

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But state court decisions and rulings of agencies other than IRS do not constitute judicial precedent. That said, state court decisions or rulings may provide reasonable basis under the "any other reasonable basis" standard.

c. Industry practice – The taxpayer must show reasonable reliance on a long-standing recognized practice of a significant segment of its industry. An industry generally consists of firms located in the same geographic or metropolitan area which provide the same product or service and compete for the same customers.

d. Any other reasonable basis – A taxpayer that fails to meet any of the three "safe harbors" may still be entitled to relief if they can demonstrate that it relied on some other reasonable basis for not treating a worker as an employee. Examples may include advice from an attorney or accountant; state, non-tax federal law, and other determinations; prior audit of a predecessor; PLR or TAM to predecessor; or good faith. Per the IRS, this requirement is to be liberally construed in ***favor of the taxpayer*** (see the "Preparer note" above).

Preparer note – the employer must have relied on the authority at the time the employment decisions were being made for the periods at issue. The statute does not allow ex post facto justification.

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Burden of proof shifts to IRS if business establishes a *prima facie* case and cooperates with IRS's investigation Starting in 1997, businesses seeking to show reasonable reliance on one of the first three safe harbor factors (i.e., precedent, prior audit or industry practice) will only have the burden of establishing a prima facie case (meaning "at first sight; on first view; before further examination") that it was reasonable not to treat a worker an employee under the safe haven. If the business cooperates with the IRS investigation (including reasonable requests for information relevant to the taxpayer's treatment of the worker as an independent contractor), the burden of proof shifts to the IRS of proving the business wrong (Act §530(e)(4)).

IRS Updates Act §530 Guidance for the First Time in Decades (Rev. Proc. 2025-10)

For the first time in decades, the IRS provided updated worker classification guidance and related penalty relief addressed in Act §530. The IRS modified and superseded Rev. Proc. 85-18. Each line item below clarifies a provision of Rev. Proc. 85-18 or Act §530 as per Rev. Proc. 2025-10:

1. **Definition of an "employee"** – the IRS has clarified that the definition of an employee includes:
   - Corporate officers,
   - Workers classified as common law employees under §3121(d)(1),
   - Agent-drivers, commission-drivers- full-time life insurance salespersons, home workers, and traveling or city sales workers (statutory employees),
   - Workers where an Indian tribal government has agreed that workers who perform services and are covered by FICA, and
   - Officers, employees, or elected officials of a State, or any political subdivision or the District of Columbia. under 3121(d)(3)."

2. **Information returns filing consistency requirements:**
   - All required returns must be filed for all periods.
   - Reporting consistency must be met on a period-by-period basis. Act §530 relief is not available for any year the required forms aren't filed. But not filing in one year doesn't preclude relief in another year if the required forms a refiled.
   - Reporting consistency is determined on a worker-by-worker basis. If all required reporting is completed for one worker but not another, §530 relief is bifurcated and is available for the worker where the required reporting was completed.
   - A taxpayer does not fail the reporting consistency requirement if the taxpayer, in good faith, mistakenly files the wrong type of information return or reports an inaccurate amount paid. Moreover, a taxpayer does not fail the reporting consistency requirement if the taxpayer didn't file an information return because they weren't required to do so (e.g., worker made less than the 1099-NEC threshold amount).

3. **Substantive consistency requirement** – the determination of whether a worker holds a position substantially like another worker includes consideration of the relationship between the taxpayer and the individual. Accordingly, a substantially similar position exists if the job functions, duties, and responsibilities are substantially similar and the control and supervision of those duties and responsibilities are substantially similar.

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- Treatment of a worker, or a worker holding a substantially similar position, as an employee in a period after the period under audit does not cause a taxpayer to fail the substantive consistency requirement for the period under audit or prior periods under audit.
- Entering a Classification Settlement Program (CSP) or Voluntary Classification Settlement Program (VCSP) agreement with the IRS with respect to an individual will be considered treatment of the individual as an employee for substantive consistency purposes from the effective date of the agreement.

4. **A worker is "treated" as an employee if:**
   - Income tax or FICA is withheld,
   - Payments reported on Forms W-2, 941, 940, 944 or Sch. H were filed and treated the worker's payments as wages,
   - Contracting with a third party to provide employer services for the worker (e.g., payroll service),
   - Note – filing of delinquent payroll tax returns or amended returns in response to an IRS demand is not "treatment" of the worker as an employee.

5. **Reasonable basis requirement** – When considering whether a taxpayer had a reasonable basis to treat an individual as a non-employee, and the safe harbors are not applicable, then, if factually relevant, the IRS may consider, and the taxpayer may raise facts during the years under audit such as:
   - How the taxpayer claimed income tax deductions for amounts paid to the workers, or if any payments were excluded from workers income under provisions of IRC that are applicable only to employees (e.g. §§62(a)(2)(A), 105, 106, 117(d), 119, 127, 129, 132, etc.),
   - If the taxpayer claimed employer credits such as credits for paid sick and/or family leave, the Employee Retention Credit, or any other credits that are calculated based on employee wages,
   - Whether the employer complied with Federal or state labor laws, including minimum wage, overtime pay, pensions and other employment related rules,
   - Whether the worker is included in a worker group that is part of a collectively bargained agreement entered into by the taxpayer;
   - Whether the worker is allowed to participate in any non-qualified deferred comp plan if such participation is limited to employees of the taxpayer;
   - Whether worker is provided with state unemployment insurance, worker's comp insurance coverage, or other state employment benefits available to common law employee workers.

6. **Burden of proof shift** – The IRS clarified that the shifting of the burden of proof to the IRS does not apply unless the taxpayer is able to rely on prior audit, court case, or industry standard safe harbors to establish reasonable cause. The "any other basis" for establishing reasonable basis does not shift the burden of proof to the IRS.

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IRS provides new examples to demonstrate the application of Act §530 and the related rule clarifications (Rev. Rul. 2025-3)

Example 1 - Terry hires individuals who provide services during 2026. Terry pays each worker $500 a week base pay plus a weekly bonus. Terry doesn't withhold any employment taxes from the workers and reports the total annual amount paid on a separate Form 1099-NEC for each worker. Upon audit, the IRS determines Terry does not meet the statutory requirements for §530 relief, and the workers were Terry's employees. Terry argues she qualifies for §530 relief and she doesn't owe any tax or penalties.

Solution 1 – §530 is applicable in this circumstance, although it is not clear if related relief is available. Terry paid her workers as independent contractors, and the IRS reclassified the workers as employees. This disagreement makes Act §530 applicable to the circumstances. Terry consistently treated the workers as independent contractors (substantive consistency), and she filed all required Forms 1099-NEC (reporting consistency). Terry will need to prove that she satisfies the reasonable basis requirement to receive Act §530 relief. If the IRS disagrees, it may assess tax and penalties under §3509. The IRS will issue a §7436 Notice at the conclusion of the audit if no agreement is reached. If that happens, Terry's only recourse is tax court.

Example 2. Terry hires several individuals who perform services during 2026. Terry treats the workers as employees and pays wages of $1,000 per week plus periodic bonuses. Terry reports the weekly salary as wages for Federal employment tax purposes, and she withholds and pays related employment taxes. Terry files Form 941 and Form W-2. Terry treats any bonuses she pays to workers as exempt from Federal employment tax purposes and she reports the bonus payments on Form 1099-NEC, rather than on Forms 941 and W-2. The IRS audits Terry and concludes that the bonus amounts are wages and proposes an assessment for unpaid payroll taxes.

Solution 2 – Act §530 is not applicable to this situation because the employees are not being reclassified – they are already being treated as employees. There is no controversy over whether the individuals are employees or independent contractors with respect to their services, hence no §530. Terry is not entitled to relief under §530.

Example 3 – Terry has several individuals who perform services for her during 2026. Terry has treated her workers as independent contractors since she started her business 2010. Before she started her own business, Terry worked in the same industry and was always paid as an independent contractor. Terry pays each of her workers $1,000 a week base pay plus a weekly bonus. She doesn't withhold any employment taxes from the workers and reports the total annual amount paid on a separate Form 1099-NEC for each worker. Terry is audited by the IRS and the conclude her workers are employees, not independent contractors.

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Solution 3 – §530 is applicable in this circumstance as Terry paid her workers as independent contractors and the IRS reclassified the workers as employees. This disagreement makes Act §530 applicable to the circumstances. Terry consistently treated the workers as independent contractors (substantive consistency), and she filed all required Forms 1099-NEC (reporting consistency). Terry argues that it is an industry practice that workers in her industry are paid as contractors, not employees. As evidence, Terry uses her own work history, and she is also able to produce an article in an industry publication that confirms she is correct. Assuming Terry prevails, she is not required to pay any tax or penalties for past payments. In addition, Terry is not required to reclassify the workers as employees in future years.

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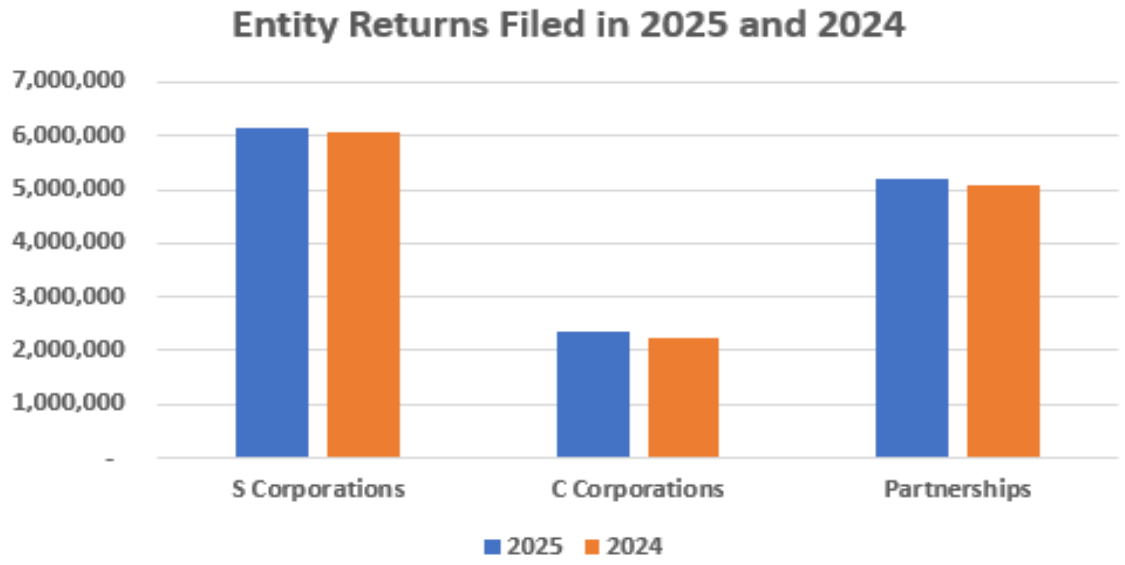
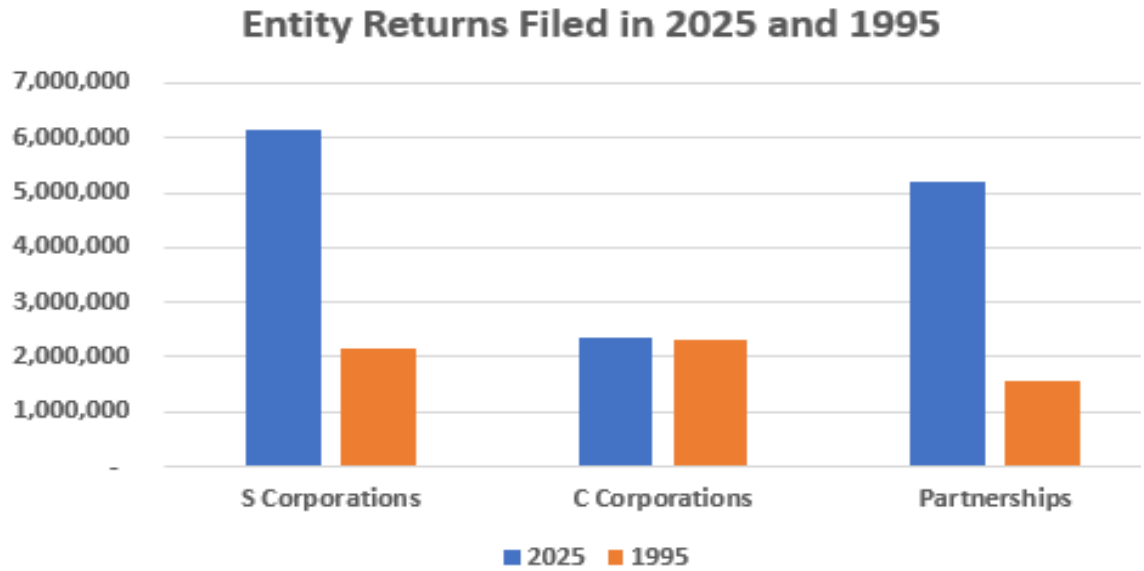
Corporations

Business Entity Filing Overview

S Corporations are by far the most common choice of business entity other than Sole Proprietorships with 6,154,614 filed in 2025, up from 6,080,370 filed in 2024 (2025 IRS Data Book). The number of partnerships started climbing again after a dip down last year. There were 5,215,815 partnership returns filed in 2025, up from 5,100,408 in 2024. There were more C corporation returns filed in 2025 (2,350,205) than 2024 (2,252,027). This means that C corporation returns increased the most by percentage (4.4%).





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Business Entities – Who Gets Audited (IRS 2025 Data Book)

According to the 2025 IRS Data Book, which covers the fiscal year Oct. 1, 2024, through Sept. 30, 2025, the number of 2023 business entity returns audited were:

Entity Type	Returns Filed	Returns Audited	As a %	# of Audits per 10,000 Filed
S corporation	5,440,879	1058	.019%	1.9
C corporation	1,575,851	2303	.146%	14.6
Partnership/LLC	4,575,280	572	.0125%	1.25

Entities and BOI Reporting – 2026 Version!

BOI Reporting Mostly Eliminated By FinCEN (FinCEN Rule 31 CFR Part 1010, Aug. 14, 2026)

Background. Congress passed the Corporate Transparency Act (CTA) in 2019 that required many small and medium size businesses to report ownership information to FinCen. The required information was called "beneficial ownership information" (BOI) and reporting began in 2024. But reporting was halted in 2025, and the Treasury Department indicated that at least some of the reporting requirements would be eliminated.

FinCEN issues final rule on BOI reporting (FinCEN 31 CFR Part 1010, Aug. 14, 2026). The final rule permanently removes the requirement for U.S. companies and U.S. persons to report BOI to FinCEN under the Corporate Transparency Act. The final rule became effective on August 14, 2026. FinCEN also announced that it would delete previously reported information by U.S. persons – now exempt from the reporting requirements – from the beneficial ownership information database.

Final rule summarized. The final rule:

- Adopts the exemptions set out in the interim rule issued in March 2025, making the rollback of beneficial ownership reporting by U.S. companies permanent;
- Exempts U.S. persons who have obtained FinCEN IDs from any obligation to update or correct the information they originally provided to FinCEN to obtain their FinCEN IDs;
- Eliminates the requirement for foreign companies to report U.S. person "company applicants" (i.e., the individuals who helped those foreign companies register to do business in the United States);
- Exempts foreign pooled investment vehicles registered in the United States from reporting the beneficial ownership information of a U.S person in control of the investment vehicle; and
- Confirms that FinCEN will delete information about any individuals – company applicants, beneficial owners, or recipients of a FinCEN ID – that FinCEN reasonably believes is a U.S. person (e.g., the information is linked to a U.S. passport or U.S. driver's license).

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Preparer note. Under the final rule, foreign entities that are reporting companies will still be required to report beneficial ownership information for foreign individuals.

§1202 Stock Update and Review

Overview. Investing in small businesses can be both a high-risk and high-reward endeavor. However, the U.S. tax code offers a significant incentive for those who invest in certain small businesses through §1202. This provision allows for an exclusion of capital gains derived from the sale of qualified small business stock (QSBS). QSBS is stock in a corporation that meets certain requirements set forth by the IRS. QSBS, held by non-corporate investors for five or more years, may be eligible to exclude up to 100% of the capital gains taxable income when they sell their stock.

QSBS qualifications for the exclusion. The gain exclusion only applies to domestic C corporations:

- That have assets of no more than $50 million at the time the stock is issued; and
- Whose stock is acquired at original issue in exchange for money, property (not including stock), or as compensation for services provided to the corporation; and
- That use at least 80% of its assets in the active conduct of one or more qualified trades or businesses during substantially all the investor's holding period for the stock.

C corporation requirement. A domestic C corporation must issue the stock. While this requirement sounds straightforward, what about the client that informs you that their company 'started as an LLC but later became a C corp.' The courts ruled in this situation that stock received in exchange for prior LLC interests may not qualify as QSBS.

Court says LLC to Corp conversion was not original issue (Michael R. Leto v. US, No. CV-20-02180 (USDC AZ 2022). Micheal Leto owned GlobalTranz Enterprises, which began operations in 2003 as an Arizona LLC. Upon conversion, the LLC dissolved and its members received C corporation stock. Michael Leto sold his stock five years later, excluded gain from the sale of the C corporation stock, and saved $528,000 of tax under §1202.

Prior S corporation election dooms 1202 treatment. Before converting to a C corporation, GlobalTranz had elected S corporation tax treatment. The IRS argued this election meant the LLC had already consented to having its membership interests treated as "stock" for federal tax purposes and that the subsequent conversion to a C corporation was stock-for-stock non-original second issuance. §1202(c)(1)(B) requires QSBS to be acquired either for money or property or as compensation for services, but not for stock. If the LLC interests were already stock, the conversion was a stock-for-stock exchange that disqualified the newly issued C corporation shares from QSBS treatment. Leto argued that LLC interests aren't stock under Arizona law (or any state law), and that the entity was never actually an S corporation—it merely elected to be taxed as one. The Court, however, noted that Federal law controls, not state law and, under Federal law, "stock" is defined as shares in associations, joint-stock companies, and insurance companies – all corporate forms distinguished from partnerships.

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Court keeps ruling narrow. The Court noted it didn't need to decide whether LLC interests are stock generally, only whether interests in an LLC that elected S corporation status are stock. It ruled that, by electing S corporation treatment, GlobalTranz was deemed to have contributed its assets to a corporation in exchange for stock, so stock issuance #1. And then the S corp stock was exchanged for the C corp stock – non-original issue.

Preparer note. What triggered the audit? It was what always triggers an audit – Leto didn't claim the §1202 exclusion on his originally filed return. He claimed it later by amending his return when he claimed a $528,099 refund. Yeah, good luck with that!

Original issuance requirement. The stock must be acquired at original issue directly from the corporation — not purchased from an existing shareholder on the secondary market. Qualifying consideration includes money, property (which can include intangible assets such as know-how and intellectual property), and services. Stock acquired in exchange for services must have been taxable to the recipient at fair market value at the time rendered. Options and warrants do not constitute QSBS; the holding period begins only when the underlying stock is issued upon exercise.

Preparer note. For QSBS acquired via gift, inheritance, or distribution from a partnership, the recipient is treated as if the QSBS was acquired in the same manner and at the same time as the original owner. This allows the recipient to retain the stock's QSBS eligibility and gain exclusion. A §368 tax-free reorganization can also preserve QSBS status and the original holding period, subject to careful structuring.

Active business test – 80% test. The issuing corporation must use at least 80% of its assets (by fair market value) in the active conduct of one or more qualified trades or businesses during substantially all the investor's holding period. 'Substantially all' is not defined in §1202 itself; courts and the IRS have generally interpreted the phrase to mean somewhere between 80% and 95% of the relevant period. The requirement applies from issuance through sale — a corporation that pivots into disqualified activities partway through the holding period can retroactively taint the QSBS.

Start-up and research activities receive a grace period: under §1202(e)(2), assets used in start-up or R&D activities are treated as used in a qualified trade or business even if the company has not yet generated gross income. Similarly, working capital held as reasonably required for the business's operating needs counts toward the 80% test under §1202(e)(6)(A), though assets held as investments beyond two years generally do not.

Disqualified businesses. Congress, having decided to encourage small business investment, simultaneously drew up a robust list of businesses that do not count as 'qualified.' The following are disqualified from QSBS treatment and are unchanged under the OBBBA:

- **Professional Services** – health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, and brokerage services. Also disqualified: any business whose principal asset is the reputation or skill of one or more employees.

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- **Financial Businesses** – banking, insurance, financing, leasing, and investing.
- **Natural Resources & Farming** – farming, oil and gas extraction, and businesses involving the extraction of natural resources.
- **Hospitality** – hotels, motels, and restaurants.
- **Real Property** – any business involving the ownership, dealing, or renting of real property.

Example. Marcus Delgado operates ClearPath Strategy Corp., a C corporation providing management consulting to Fortune 500 companies. ClearPath issues stock to Alejandro, an outside investor, for $500,000 in 2026 when ClearPath meets the asset and active business tests. Alejandro holds the stock until 2033, 7 years, at which time he sells the stock for $5,000,000. At the sale, ClearPath's revenue was derived entirely from client engagements billed at rates tied to Marcus's personal expertise and relationships. The IRS would argue, and likely win, that ClearPath's principal asset is Marcus's reputation or skill, preventing Alejandro from benefitting from §1202. His entire $4.5 million gain is taxable.

Capital gain exclusion for QSBS owners.

The exclusion for QSBS is subject to several rules, including:

- For stock acquired after September 27, 2010, the exclusion is 100%.
- The maximum gain eligible for the exclusion is ***the greater of*** $10 million or 10x the adjusted basis of the stock.
- The exclusion applies only to capital gains – ordinary income from dividends or interest is not eligible.

The preferential tax treatment for QSBS was originally enacted in 1993 and was either a 50% or 75% exclusion, depending on the date the stock was issued. Since Sept. 27, 2010, the exclusion for a qualified gain has been 100%.

Reporting requirements. Shareholders must report their pro rata share of the adjusted basis and sales price of the QSBS. The dates the QSBS was bought and sold must also be reported. For partnerships, each partner individually determines if they qualify for the §1202 exclusion and reports their share of the gain on Schedule K-1.

Significant Changes to §1202 Benefits. The OBBBA revised and enhanced the QSBS §1202 provisions, making this an even more important planning tool than it's been in the past. The most meaningful change is there is now a tiered gain-exclusion regime that allows a 50%, 75%, and 100% exclusion that changes depending on how long the QBSB is held. Under pre-OBBBA law, if the taxpayer held QSBS less than 5 years, no exclusion was available. Under the new law, for stock acquired on or after July 4, 2025:

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- QSBS held at least 3 years – gain exclusion is 50%.
- QSBS held at least 4 years – gain exclusion is 75%.
- QBSB held at least 5 years – gain exclusion is 100%.

QSBS acquired prior to July 4, 2025, and held at least 5 years, may be eligible for at least a 50% capital gain exclusion. The exclusion increases to 75% if the QSBS was acquired after Feb. 17, 2009, and before Sept. 28, 2010, and then 100% if the QSBS was acquired after Sept. 27, 2010.

Preparer note. It appears the OBBBA incorporates tacking principles under §1223 for purposes of determining when a taxpayer "acquired" QSBS. Generally, this means that stock-for-stock exchanges – such as a tax-free reorganization – will not allow taxpayers holding pre-OBBBA QSBS to convert such stock into post-OBBBA QSBS.

QSBS Acquisition Date	Minimum Holding Period	Gain Exclusion %
Aug. 11, 1993 to Feb. 17, 2009	**5 years**	**50%**
Feb. 18, 2009 to Sept. 27, 2010	**5 years**	**75%**
Sept. 28, 2010 July 4, 2025	**5 years**	**100%**
July 5, 2026 and beyond	**3 years**	**50%**
July 5, 2026 and beyond	**4 years**	**75%**
July 5, 2026 and beyond	**5 years**	**100%**

Excludable gain limits increased. OBBBA increased the gain exclusion dollar limit for QSBS acquired after July 3, 2025, from $10 million to $15 million. The new limit is subject to annual inflation adjustments starting in 2027. However:

- Gain on pre-OBBBA QSBS continues to be subject to the original $10 million cap.
- Once the shareholder claims the entire $15 million limit, subsequent inflation adjustments do not provide additional exclusions – the taxpayer's limit has been reached.

10x basis rule remains unchanged. The long-standing 10x basis limitation was not changed. The maximum exclusion remains the ***greater of*** 10x basis or $15 million. For those whose filing status is MFS, the limit is reduced to $7.5 million.

Gross asset limit increased. For stock to qualify as QSBS, the issuing corporation must be a "qualified small business," which, among other tests, requires that the corporation's "aggregate gross assets" not exceed a statutory threshold at any time before and immediately after the stock issuance. OBBBA increases this "aggregate gross assets" threshold from $50 million to $75 million for stock issued after July 4, 2025. The new threshold is subject to inflation adjustments beginning in 2027.

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OBBBA Change	Pre-Enactment QSBS (issued on/before 7/4/25)	Post-Enactment QSBS (issued after 7/4/25)
Per-issuer gain exclusion cap	$10 million	$15 million (inflation-adjusted from 2027)
10x basis limit	Unchanged	Unchanged
Aggregate gross assets ceiling	$50 million	$75 million (inflation-adjusted from 2027)
Tiered holding periods (50%/75%)	Not available	Available (3 and 4 year holds)
AMT preference treatment	Excluded gain is NOT AMT preference	Excluded gain is NOT AMT preference
MFS halved cap	$5 million	$7.5 million

Summary and reminders:

- OBBBA confirmed that gain excluded under the new 50% and 75% tiers, as well as under the existing 100% rule, is not an item of tax preference for AMT.
- The new tiered gain exclusion regime, the $15 million per-issuer cap, and the $75 million aggregate gross assets ceiling each apply only to stock acquired or issued after July 4, 2025.
- Taxpayers holding separate blocks of QSBS in a single issuer acquired both before and after OBBBA's enactment, must track each QSBS block separately to determine the applicable exclusion percentage, dollar cap, and holding-period requirement.
- OBBBA does not alter various other QSBS rules, such as the prohibition on QSBS benefits for certain non-qualifying businesses and generally consisting of certain service-oriented businesses as well as certain financial businesses and those involving farming, natural resources, and hospitality.

State Tax Conformity — The Other Shoe!

§1202 is a Federal provision that states are free to adopt or ignore and several states enthusiastically to ignore it. A taxpayer who achieves a $15 million Federal exclusion may still owe full state income tax on the same gain, depending on their state of residence at the time of sale. ***Most states not listed below fully conform to the §1202 rules.***

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State	Conformity Status	Notable Detail
California	Does NOT conform	Full state tax up to 13.3%. No QSBS exclusion.
Pennsylvania	Does NOT conform	QSBS gain taxed at full PA rate.
Alabama	Does NOT conform	No state equivalent to §1202.
Mississippi	Does NOT conform	No state equivalent to §1202.
New Jersey	Conforms from 2026	Signed 6/30/25; effective for tax years beginning 1/1/26.
New York	Conforms	Federal exclusion generally respected for NY purposes.
Hawaii	Partial conformity	50% exclusion only, even when federal allows 100%.
Massachusetts	Partial conformity	Historically limited; verify current rules.
Texas / Florida	No state income tax	Federal exclusion = full exclusion.

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QSBS Qualification Checklist

All the following questions must be answered 'Yes' for the §1202 exclusion to apply. A single 'No' answer is generally disqualifying. Think of it as a checklist where partial credit is not available.

Client:_____ **Date of Sale:**_____

Prepared By:_____ **Date Prepared:** _____

QSBS Exclusion Summary (check applicable)		
100% exclusion — acquired after 9/27/2010, held >5 years	☐	
75% exclusion — acquired after 2/17/09 and before 9/28/10, held >5 years	☐	
50% exclusion — acquired after 8/10/93 and before 2/18/09, held >5 years	☐	
POST-OBBBA: 50% exclusion — issued after 7/4/25, held >3 but <4 years	☐	NEW
POST-OBBBA: 75% exclusion — issued after 7/4/25, held >=4 but <5 years	☐	NEW
AMT: QSBS exclusion is NOT a preference item (all tiers, per OBBBA)		
Annual exclusion: lesser of $10M ($15M if issued after 7/4/25) or 10x adjusted basis		

1. Was stock initially acquired by a non-corporate taxpayer? (Eligible: individuals, trusts, estates, and pass-through entities)
    a. S corporations may not issue QSBS; any period during which the issuing entity was an S corporation disqualifies the stock from the 'substantially all' active business test.
    b. Foreign taxpayers and tax-exempt organizations do not qualify for the exclusion.
    c. Partners of a partnership that holds QSBS must have been partners at the time the partnership acquired the stock.

2. Was the entity a C corporation for substantially all its existence up to the date of sale?
    a. Courts interpret 'substantially all' as approximately 80–95% of the relevant period.

3. Was the entity a C corporation at the time of sale?

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4. Was the stock acquired directly from the corporation? (not a secondary-market purchase).

    a. Per Leto v. US, a stock-for-stock exchange on conversion from LLC/S corp does NOT satisfy this requirement.
    b. Asset contributions to a newly formed C corp in a §351 exchange generally DOES satisfy this requirement.

5. Was the stock acquired with cash, property, or services?

    a. Property may include intangible assets such as know-how and intellectual property.
    b. Stock acquired for services must have been taxable at FMV to the acquirer at time rendered.
    c. Qualifies if acquired via conversion from LLC ownership interest in a properly structured §351 exchange.
    d. Stock acquired via grant that is vested when issued, or for which a §83(b) election was made, qualifies.
    e. Stock acquired via inheritance, gift from a qualified owner, or distribution from a partnership retains QSBS characteristics.

6. Was the stock sold?
    a. Options, warrants, and unvested amounts do not qualify as QSBS.
    b. Holding period for exercised options or warrants begins on the date of stock issuance, not the grant date.
    c. Asset sale elections (e.g., §338) may void QSBS treatment — consult counsel before signing.
    d. Redemptions and liquidating distributions are generally treated as stock sales for §1202 purposes.

7. Was the stock held for at least 3 years (Post-Enactment QSBS) or more than 5 years (Pre-Enactment QSBS)?

    a. §1045 allows proceeds from a QSBS sale before the 5-year holding period to be reinvested in replacement QSBS on a tax-deferred basis.
    b. §368 tax-free reorganizations can preserve QSBS status and allow holding period tacking.
    c. Short positions during the holding period void QSBS qualification.
    d. Per Ju v. US, the holding period begins when legal ownership is established — not when equitable or contractual rights are believed to exist.

8. Was a short position or offsetting position avoided during the holding period?

    a. Any short sale or put option on substantially identical stock during the holding period disqualifies QSBS.

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9. Did the issuing entity have $50 million or less in aggregate gross assets at and immediately after issuance ($75 million for QSBS issued after 7/4/25)?

a. Cash and contributed property (at FMV) are included in the test.
b. Use cash plus adjusted tax basis of other assets.
c. Exceeding the threshold in later years does not affect QSBS status retroactively — the test is a snapshot at issuance.
d. Per Ju, the taxpayer bears the burden of proving compliance; retain contemporaneous balance sheets.

10. Were 80% or more of corporate assets used in a qualified trade or business for substantially all the holding period?

a. Qualified businesses include technology, manufacturing, and companies earning royalties from computer software.
b. Disqualified: health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, businesses whose principal asset is reputation or skill of employees.
c. Disqualified: banking, insurance, financing, leasing, investing.
d. Disqualified: farming; oil and gas extraction; hotels, motels, and restaurants.
e. Disqualified: ownership, dealing in, or renting real property.
f. Start-up/R&D assets are treated as used in a qualified business under §1202(e)(2).

11. Did the corporation avoid holding stock worth more than 10% of the corporation's assets?

a. Certain de minimis portfolio investments are permitted; significant stock holdings can disqualify the QSBS.

12. Did the corporation avoid holding real property not used in an active trade or business more than 10% of corporate assets?

Example – the $15 million cap, the 10x Limit, and multiple investors. Three investors – Haruto, Celine, and Raj – invested in TerraLoop Corp., a C corporation, in August 2025 (post-enactment QSBS). Haruto invested $500,000 for 5% of the stock; Celine invested $1,500,000 for 15%; Raj invested $200,000 for 2%. TerraLoop was acquired in 2031, resulting in the following gains:

Haruto: $3.5M (10x basis = $5M; cap = $15M; full gain excluded).
Celine: $10.5M (10x basis = $15M; cap = $15M; full gain excluded).
Raj: $1.4M (10x basis = $2M; cap = $15M; full gain excluded).

All three investors pay $0 Federal tax from the sale of their TerraLoop stock. The §1202 cap is per taxpayer per issuer – each investor has their own cap.

Preparer note. If TerraLoop's aggregate gross assets exceeded $75M at issuance, none of these investors would qualify. Confirm the balance sheet at closing.

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Ordinary Loss Allowed on Stock Disposition (§1244)

The §1244 small business stock provision allows shareholders of domestic small business corporations to deduct any losses sustained when they dispose of the small business stock as ordinary, not capital, losses. To receive this beneficial treatment, the Code prescribes specific requirements for the corporation issuing the small business stock, the stock itself, and the shareholders of the corporation.

Corporation requirements. The corporation issuing the stock must qualify as a domestic small business corporation. This means the corporation must:

- Be created under the laws of the United States;
- Have its aggregate capital must not exceed $1,000,000 at the time the §1244 stock is issued to its shareholders. For this purpose, the first taxable year in which the capital of the corporation exceeds $1,000,000 is called the transitional year, when the corporation must designate which shares issued qualify for §1244 and which don't. For example, if a newly formed corporation received $2,000,000 for its initial issue of stock, it could designate up to $1,000,000 of its stock as qualified §1244 stock.
- During the five most recent years ending before the date the loss on its stock was sustained, derived more than 50% of its gross receipts from sources other than passive investment income. This effectively limits the §1244 treatment to the stock of corporations actively engaged in a trade or business. The gross receipts test does not apply if the corporation's gross income was less than its business deductions for the entire period for which gross receipts are measured.
- Maintain adequate records to establish §1244 stock eligibility.

Stock requirements. Common stock (and preferred stock issued after July 18, 1984) qualifies as §1244 stock. The stock must be issued, and the consideration paid by the shareholder must consist of money or other property, but not services. Stock and other securities are not "other property" for this purpose. However, cancellation of indebtedness may be sufficiently valid consideration.

Shareholder requirements. §1244 is only available for losses sustained by shareholders who are individuals. Stock held by corporations, trusts, or estates do not qualify. Subject to limited exceptions, the benefits of §1244 are only available to individuals who acquire the stock by issuance from a domestic small business corporation and are not available to a subsequent transferee of the stock. Partnerships may qualify to the extent the partners are individuals. Generally, all transfers of §1244 stock by the shareholder, whether in a taxable or nontaxable transaction, whether by death, gift, sale or exchange, terminate §1244 status.

Ordinary loss treatment. Once all the requirements of §1244 stock are met, ordinary loss treatment for losses on a sale or exchange of §1244 stock is permitted if the loss would otherwise be treated as a capital loss. The amount of ordinary loss that an individual taxpayer may realize by reason of the small business stock provision is subject to certain limitations. Any amount of §1244 loss more than this limitation is treated as a capital loss. For losses incurred in taxable years beginning after 1978, the maximum amount that a taxpayer may claim as an ordinary loss

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for all losses sustained on §1244 stock ***in a taxable year*** is $50,000, generally, or $100,000 if a joint return is filed. The §1244 ordinary loss is reported on Part II of Form 4797.

Example. Marlena Voss contributes real property with an adjusted basis of $180,000 and an FMV of $120,000 to Voss Craft Corp., a qualifying small business corporation. She receives 1,200 shares of common stock as her sole consideration. Three years later, Voss Craft fails and the shares become worthless. Marlena's §1244 ordinary loss is limited to $120,000 (the FMV at transfer), not $180,000 (her adjusted basis). The $60,000 built-in loss evaporates entirely. Because her §1244 loss does not exceed the $100,000 joint-return limit, the full $120,000 is deductible as an ordinary loss in the year of worthlessness. Had she contributed cash of $120,000 instead, the result would be identical. The lesson: contributing appreciated property to a small business corporation costs nothing under §1244; contributing depreciated property sacrifices the built-in loss permanently.

Basis increase rules and the non-§1244 taint. When a shareholder makes subsequent capital contributions to a corporation after the original stock issuance, those contributions increase the shareholder's basis in the stock. However, §1244(d)(2) provides that any increase in basis through capital contributions or otherwise is treated as allocable to stock that is not §1244 stock. This creates a split-basis situation where the original issuance amount retains §1244 character, but subsequent basis increases do not.

Example. Dylan Park originally invests $80,000 in Sunrise Analytics Corp. for 800 shares (§1244 stock, at $100 per share). Two years later, with the company struggling, Dylan makes an additional $40,000 capital contribution to keep the business alive. Dylan's total basis is $120,000, but only $80,000 is §1244 stock basis; the $40,000 basis increase is non-§1244 basis. When Sunrise fails and the shares become worthless, Dylan sustains a $120,000 loss, of which $80,000 is an ordinary loss under §1244 and $40,000 is a capital loss. The $40,000 capital loss is subject to the standard $3,000 annual limitation. Dylan's tax advisor confirms that additional equity injections after original issuance do not gain §1244 protection retroactively.

Reporting requirements – Form 4797. Ordinary losses from the sale, exchange, or worthlessness of §1244 stock are reported on Form 4797 (Sales of Business Property), Line 10. The description field should read "Losses from §1244 stock." The maximum amount that may be reported as an ordinary loss on Line 10 is $50,000 ($100,000 on a married filing jointly return). Any amount more than the annual limit is a capital loss and flows to Schedule D. The loss is not reported on Schedule D as a capital loss. It is specifically classified as a business loss on Form 4797, which means it is included in the computation of adjusted gross income as a trade or business deduction – an important distinction for purposes of computing the self-employment tax, the net investment income tax (§1411), and various AGI-based phase-outs.

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Recordkeeping requirements. Regulation §1.1244(e)-1 imposes specific recordkeeping obligations. Investors must maintain adequate records to:

1. Distinguish §1244 stock from other stock in the same corporation (particularly where multiple classes or tranches have been issued over time).
2. Establish that the stock was originally issued to the taxpayer (not purchased from another shareholder).
3. Show the amount paid for the stock and the nature of the consideration (cash or property).
4. Demonstrate that the corporation met the $1,000,000 capital test at the time of issuance.
5. Confirm that the corporation satisfied the 50% gross receipts test for the five taxable years (or shorter period) preceding the loss.

C Corporation Charitable Deductions (§170(b)(2))

Overview. C corporations have historically been allowed to deduct charitable contributions made to qualifying organizations up to 10% of the C corporation's taxable income for the year the contributions were made. For this purpose, corporate income is determined before the charitable contribution deduction, NOLs, capital loss carry backs, etc. Contributions that exceed the 10% limit may be carried forward for up to 5 years.

Qualified donations. Donations must be made to a qualified §501(c)(3) nonprofit or other eligible entity. Donations of cash are valued at face amount; non-cash property is generally valued at fair market value, though certain rules reduce the deduction for ordinary income property, inventory, or appreciated assets.

2026 changes to contribution calculation for corporations (§170(b)(2)(i)). For tax years beginning after 2025, corporate charitable contributions have two limits:

1. Only contributions more than 1% of the corporation's taxable income are deductible, and

2. Contributions more than 10% of the corporation's taxable income continue to be disallowed and may still be carried forward for up to 5 years.

Contributions disallowed due to the 1% floor are lost unless there is an overall carry forward.

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Example 1. Carefour, a C corp., has 2026 taxable income (before charitable deductions) of $1,000,000. Carefour made charitable contributions in 2026 of $80,000. Carrefour's charitable contribution deduction is calculated:

Step 1 – calculate the 1% floor: $1,000,000 x 1% = $10,000
Step 2 – calculate maximum deductible contributions: $80,000 total less $10,000 floor = $70,000
Step 3 – apply the 10% cap: $1,000,000 x 10% = $100,000, which is greater than $70,000
Step 4 – calculate the deduction: $80,000 less $10,000 floor = $70,000
Step 5 – calculate any carryforward: none in this example
Step 6 – reduce taxable income by the contribution deduction: $1,000,000 - $70,000 = $930,000

Preparer note. As there are no other carryforwards, the $10,000 floor amount is simply not deductible, and it goes away – it is not carried forward under this scenario because contributions did not exceed the 10% cap.

Example 2. Carefour, a C corp, has taxable income (before charitable deduction) of $2,000,000 in 2026. Carefour made charitable contributions in 2026 of $280,000. Carefour's charitable contribution deduction is calculated:

Step 1 – calculate the 1% floor: $2,000,000 x 1% = $20,000
Step 2 – calculate maximum deductible contributions: $280,000 total less $20,000 floor = $260,000
Step 3 – apply the 10% cap: $2,000,000 x 10% = $200,000
Step 4 – calculate the deduction: $280,000 less $200,000 cap less the $20,000 floor = $180,000
Step 5 – calculate any carryforward: $280,000 total contributions less $180,000 contribution deduction = $100,000
Step 6 – deduct the contribution deduction to arrive at taxable income: $2,000,000 - $180,000 = $1,820,000

Preparer note. Note that in Example 2, the contribution carryforward is $80,000 ($280,000 total contributions minus the $180,000 of contributions claimed). Essentially, the contributions not allowed due to the 1% floor are included in the carried forward to 2027. This prevents the same contributions from being limited by the floor in multiple years.

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2026 Draft S Corporation K-1

NOTE – very little change from 2025.

Final K-1 ☐ Amended K-1 ☐ OMB No. 1545-0123

Schedule K-1 (Form 1120-S) 2026

Department of the Treasury
Internal Revenue Service

For calendar year 2026, or tax year beginning / / 2026 ending / /

Shareholder's Share of Income, Deductions, Credits, etc. See separate instructions.

Part I Information About the Corporation

A Corporation's employer identification number

B Corporation's name, address, city, state, and ZIP code

C IRS Center where corporation filed return

D Corporation's total number of shares
Beginning of tax year . . . . . .
End of tax year . . . . . .

Part II Information About the Shareholder

E Shareholder's identifying number

F1 Shareholder's name, address, city, state, and ZIP code

F2 If the shareholder is a disregarded entity, a trust, an estate, or a nominee or similar person, enter the individual or entity responsible for reporting:
TIN Name

F3 What type of entity is this shareholder?

G Current year allocation percentage . . . %

H Shareholder's number of shares
Beginning of tax year . . . . . .
End of tax year . . . . . .

I Loans from shareholder
Beginning of tax year . . . . . $
End of tax year . . . . . $

For IRS Use Only

Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss)	13	Credits
2	Net rental real estate income (loss)		
3	Other net rental income (loss)		
4	Interest income		
5a	Ordinary dividends		
5b	Qualified dividends	14	Schedule K-3 is attached if checked . . . . . ☐
6	Royalties	15	Alternative minimum tax (AMT) items
7	Net short-term capital gain (loss)		
8a	Net long-term capital gain (loss)		
8b	Collectibles (28%) gain (loss)		
8c	Unrecaptured section 1250 gain		
9	Net section 1231 gain (loss)	16	Items affecting shareholder basis
10	Other income (loss)		
		17	Other information
11	Section 179 deduction		
12	Other deductions		

18 ☐ More than one activity for at-risk purposes*
19 ☐ More than one activity for passive activity purposes*

* See attached statement for additional information.

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Non-Taxable Reorganizations Under §355 (§355)

Overview. IRC §355 provides that, if certain requirements are met, a distribution of stock, or stock and securities, of one or more controlled corporations to the distributing corporation's shareholders and/or security holders, may be completed without the distributees recognizing gain or loss. No gain or loss is recognized by the distributing corporation upon the distribution of qualified property that is not in pursuance of a plan of reorganization. The term "qualified property" is defined as any stock or securities in a controlled corporation. If the distributing corporation distributes property other than qualifying property in a §355 transaction and the fair market value of the other property exceeds the distributing corporation's adjusted basis in the other property, gain is recognized by the distributing corporation as if the property were sold to the distributee at its fair market value.

The nonrecognition treatment applies to most §355 transactions, including:

- Spin-offs, which are pro rata distributions of stock of the controlled corporation to shareholders of the distributing corporation;
- Split-offs, which are distributions of stock of a controlled corporation to some (but not all) shareholders of the distributing corporation in exchange for some or all their stock of the distributing corporation; or
- Split-ups, which are liquidating distributions in which the distributing corporation distributes to its shareholders, either pro rata or non-pro rata, the stock of more than one controlled corporation.

IRS Reverses Course – Form 7216 and Related Reporting Gone (Rev. Proc. 2025-30)

Background (§355(a)(1)). If certain requirements are met, a corporation (Distributing corp.) may distribute a) stock of a controlled corporation (Controlled corp.) to Distributing's shareholders, or b) controlled stock and securities to Distributing's shareholders and security holders, without recognition of gain or loss to, or inclusion of any amount in the income of the shareholders or security holders. The law provides that no gain or loss is recognized to Distributing corp. upon a distribution of Controlled corp. stock, or stock and securities, to which §355 (or so much of §356 as relates to §355) applies and which is not in pursuance of a plan of reorganization.

Divisive reorganization. In a reorganization under §§355 and 368(a)(1)(D) (Divisive Reorganization), Distributing corp. transfers property to Controlled corp. in exchange for consideration (§361 Consideration). The §361 Consideration received by Distributing corp. includes Controlled corp. stock and may include money, securities, or other debt obligations of which Controlled corp. is the obligor, and other property. Controlled corp. also may assume liabilities of Distributing corp. To complete the Divisive Reorganization, Distributing corp. distributes the Controlled corp. stock, and possibly other §361 considerations, to its shareholders and may distribute §361 Consideration in satisfaction of its obligations to holders of its securities or to other creditors.

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IRS decided additional reporting was required. The IRS concluded the §355 reporting requirements needed improvement to ensure that transactions intended to qualify under §355 (and such related provisions) satisfied the requirements for non-recognition treatment. Accordingly, the IRS issued proposed regulations in 2024 that revised §1.355-5 so that all covered filers will be required to file an ***annual report*** with §355 information. The IRS released a draft Form 7216 – Multi-Year Reporting Related to §355 in 2025. The form was expected to become final in December 2025 and was to be required to be attached to the covered filer's 2025 and beyond Federal income tax returns.

Form 7216 and all related reporting abandoned (Rev. Proc. 2025-30). The IRS completely reversed course on the reporting requirements and Form 7216 in Rev. Proc. 2025-30. This RP reinstated guidance originally provided in Rev. Proc. 2018-53 and Rev. Proc. 2017-52. Effectively, this means we go back to the pre-2025 rules, which means no reporting requirements and the IRS will issue rulings on whether a particular transaction qualifies. Form 7216 has been withdrawn and is no longer applicable.

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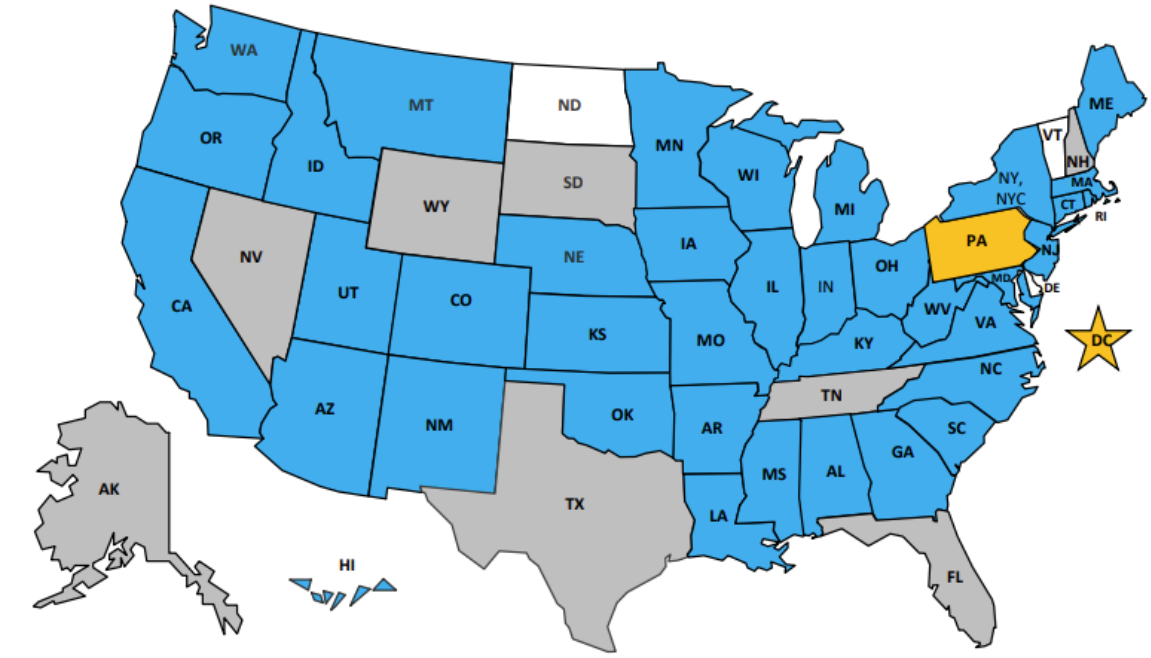
Pass Through Entity Tax - SALT Tax Deduction Workarounds

The Tax Cuts and Jobs Act (TCJA) limited the annual Schedule A deduction for state and local taxes (SALT) to $10,000. OBBBA increased the SALT tax limit to $40,000 in 2025 - 2029. Early versions of the OBBBA eliminated the deduction of state income tax at the entity level for passthrough entities (i.e., PTE tax). The final OBBBA version, however, kept the PTE tax deduction intact for the foreseeable future. The AICPA produced a chart that identifies the states that have adopted PTE tax deductions:

As of June 1, 2026



38 states (& 1 locality) that enacted a PTE tax since TCJA SALT deduction limitation, effective for 2024 (or earlier) unless noted:
AL, AR, AZ, CA[3], CO[2], CT[1], HI, GA, IA[2], ID, IL[4], IN, KS, KY, LA, MA[2], ME[4], MI[2], MD, MN[6], MO, MS, MT, NC, NE, NJ, NM, NY, OH, OK, OR[6], RI, SC, UT[4], VA[4], WA[5], WI, WV, and NYC

1 state and 1 locality with active proposed PTE tax bills for 2026 (PA - SB 396, HB 1610, and DC - B26-0324)

8 states with no owner-level personal income tax on PTE income:
AK, FL, NH, NV, SD, TN, TX, and WY

3 states with an owner-level personal income tax on PTE income that have not yet enacted and/or do not have an active proposed bill on PTE taxes:
DE, ND, and VT

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PTE in 2026 and beyond. Now that PTE is in the law, it is up to the states to adopt legislation to allow its residents and non-residents to take full advantage. While 38 states previously passed legislation to enact PTE deductions, many set December 31, 2025, as the PTE deduction expiration date to coincide with the expiration of the SALT tax limit under the TCJA

What taxes are included? Only state and local taxes specifically assessed against the entity qualify, not taxes assessed to the owners. This means mandatory withholding and composite tax payments would not qualify as these tax payments are mechanisms established by states to ease the collection and payment of individual tax obligations but are not specifically entity level taxes.

So, could a resident individual have the entity pay their state taxes in their own state of residency? Yes, but only if the state assesses the tax at the entity level. Could an individual have the entity pay their state estimated taxes and deduct them as a business expense? No, not unless the state tax is assessed against the partnership or S corporation directly instead of against the individual owners. Could the partnership or S corporation pay and deduct any state income tax due with the filing of the return? Only if the tax was specifically assessed against the partnership or S corporation and not if it is merely a mandatory individual withholding or comprehensive (Comp) payment.

PTE planning. Some assume that the new $40,000 SALT limit makes the PTE deduction irrelevant. However,

1. The $40,000 SALT tax limit is AGI limited, meaning some taxpayers will have a lower limit due to a relatively high AGI. If any state income can be deducted on the entity return, there is no AGI limitation. Additionally, deducting the tax at the entity level reduces AGI, allowing more SALT deduction on Schedule A.

2. Not everyone itemizes deductions. Using PTE allows non-itemizers to benefit from state income tax paid on profits from pass-through entities as the deduction is allowed against K-1 income, not as an itemized deduction.

3. Taxpayers with high tax payments (e.g., high amounts of real estate taxes, state income taxes, etc.) may benefit from PTE and the higher SALT limit.

Preparer note. If there is no other reason, we would all agree that a deduction pre-AGI is always preferential to a deduction anywhere else in the return. The author has yet to find any reason to forgo PTE when it is available.

Preparer caution. PTE payments in most states are elective, not required. If some owners elect to use PTE and others do not, the IRS hasn't given any guidance as to whether the tax payments create unequal distributions. Practitioners who have S corporation clients where some owners elect out of PTE and others elect in need to keep the problems associated with unequal distributions in mind.

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Example. Dana and Janine live in Wisconsin and their AGI is $450,000. Dana's income includes S corporation earnings of $200,000. Dana and Janine have itemized deductions of:

Mortgage interest	$15,000
SALT – state income tax	$35,000
SALT – real estate tax	$15,000
Charity	$10,000
Total	$75,000

Dana and Janine's tax, with and without PTE, is calculated:

	W/O PTE	With PTE
AGI	$ 450,000	$ 434,700
Itemized	($ 65,400)*	($ 59,700)+
QBI	($ 40,000)	($ 36,940)**
Taxable income	$ 344,600	$ 338,060
Federal income tax	$ 68,494	$ 66,828

** PTE reduces QBI as K-1 income is reduced
*$15,000 interest + $40,400 SALT + $10,000 charity)
+$15,000 interest + $34,700 SALT + $10,000 charity)

Split-Dollar Life Premiums Taxable to Shareholder – No Deduction for Corporation (Peter E. McGowan et al v. U.S., 6th Circuit, No. 24-3228)

Peter McGowan was a dentist who operated his dental practice as a C corporation – Peter E. McGowan DDS, Inc. (PEM). The corporation entered a complex life insurance arrangement where it annually contributed $50,000 to two subtrusts: one a life insurance policy covering McGowan, payable to McGowan's wife if he died; and the other could potentially be donated to the Toledo Zoo, a charity. PEM deducted the entire $50,000 premiums and McGowan reported approximately $12,000 of the premiums as taxable income. McGowan did not report the value of the death benefit nor the policy cash value as income on his tax returns.

IRS says policies subject to split-dollar rules and assesses tax (§1.61-22 – aka, the "Split-Dollar Reg"). The IRS asserted that PEM's insurance policies fell under the "split-dollar" regulations, which required McGowan to include the full value of the policy's economic benefits in gross income. The IRS also denied the deductions for the premiums paid by PEM. The combined 2014 and 2015 additional tax assessments were approximately $100,000.

Court says nice try! 6th Circuit Court of Appeals ruled that the split-dollar regulation applied to McGowan's arrangement, requiring him to include the full value of the policy's economic benefits in his gross income and prohibiting the dental practice from deducting the premiums. The use of trusts to hold the policies, even with an independent third-party trustee, did not exempt PEM's and McGowan's arrangement from the split-dollar rules. Lastly, the Court held that McGowan's income from the arrangement should be treated as a shareholder distribution rather than services-based compensation, entitling him to a refund due to the lower tax rate on dividends.

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Constructive Dividends

Overview. A constructive dividend is a distribution of corporate earnings to a shareholder that is disguised as a deductible corporate expense (e.g., salary, rent, interest, management fees, or other payments). When the IRS disallows the deduction, the corporation faces higher taxable income, and the shareholder is treated as having received taxable dividend income. The result is double taxation with no compensating deduction for the corporation.

The chart below outlines the most common categories of payments challenged as constructive dividends. All share the same structure – a transfer of corporate value to or for the benefit of a shareholder, not justified by an arm's-length business purpose.

Category	Description	Key Requirements to Avoid Reclassification
Below-market loans to shareholders	Interest-free or below-AFR loans; imputed interest treated as distribution	Written note; stated interest at AFR; documented repayment schedule; actual payment history
Cancellation of shareholder debt	Forgiven shareholder loans treated as distributions	Must document business purpose for forgiveness; distinguish from gifts
Below-FMV transfers of corporate property	Selling corporate property to shareholders below FMV	Sales at documented FMV; independent appraisal for significant assets
Personal expenses paid by corporation	Food, fuel, personal travel, home improvements, personal vehicle, club dues	Accountable plan with business connection; proper documentation; repayment of non-business amounts
Unreasonable rents paid to shareholder	Corporation paying above-FMV rent to shareholder-owned property	Lease at documented market rent; independent comparison
Unreasonably high compensation to shareholder-employees	Salary exceeding FMV of services — excess reclassified as dividend	Independent investor test; multi-factor analysis; compensation study
Management fees to related entities with no economic substance	Fees paid to related companies for services not actually rendered	Written contracts; invoices; evidence services were performed
Corporate payment of personal life insurance premiums	Corporation paying premiums on policies owned by or benefiting shareholder personally	Deductible only if corporation is NOT a beneficiary and amount is reasonable compensation

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Factors used to determine if loans to shareholders are distributions (*Bobby Welch v. Comm.*, 9th Cir., No. 98-70930, March 1, 2000*).* The Court uses seven factors to determine whether a distribution was a loan, a taxable dividend, or AAA distribution:

1. Was the promise to repay evidenced by a note or other instrument;
2. Was interest charged;
3. Was a fixed schedule for repayments established;
4. Was collateral given to secure payment;
5. Were repayments made;
6. Whether the borrower had a reasonable prospect of repaying the loan;
7. Whether the lender had sufficient funds to advance the loan; and
8. Whether the parties conducted themselves as if the transaction were a loan.

Cases.

Taxpayers held criminally liable (Albert and Wendy Hee v. Comm. USTC No. 24068-22, 24077-22, June 23, 2026). Albert Hee as the sole shareholder and CEO of Waimana, Inc. from 2007 – 2012, the years at issue. Hee was found guilty of a variety of criminal charges related to these returns, including fraud and impeding an IRS investigation. The Court found that Hee utilized Waimana to pay personal expenses while accounting for these payments as business expenses. He also had Waimana pay wages to his children despite his children doing little or no work for Waimana. The Court ruled that Hee underpaid taxes for tax years 2007 through 2012, filed false tax returns for tax years 2007 through 2012 and assessed civil penalties in addition to the criminal penalties.

Personal meals and fuel disallowed (David Alioto v. Comm., TC Memo 2025-125). David Alioto was the CEO of Probity Enterprises, a C corporation. Probity paid Alioto's personal expenses – primarily food and fuel – totaling approximately $15,000 over the two tax years in question (2014 and 2015). Alioto claimed the expenses were business-related but presented no evidence to prove it. The Court ruled the payments were constructive dividends tax to Alioto and non-deductible for Probity. The case reinforces the fundamental rule: payments made primarily for the benefit of the shareholder, rather than for a legitimate corporate business purpose, are constructive dividends regardless of how they are recorded on the corporate books. Practitioners should advise C corporation clients to maintain strict documentation of business purposes for all reimbursements to shareholder-employees.

See also: Walter and Kimberly Prezioso v. Comm., TC Memo 2026-63, where shareholder employee claimed significant personal expenses as business expenses for the corporation. Prezioso was not only required to pay back taxes, but he was also found guilty of willfully filing a false tax return in criminal court.

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Miscellaneous Corporation Developments

S corporation beneficial ownership. We have two cases this year where taxpayers failed to report pass-through income from an S corporation in which they were shareholders.

1. **Own the stock, pay the tax (Andrew and Sara Berry v. Comm., TC Memo 2025-109).** Andrew Berry and his father, Ron Berry, owned Phoenix Construction & Remodeling (PCR), an S corporation, 50% each. PCR timely filed a 2016 S corporation tax return and issued K-1s to Andrew and Ron for their respective 50% shares of income. Subsequently, the IRS audited PCR's returns and adjusted for under reported income of $154,000. The IRS proposed splitting the adjustment 50% to Ron Berry and 50% to Andrew Berry.

   Beneficial owner argument not good enough. §1366(a)(1) requires S corp. SHs to report their pro rata share (50% in this case) of the S corp.'s income, loss, deductions, and credits, regardless if the income is distributed to the SH. Andrew Berry explained that he was removed as an officer of PCR in March 2016 and he argued that subsequently, he did not have beneficial ownership of PCR. He further argued that any audit adjustment should be allocated 100% to Ron Berry.

   Court acknowledged beneficial ownership rules. The acknowledged that a shareholder may not be a beneficial owner of shares if an agreement with another party removed ownership, or provisions in the corporation's governing articles restricted or limited ownership rights. But the Court held that even if Andrew was removed as an officer, he still owned a 50% interest in PCR at the end of 2016. No evidence was offered to show that Andrew no longer had any interest in PCR in 2016 or that any agreements restricted Andrew's ownership rights causing him to lose beneficial ownership. The Court ruled Andrew had to pay tax on his pro-rata share of the IRS adjustment.

2. **Spouse must dispose of stock to end ownership (Karen Veeraswamy v. Comm., 2nd Circuit CA, 25-102-cv, Feb. 2, 2026).** The 2nd Circuit affirmed the Tax Court and held that a taxpayer who formed an S corporation with her husband but later stopped receiving distributions from the company after divorcing him, was nevertheless liable for tax on capital gains and rental income realized by the S corporation. The Court found that the taxpayer never abandoned her interest in the S corporation and that the government was not precluded by two earlier bankruptcy proceedings from arguing that she was a part owner because no final judgment on the issue of the company's ownership was ever issued in the bankruptcy proceedings.

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Partnerships and LLCs

LLCs and Partnerships in General (§§701-761)

Overview. IRS partnership rules are generally contained in §§701-761 (Subchapter K). The term "partnership" is defined as any organization (including a syndicate, group, pool, joint venture, or other unincorporated organization) through which any business, financial operation, or venture is carried on by more than one person, which is not a corporation, trust, or estate (§761(a)).

A partnership is formed when two or more "persons" agree to carry on a joint venture. A written agreement, although preferred, is not required by the IRS. Many states do require partnerships to have a written agreement. Partnership agreements should cover initial capital contributions, required services, income and loss allocation terms, life of the partnership and other important items. Such agreements must always be inspected prior to preparing a partnership return. Those "persons" who may be partners include individuals, other partnerships, estates, trusts, and all types of corporations (foreign or domestic).

The three types of partnerships that are typically seen in practice are: 1) general partnerships, 2) limited partnerships, and 3) limited liability partnerships. Over the past 30 years the number of these types of partnerships have declined significantly in favor of limited liability companies (LLCs), which provide all the flexibility of a general partnership while providing liability protection to its members.

Form 1065 normally allocates items to partners using the partnership agreement.

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2026 LLC Preparation & Review Checklist
Form 1065, U.S. Return of Partnership Income — IRC §§ 701–777 (Subchapter K); IRS Publication 541

Client: _____ **Year End:** _____ **Preparer:** _____

> **Note: Print all** documents, support, client correspondence and workpapers to file.

Part 1 — Accounting Work, Pre-Return

Yes / No / N/A	Checklist Item
	1.) Obtain signed engagement letter
	2.) Confirm permanent file contains LLC operating agreement
	3.) Confirm LLC profit/loss allocations per operating agreement
	4.) Confirm operating agreement 754 election existence
	5.) Confirm operating agreement guaranteed payment amounts
	6.) Obtain & print entire client transaction report to PDF before making adjustments
	7.) Obtain & print client activity report on selected accounts: __ Inventory; __ Equipment;__ ***Obtain invoice copies of additions from client*** __ Inventory: Obtain client year end cost statement __ Other Assets; __ Notes Payable; __ ***Obtain new loan copies from client*** __ Capital Accounts __ Auto and truck __ Repairs __ Payroll tax __ Other tax & License __ Other accounts: List: _____
	8.) Ask client for copies of new leases
	9.) Obtain or prepare: __ Bank Reconciliation; __ Unpaid payroll tax (look at January of next year) __ Unpaid sales tax (Look at January of next year) __ Other accounts: List: _____
	10.) Obtain or prepare: __ Loan amortization schedules; __ Loan payoffs: __ Accrued interest if applicable __ List of donees and amounts for charitable contributions
	11.) Inquire and identify digital asset reporting items
	12.) Obtain pension and health insurance for members for proper reporting
	13.) Identify and schedule non-taxable income items and non-deductible expenses
	14.) Identify and schedule any US interest income

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Yes / No / N/A	Checklist Item
	15.) Identify rental activity separately reported interest and other expenses
	16.) Prepare depreciation schedule __ Obtain invoices for items purchased above $2,500 __ Obtain details of items sold or scrapped __ Tie to trial balance __ Identify which assets qualify for bonus and Section 179
	17.) Inquire as to any unpaid company pension contributions & adjust
	18.) Adjust all accounts to match above support and to correct mis-postings. __ Tie indexed support documents to final trial balance with tick marks.
	19.) Inquire if other state or website activity is occurring causing other state nexus
	20.) Inquire if there is any non-US activity
	21.) Confirm ownership changes or lack thereof with client: __ Obtain name, SSN, and address of new members & date of transfers __ File Form 8308 Parts 1-3 by 1/31 if sale/exchange with hot assets
	22.) Verify new members are qualified individuals to continue Sch. B-2 election __ Verify new investments in ownership
	23.) Inquire as to, and note, address of any new physical locations
	24.) Confirm partnership representative

Part 2 — Tax Return Preparation

Yes / No / N/A	Checklist Item
	1.) Go to Secretary of State website and print "good standing" report
	2.) Verify name and address with Secretary of State to tax return and IRS
	3.) Confirm NAICS code and address with client ***based on current activity***
	4.) Confirm current address of existing members/partners
	5.) Obtain 1099-K, 1099-Misc, 1099-NEC, summarize and confirm receipts reported exceed Form totals
	6.) Determine if $32 million 3-year trailing average revenue test has been exceeded thus requiring accrual method and inventory capitalization
	7.) Open prior year return and look for: __ Unusual items; __ Credits __ Carry-forward amounts __ Account combinations into 1 account on return & duplicate or note change __ Account combinations into COGS accounts & duplicate or note change __ Installment sales __ Sec. 754 special allocations
	8.) Obtain guaranteed payment amounts by member __ Obtain member other distribution amounts
	9.) Obtain state allocation amounts for sales, wages, rent, assets

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Yes / No / N/A	Checklist Item
	10.) Input final trial balance to tax software, noting TB accounts combined for 1 tax account and combining and presenting in same manner as prior year
	11.) Attach K-1 Statement regarding "No K-3 to Be Issued" unless K-3 prepared
	12.) Properly complete Schedules M-1 and M-2 noting any ownership changes, non-taxable and non-deductible items, distributions
	13.) Review return for **required elections** or other separate disclosures: __ De minimis repairs for real estate: __ De minimis asset purchases: __ Bonus depreciation; __ Production Property Bonus Depreciation __ Section 179; __ Digital asset activity __ Tax credits (Wage__, energy__, pension plan__, foreign__, __, etc..) __ Sec. 199A disclosures __ Specific charity information __ Schedule B-2 election out of CPAR audit rules __ Sec. 754 Step-Up Basis election
	14.) Subject return to software checking
	15.) Analytically review the final return with prior year before processing
	16.) Review the letter for any necessary changes
	17.) Clear all diagnostics
	16.) Send return to processing

Sign-off: Complete both lines before the return is released.
Preparer: _____ Date: _____
Reviewer: _____ Date: _____

Cream fields are for entry. This checklist is a preparation aid, not tax advice.

Preparer note. Taxspeaker offers a digital Elections, Checklists and Letters library either online or via USB. It includes more than 200 useful tools for tax professionals. The above checklist is just one small example. It is available at our website; Taxspeaker.com.

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Partnership Forms Update

No Significant Changes to 2026 Form 1065 Expected

As of September 2026, the most current draft of the 2026 Form 1065 is identical to the 2025 version. Very few, if any, changes are expected.

Form 7217 - Basis Reporting for Partner(s) Who Receive Property Distributions (§732)

Overview. Form 7217 is used to track the adjusted basis and basis allocations of non-cash property distributed in liquidating or non-liquidating partnership distributions made under §732. The form is filed by any partner who receives a property distribution from a partnership. The form is used to report the basis of the distributed property, including any required basis adjustments, in the partner's hands to the IRS.

Preparer note. This is a partner-level obligation, separate from the partnership's Form 1065 reporting. The partnership is not required to report to the IRS.

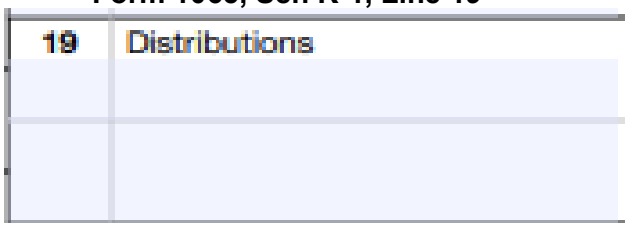
Filing deadline. Partners are required to attach a separate Form 7217 to their annual tax return (e.g., Form 1040) for each date a property distribution is received. The form must be filed by the return's due date, including extensions. Form 7217 is not required:

- If the distribution consisted only of money or marketable securities,
- For payments for services other than in the partner's capacity as a partner (under §707(a)(1)), or
- For transfers that are treated as disguised sales (§707(a)(2)(B)).

Additional info reporting on Sch. K-1 provided to help compliance. Beginning in 2026, partnerships will have additional information reporting requirements in Box 19 of Schedule K-1. These new codes include:

- Sch. K-1, Line 19 – distributions, codes:
  - B and G – partnership's basis of property distributed with any pertinent adjustments – info reported on Form 7217, line 3.
  - A and F – marketable securities info with any pertinent adjustments – reported on Form 7217, line 5b.
  - D and F – cash distributions

Form 1065, Sch K-1, Line 19



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Form **7217** (December 2024)
Department of the Treasury
Internal Revenue Service

Partner's Report of Property Distributed by a Partnership

Attach to your tax return.
Go to *www.irs.gov/Form7217* for instructions and the latest information.

OMB No. 1545-0123
Attachment Sequence No. **217**

Partner's name	Partner's TIN
Distributing partnership's name	**Distributing partnership's EIN**

Date property was distributed to partner

Part I **Aggregate Basis of Distributed Property on Distribution Date.** File a separate form for each date a partner received distributed property.

1	Was this distribution in complete liquidation of the partner's interest in the partnership?	☐ Yes ☐ No
2	Was any part of the distribution treated as a sale or exchange under section 751(b)?	☐ Yes ☐ No
3	Partnership's aggregate basis in distributed property (taking into account any basis adjustments under section 732(d), 734(b), or 743(b)) immediately before the distribution. This line should equal the total of Part II, line B, column (b)	$
4	Adjusted basis of the partner's interest in the partnership immediately before the distribution	$
5a	Cash received in the distribution $	
b	Fair market value of marketable securities (as defined in section 731(c)) received in the distribution $	
c	Add lines 5a and 5b	$
6	Enter the smaller of line 4 or line 5c	$
7	Gain recognized. Subtract line 6 from line 5c. If zero, enter -0- and go to line 9	$
8	Is U.S. tax required to be paid on the gain entered on line 7?	☐ Yes ☐ No
9	Partner's basis in partnership interest reduced by cash received in the distribution. Subtract line 5a from line 4. If zero or less, enter -0-. See instructions if you recognized gain under section 737 as a result of the distribution	$
10	Aggregate basis to be allocated to the distributed property. For a non-liquidating distribution, enter the smaller of line 3 or line 9. For a liquidating distribution, enter the amount from line 9. Line 10 should equal the total of Part II, line B, column (e)	$

Form 8308 – Partnership Interest Transfers with Hot Assets – (§6050K; §1.6050K-1; §751)

Overview. Partnerships are required to file a notification outlining the details of a transfer of a partnership interest if the partnership's underlying assets included §751 ("hot" assets) (§6050K). To create consistency and to streamline this reporting, the IRS introduced Form 8308, for the sole purpose of providing the disclosures required by §6050K. Partnerships are now required to file Form 8308 to report the sale or exchange by a partner of all or part of a partnership interest where any money or other property received in exchange for the interest is attributable to unrealized receivables or inventory items (i.e., §751(a) or "hot" assets"). The partnership must file a separate Form 8308 for each §751(a) exchange of an interest in the partnership. Form 8308 is required once the partnership:

1. Receives written notice of the exchange from the partner/transferor that includes the names and addresses of both parties to the exchange, the identifying numbers of the transferor and (if known) of the transferee, and the date of the exchange; or

2. The partnership has knowledge that there has been a transfer of a partner's interest, and, at the time of the transfer, the partnership had unrealized receivables or inventory items.

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No reporting if §751 doesn't apply. No reporting is required unless §751 is applicable (e.g., partnership interest transferred via gift). A partnership may rely on a written statement from the transferor that the transfer wasn't a §751 exchange unless the partnership has knowledge to the contrary.

Information to include. Form 8308 is filed with the partnership's Form 1065 for the year of the sale and must include:

- Names, addresses, and identification numbers for the seller, purchaser, and the partnership, and
- The date of the sale.

The partnership must also furnish a copy of Form 8308 to each partner whose name is on the form.

When to file. Form 8308 is filed as an attachment to Form 1065 for the tax year in which the transfer took place. Form 8308 is due on the partnership return due date, including extensions, regardless if Form 1065 is filed.

Seller requirements. Sellers are required to notify the underlying partnership in writing within 30 days of the sale:

- Name, address, and identification number (e.g., social security number) for the seller,
- Name, address and identification number for the buyer, and
- Date of sale.

The seller must also attach a separate statement to her or his personal income tax return the year of the sale that includes:

- The date of the sale
- The amount of any ordinary income from the sale of the "hot assets."
- The amount of any capital gain or loss from the transfer.

Preparer note. If the partnership fails to file Form 8308, it may face a penalty of $50 for each failure, up to a maximum of $50,000 per calendar year.

Form 8308 instructions include BBA info. The Form 8308 instructions provide guidance on coordinating Form 8308 when an AAR may be required due to the BBA rules. The instructions specifically address:

- Late or incorrect reporting of a §751(a) exchange by partners in a BBA and non-BBA.
- Non-filing of Form 8308 by the partnership.
- Incorrect reporting of a §751(a) on Form 8308 by the partnership but correct reporting on Schedule K-1.
- Incorrect reporting of a §751(a) exchange on Schedule K-1.

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Form **8308**
(Rev. October 2024)
Department of the Treasury
Internal Revenue Service

Report of a Sale or Exchange of Certain Partnership Interests

Go to *www.irs.gov/Form8308* for instructions and the latest information.

OMB No. 1545-0123

Name of partnership	Phone number	Employer identification number

Number, street, and room or suite no. If a P.O. box, see instructions.

City or town, state or province, country, and ZIP or foreign postal code

Check if this is an amended Form 8308 ☐ or filed in respect to an administrative adjustment request ☐

Part I Transferor Information

Beneficial owner of the partnership interest immediately before transferring that interest:

Name	Identifying number

Number and street (including apt. no.)

City or town, state or province, country, and ZIP or foreign postal code

Check if providing record holder information: ☐ Check if the transferor is foreign: ☐

Notice to Transferors: The information on this form has been supplied to the IRS. The transferor in a section 751(a) exchange is required to treat a portion of the gain realized from the exchange as ordinary income. For more details, see Pub. 541, Partnerships.

Statement by Transferor: The transferor in a section 751(a) exchange is required under Regulations section 1.751-1(a)(3) to attach a statement relating to the sale or exchange to their return. See the Instructions for Form 8308 for more details.

Part II Transferee Information

Beneficial owner of the partnership interest immediately after the transfer of that interest:

Name	Identifying number

Number and street (including apt. no.)

City or town, state or province, country, and ZIP or foreign postal code

Check if providing record holder information: ☐

Part III Transfer of Partnership Interest

1 Date of sale or exchange of partnership interest: ___ / ___ / ___

2 Type of partnership interest transferred:

A Capital ☐ **B** Preferred ☐ **C** Profits ☐ **D** Other ☐

Part IV Partner's Share of Gain (Loss) Required by Sections 751(a) and 1(h)(5) and (6)

The amounts in column (c) should be reported to the selling partner on their Schedule K-1 in box 20 using the relevant code.

		(a) Partnership-level deemed sale gain (loss)	**(b1)** Percentage interest in the partnership transferred	**(b2)** Number of units in the partnership transferred	**(c)** Partner-level deemed sale gain (loss)	K-1 box 20 code
1	Section 751(a) gain (loss) . . .					AB
2	Section 1(h)(5) collectibles gain .					AC
3	Section 1(h)(6) unrecaptured section 1250 gain					AD

Sign here only if you are filing this form by itself and not with Form 1065.

Under penalties of perjury, I declare that I have examined this return, including accompanying attachments, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature of partnership representative or partner or limited liability company member — Date ___ / ___ / ___

Form 8308 related regulations finalized in 2026 (TD 10048). The final regulations clarify that a partnership is required to furnish the information reported on only Parts I, II, and III of Form 8308

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to the transferor and transferee in a §751(a) exchange by the later of 1) January 31st of the year following the calendar year, or 2) 30 days after the partnership received notice of the exchange. The regulations also clarify that the fully completed Form 8308 (including Part IV) is not required to be filed until the due date of the partnership's tax return, including extensions. To summarize:

1. Partnerships must provide Form 8308, Parts I, II, and III to partners who've entered §751(a) exchange by the later of 1) January 31st of the year following the calendar year, or 2) 30 days after the partnership received notice of the exchange.

2. Partnerships must provide a fully completed Form 8308, including Part IV, to the IRS by the due of its tax return, including extensions.

Limited Partners, LLC Members and Self Employment Tax – Yes, Again! Or Still!

Background. While LLCs first came on the scene in 1978, they really started to become popular in the early 1990s. With the gain in popularity came a host of tax issues. While most have been settled over the years, everyone is still trying to figure out self-employment tax and its application to LLC members. Internal Revenue Code §1402 defines SE income very broadly to include everything unless it is specifically exempt, like the definition of gross income per §61. Under §1402, the term net earnings from self-employment is defined as:

"…gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss from any trade or business carried on by a partnership..."

Under this definition, rental real estate would be subject to SE tax, as well as capital gains, dividends and more. However, several SE tax exemptions are listed in §1402(a)(1) through (17). Of most import here, §1402(a)(13) states there shall be excluded the distributive share of any item of income or loss of a limited partner other than guaranteed payments made to that partner for services provided to the partnership.

What's the issue? The core issue is that any taxpayer wanting to argue they have income exempt from SE tax must meet at least one of the §1402(a) exceptions. There is no other way. When we turn to LLCs and SE tax, there are no tax laws specific to LLCs, single or multimember. The IRS says to treat single member LLCs as sole proprietors and multi-member LLCs as partnerships. For a partner's trade or business income to be exempt from SE tax, the partner must argue they meet the limited partner exception. There is no other basis for argument. This brings us to the big issue – there is no definition of a "limited partner" in the tax law. This definition is a state law definition, and while mostly consistent among the states, it is not completely consistent.

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IRS acts and Congress doesn't like it. In the 1990s, the growth in the number of LLCs began to increase substantially. In response, the IRS recognized that LLCs and SE tax was going to become an issue. To get ahead of the issue, in 1997 the IRS issued proposed regulations with a specific definition of "limited partner" under §1402. Under the IRS proposed regulations, the IRS held that a partner in partnership would be a limited partner for SE tax purposes if the entity were not engaged in the business of consulting, health, law, engineering, architecture, accounting or actuarial science and the partner did not:

- Work more than 500 hours in the LLC during the LLC's tax year;
- Execute contracts for the LLC; ***and***
- Have personal liability for the debts or claims against the LLC.

Congress lashed out at the IRS, telling them that defining who is, and who is not, a limited partner is decided by law and that Congress, not the IRS, writes law. Congress also forbid the IRS from making the proposed regulations final. The regs are still out there as the IRS never withdrew them. Of course, no one in Congress even understands the issue so here we are, almost 30 years later, waiting for Congress to act. But that's another story!

Preparer note. The IRS has stated multiple times that those who follow the proposed regulations will not be attacked on audit.

We turn to the courts for guidance. The IRS cannot act, Congress will not act, so the tax community has watched with interest for any court developments on this issue and the courts have recently decided to weigh in.

Soroban provided a very comprehensive analysis (Soroban Capital Partners, v. Comm., TC Memo 2025-52). Soroban Capital Partners (SCPs) was a hedge fund organized as a limited partnership under Delaware law. It had one general partner and three limited partners. Soroban acknowledged that the limited partners' unique skills and experience were indispensable to the business. Each limited partner worked full time at SCP and exercised managerial control. They contributed little to no capital relative to their share of income. Functionally, Soroban's limited partners were not acting as limited partners. Each limited partner was paid guaranteed payments for their services rendered. The K-1s from SCPs reported the guaranteed payments as SE income but not the partners' distributive shares of income. The IRS audited SCP's 2016 and 2017 returns and determined:

Year	2015	2016
Total K-1 income	$78,449,000	$64,512,000
Income reported as SE income	$ 2,037,000	$ 1,901,000
Under reported SE income	$76,412,000	$62,611,000

The Court determined that the only issue was whether the partners were limited partners for SE tax purposes.

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Limited partner not defined in Federal tax code. The Court noted that the Internal Revenue Code does not define "limited partner." Looking to case law, the Court discussed Renkemeyer, where the Federal tax court applied statutory construction principles to determine whether partners in an LLP should be considered limited partners (Renkemeyer v. Comm., USTC, Feb. 9, 2011). The Court in Renkemeyer analyzed the legislative history of §1402(a)(13) and concluded that its intent "was to ensure that individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations … would not receive credits towards Social Security coverage." Further, the Court found that "[t]he legislative history … does not support a holding that Congress contemplated excluding partners who performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons), from liability for self-employment taxes." In Renkemeyer, the Court ruled that the partners were not limited partners for SE tax purposes because their "distributive shares arose from legal services … performed on behalf of the law firm" and not "as a return on the partners' investments."

Function test at the core of the argument. The Renkemeyer Court further noted none of the previous cases addressed whether a limited partner in a state law limited partnership must satisfy a functional analysis test to be entitled to the limited partner exception under §1402(a)(13) (Renkemeyer was an LLP, not a limited partnership). The Court found the limited partner exception under §1402(a)(13) does not apply to a partner who is limited in name only. If Congress had intended that limited partners be automatically excluded, it could have simply said "limited partner." By adding "as such," Congress made clear that the limited partner exception ***applies only to a limited partner who is functioning as a limited partner***. The Court effectively ruled that, to determine whether a limited partner's income is subject to SE tax, a function test must be applied. What is the partner's role in the partnership and, if the role is not that of a limited partner, then the SE tax applies. While the IRS 1997 proposed regulations are not enforceable, they are a place to start to determine function. ***The Court also noted that classification under state law has no bearing.***

Soroban Court also adopts the function test. The Soroban court followed the Renkemeyer Court and applied the function test. It ruled that partners, who all worked full-time and held managerial positions, were active participants, not passive investors. The Court considered the key factors for analysis to be:

1. Role and control of the partnership;

2. How much the partners worked in the partnership;

3. Earnings versus contributed capital – very little contributed capital so no argument that income was a return on capital; and

4. Holding partners out to the public – Soroban advertised the partners' special talents in the marketing efforts.

Partners subject to SE tax on 100% of income. The Soroban Court determined that the function test showed that the Soroban partners were limited partners in name only and ruled the guaranteed payments and 100% of the allocable share of income were subject to SE tax.

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Fifth Circuit Splits with Itself (K. Alain, LLLP v. Comm., No. 24-60240, 5th CA, Aug. 12, 2026). Sirius Solutions, L.L.L.P. (now known as K. Alain, L.L.L.P.), was a Delaware limited liability limited partnership that operated a business-consulting firm headquartered in Houston, Texas. The LLLP had a corporate general partner (less than a 1% owner) who served as Tax Matters Partner. The remaining partnership interests were held by individuals (nine in 2014; five in 2015–2016). All the individual partners were treated as "limited partners" for SECA purposes.

Preparer note. To make this case even more confusing, Sirius Solutions changed its name to K. Alain, LLLP in mid-2026. There were three court cases (to date) involving this LLLP, two under the Sirius name and one under the K Alain name.

Partner function. While the Sirius Solutions partnership agreement stated that limited partners would not participate in management, the individual partners:

- Worked full-time and exclusively for the partnership (under a non-compete/no-outside-employment covenant);
- Delivered client services and billed hours;
- Developed new business and negotiated client engagements; and
- Supervised staff and made hiring/evaluation/termination decisions.

By contrast, the corporate GP existed solely to serve in that role – it received no compensation, held no formal board meetings, and performed only nominal GP functions.

Tax reporting issues. For 2014–2016, Sirius reported excluded 100% of its ordinary business income/loss – $5,829,000 in 2014, $7,243,000 in 2015, and $490,000 loss in 2016 – from SE tax because it was limited-partner income. The IRS determined the individual partners were subject to SE tax on their allocable shares of income and assessed SE tax accordingly.

Court opinions – 3 in total. Originally, the Tax Court adopted the logic used in Soroban to rule in favor of the IRS and assessed SE tax on the entire income allocated to the individual partners. However:

1. In January 2026, the 5th Circuit Court of Appeals determined that the term “limited partner” for purposes of the limited partner SE tax exception means “a partner in a limited partnership that has limited liability” and rejected the Soroban Tax Court’s functional analysis and “passive investor” interpretation. The Court essentially created a bright-line, state-law-driven test 100% based on limited liability (Sirius Solutions v. Comm., 5th CA, No. 24-60240, January 16, 2026).

2. Wait a minute! In August 2026, the Fifth Circuit’s original panel granted a rehearing on its own petition, withdrew the January opinion in full, and issued a new majority opinion under the new taxpayer name, K Alain, L.L.L.P. v. Comm. The panel abandoned the pure state-law liability test and instead applied an "original public meaning" analysis of the phrase "limited partner" as it would have been understood in 1977, when the exclusion was enacted. The Court ruled:

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a. The original public meaning of “limited partner” is a partner who plays no significant role in managing or running a business.

b. This creates a "managerial/non-managerial" distinction rather than a binary liability test or a strict passive-investor test:

    i. A limited partner may perform some services for the partnership and still qualify for the exclusion, so long as those services are non-managerial in character.

    ii. A limited partner loses the exclusion if the partner plays a significant role in managing or running the business – regardless of the partner's state-law liability status.

5th Circuit still says Soroban is incorrect. The Court expressly rejected the Tax Court's Soroban "passive investor" standard as "divorced from statutory text," criticizing it as effectively barring even minor partner involvement. But it also expressly abandoned its own January "limited liability alone" test. Because the Tax Court in Soroban (and, by stipulation, in this case) applied the stricter passive-investor standard rather than the new "no significant managerial role" standard, the Fifth Circuit vacated the Tax Court's judgment and remanded the case back to the Tax Court for further consideration under its new test. And yes, if you read all this again, it sounds a lot like the 5th Circuit decided to apply a type of function test of its own!

See also:

- Denham Capital v. Comm., TC Memo 2024-114, where the Tax Court held that partners in an investment firm partnership were not "limited partners" and thus the partnership could not exclude the partners' distributive shares from the partnership's net earnings from self-employment. The Court also concluded that determining the applicability of the limited partner exception is a partnership item over which the Tax Court has authority.

- Renkemeyer, Campbell & Weaver LLP v. Commissioner, 136 T.C. 137 (2011), in which the Court concluded that attorney partners who actively participated in a law firm organized as a Kansas limited liability partnership were not limited partners for purposes of section 1402(a)(13).

- Castigliola v. Comm., T.C. Memo. 2017-62, where lawyers who owned and worked in a professional LLC were limited partners for SE tax purposes. The Court ruled they were not.

More cases are coming soon. Currently, there are three additional cases in various stages in Tax Court where the argument centers around SE tax and partners in partners. We will report on these cases when they are concluded. We are currently tracking:

- Point72 Asset Management LP v. Comm., where partner Steve Cohen is arguing he is not subject to SE tax on LP profits of $344 million in tax years 2015 and 2016. The tax at stake is estimated to be between $7 million and $10 million. A decision is expected by the end of 2026.

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- Riverstone Equity Partners LP, v. Comm., where the IRS determined that the income of Riverstone's limited partners was subject to self-employment tax, which would increase the tax liability for that year by more than $64 million.

- MKP Capital Management LP v. Comm., where the IRS has asserted that partners in the investment management firm, who were designated as "limited partners" under state law but performed substantial services for the partnership, are subject to self-employment taxes and are not "limited partners" under Internal Revenue Code.

Preparer note. Obviously, there is a lot of litigation about this issue. Both the Soroban and Denham cases discussed above are currently in appeals, and K Alain is back in tax court. The 5th Circuit specifically rejected the passive investor test used in Soroban, so it effectively does not apply in Texas, Louisiana, and Mississippi. Meanwhile, we wait for Congress to do their job or for the Supreme Court to provide clarity.

IRS Issues Final Regulations to Combat Abusive Conservation Easements (§170(f)(19); §170(h)(7); TD 9999; §1.170A-14)

The IRS has long perceived conservation easement deductions as an area of abuse. At the urging of the IRS, Congress adopted relatively new law to address these perceived abuses. Specifically, the law now includes two provisions that apply to partnerships and S corporations who offer conservation easement related deductions:

1. The partnership or S corporation must include a statement with their tax return that a conservation easement deduction was made and has been claimed. The statement must contain the prescribed information.

2. There is now a disallowance provision, which effectively prevents conservation easement deductions for partnerships and S corporations unless certain specific conditions are met - the disallowance provision conditions.

Conservation easement deductions made by partnerships and S corporations without complying with the new rules are treated as tax-avoidance transactions and all related penalties apply. The IRS issued regulations to clarify how these rules are applied. The regulations were effective for conservation easement deductions made after December 29, 2022.

Worst example of abuse yet (Hancock County Land Acquisitions LLC v. Comm. TC Memo 2026-28). We now have the most audacious, fraudulent conservation easement case yet. Hancock County Land Acquisitions LLC (HCLA) granted a conservation easement over a 236-acre parcel of land in rural Mississippi. The parcel was part of a 1,698-acre land tract that had changed hands three times during the previous 13 years. These sales were for prices as low as $1,520,000 ($895 per acre) and $4,000,000 ($2,356 per acre). On its 2016 tax return, HCLA claimed a charitable contribution deduction for the easement (which was only 14% of the total property) of $180,000,000 ($763,462 per acre). At trial, the taxpayer did not even try to defend the gross overvaluation, instead arguing that the value was actually $18,000,000 ($78,962 per acre).

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Court lets the taxpayer have it. The Court noted the investors were not purchasing land, in substance, they were purchasing tax deductions. Each investor was promised a charitable contribution tax deduction of $7,477 for every $1,000 invested. The Court also noted there was abundant evidence of land sales in or near Hancock County from 2012–2016 in which land similar to the 236-acre parcel used for the conservation easement. Most of these transactions occurred at prices ranging between $1,731 and $8,000 per acre. The Court found this evidence convincing that no rational buyer, acting at arm's length with reasonable knowledge of the relevant facts, would have paid $78,962 per acre for the 236-acre easement parcel. The Court ultimately allowed a conservation easement deduction of $2,183,000 ($9,250 per acre) and assessed all relevant penalties (gross misstatement of valuation, etc.).

Disallowance rule. A qualified conservation deduction will be disallowed for partnerships and S corporations if the contribution amount exceeds 2½ times the sum of each partner's or shareholder's relevant basis. For this purpose, the term "relevant basis" is defined as a partner's "modified basis" in the partnership. Modified basis is the partner's basis plus adjustments required under §704(c). The regulations clarify how acquisitions, dispositions, and the adjusted basis of properties affect the computation of relevant basis. See §1.170A-14(j-m) for an in-depth discussion of modified basis.

Disallowance rule exceptions. The disallowance rules do not apply to conservation easement deductions made:

1. By sole taxpayers (i.e., individuals, C corporations, etc.);
2. By family passthrough entities (i.e., 90% or more owned by family members), including family member estates and certain trusts; and
3. For preservation of any building that is a certified historic structure.

Anti-abuse rule. The regulations include a one-year holding-period rule for property ownership before a qualified conservation contribution, with exceptions for cases where contributions are limited to adjusted basis.

Amended returns and AARs. If a partnership or S corporation files an amended return or AAR, the application of the rules depends on whether the contribution amount is higher or lower than initially reported.

Allocation by upper-tier partnerships. The final regulations specify that contributions by upper-tier partnerships must be allocated among partners based on their interests in the contribution, not pro rata among their partnership interests.

Reporting and recordkeeping. The regulations clarify the reporting and recordkeeping requirements for partnerships and S corporations who make noncash donations, not just conservation easements. The new regs require the passthrough entities to file Form 8283 with relevant basis information for non-cash charitable contributions. This is required regardless of whether the contributions are of real property or other non-cash property.

Partnership reporting to partners (1.170A-16(d)(3)). Partnership or S corporation donors must provide a copy of its completed Form 8283 to every partner or shareholder who receives an allocation of a non-cash charitable contribution. Similarly, a recipient partner that is a partnership or S corporation must provide a copy of the donor's completed Form 8283 (Section A or Section B) to each of its partners or shareholders and so on through any additional tiers.

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Partners and S corporation shareholders reporting. Partners or S corp shareholders who receive an allocation of a noncash charitable contribution must attach a copy of each Form 8283 to its tax return when required. Form 8283 should be provided by the pass-through entity. This applies to every partner of a partnership (including a partner that is itself a partnership or S corporation) or shareholder of an S corporation that receives an allocation of a noncash charitable contribution, and, if multiple such contributions are passed through, the partner/shareholder must complete a separate Form 8283 for each. In the case of a partner that is itself a partnership or S corporation, that partnership or S corporation must provide a copy of its completed separate Form 8283 to every partner or shareholder who receives an allocation of the charitable contribution, and so on through any additional tiers.

Preparer note. Note that these reporting requirements apply to all pass-through entity non-cash contributions, not just conservation easements.

New IRS Office Set to Deal With All Things Conservation Easement (IR-2026-95).

Overview. The IRS established the new Office of Conservation Easements in 2026. The IRS plans to have the new office centralize technical expertise and coordinate policy, enforcement, and case-resolution strategy across the IRS and with the Office of Chief Counsel. It will support engagement with taxpayers, practitioners, conservation and historic preservation organizations, and other stakeholders. The Office will also work with Treasury to evaluate administrative and legislative options that advance Congress's conservation and historic preservation objectives, promote consistent tax administration, and strengthen valuation integrity.

Transition period. As part of this transition, the IRS is concluding the current uniform settlement initiative (effective August 19, 2026) and will no longer issue uniform settlement letters under the previous program. The IRS also withdrew any previously issued unaccepted settlement offers. Prior elections to participate in the settlement framework remain in effect and will be processed in accordance with their terms.

Pending cases. Taxpayers with pending cases may continue to request settlement under the May 13 framework through their assigned IRS examination or Chief Counsel representative. If the case remains eligible, the IRS will issue a new offer on the same standardized terms. Individual cases may continue to be resolved on different terms where warranted by the hazards of litigation. This transition does not signal a new or more favorable standardized offer. Rather, it ends issuance of uniform offers and deadlines.

Going forward. The IRS recommends taxpayers continue working directly with their assigned representatives on case-specific matters and settlement requests. Once operational, the Office of Conservation Easements will provide central coordination and a channel for general inquiries. Additional contact information will be announced separately.

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Electing Out of Partnership Tax Treatment (§761(a); TD 10012

Some associations of two or more people, while technically a partnership, may elect out of partnership tax treatment. To elect out, the partnership must be an investment partnership or an operating agreement partnership:

1. **Investing partnerships.** Investing partnerships can be excluded if the participants are involved only in the joint purchase, retention, sale, or exchange of investment property that meet all the following requirements:

    a. Participants own the property as co-owners. This eliminates the ability of most LLCs to elect out of partnership treatment as under most state statutes, the LLC owns the property, not the members.

    b. Participants reserve the right separately to take or dispose of their shares of any property acquired or retained. LLCs typically also will not qualify to elect out since most state statutes do not allow a member to demand a distribution of property.

    c. Participants do not actively conduct business or irrevocably authorize some person acting in a representative capacity to purchase, sell, or exchange investment property. Each separate participant can delegate authority to purchase, sell, or exchange his or her share of the investment property for the time being for his or her account, but not for a period of more than a year.

2. **Operating agreement partnerships.** An operating agreement partnership group can be excluded if the participants engage in the joint production, extraction, or use of property that:

    a. They own the property as co-owners, either in fee or under lease or other form of contract granting exclusive operating rights; and

    b. They reserve the right separately to take in kind or dispose of their shares of any property produced, extracted, or used; and

    c. They do not jointly sell services or the property produced or extracted. Each separate participant can delegate authority to sell his or her share of the property produced or extracted for the time being for his or her account, but not for a period more than the minimum needs of the industry, and in no event for more than one year.

For example, two or more owners of a rental real estate property (i.e., engaged in use of property) may elect to report their respective shares of rent income and related expenses on each owner's Form 1040, Schedule E, instead of filing Form 1065. The election must be made by the due date, including extensions of Form 1065 for the year the election is to be effective.

Preparer note. Taxpayers who take the position they qualify to elect out of filing Form 1065 under §761(a)(1) (not the active conduct of a trade or business) for rental real estate activities, and then also claim the net rental income qualifies as QBI seem to be contradicting themselves. An experienced IRS auditor could use this argument against the taxpayer – consider filing the 1065!

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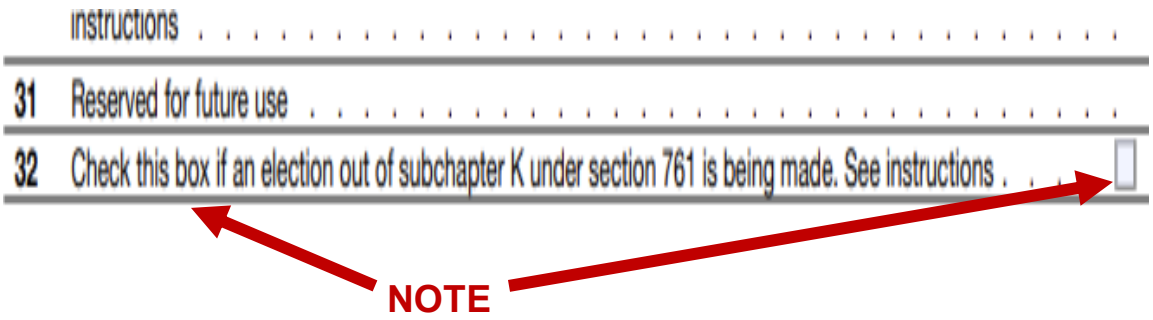
Preparer note 2. Be sure to check the state rules as this election may not be available for partnerships legally structured under state law as an LLC or LLP.

Making the election out of partnership treatment (§1.761-2(b)(2)). The election out of Subchapter K (partnership treatment) is made by checking the box on Form 1065, Sch. B, Line 32 and attaching a statement to Form 1065, which must contain:

- Names, addresses, and ID numbers for members of the organization;
- A statement that the organization qualifies to elect out under §761(a) and §1.761-2(a).
- A statement that all the members of the organization elect to exclude the organization from all of subchapter K.
- A statement indicating where a copy of the partnership operating agreement is located. If the agreement is oral, identify who may provide the agreement specifics.



In other words, the only way to elect out of filing a partnership return is by filing a partnership return, checking the appropriate box, and attaching the required statement.

EIN is required. A partnership return cannot be filed without obtaining and providing an EIN. Even if there is only one tax return that will ever be filed, an EIN must be obtained. From a practical standpoint, the taxpayer will need the EIN to open a bank account.

What if the election is not made (1.761-2(b)(ii)? If an organization fails to make the formal election out of §761, it may still be deemed to have made the election if it can show from all the surrounding facts and circumstances that it was the intention of the members of such organization at the time of its formation to be excluded from subchapter K of the Internal Revenue Code. While this is a facts and circumstance test, the IRS has indicated the following factors indicate the requisite intent:

1. At the time of the formation of the organization there is an agreement among the members that the organization be excluded from subchapter K beginning with the first taxable year of the organization, or

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2. The members of the organization owning substantially all of the capital interests report their respective shares of items of income, deductions, and credits of the organization on their respective returns (making elections as to individual items as may be appropriate) in a manner consistent with the exclusion of the organization from subchapter K beginning with the first taxable year of the organization's existence.

IRS Small Business/Self Employed Partnership Job Aid (Pub 5800)

Occasionally, the IRS releases information that gives tax professionals insight into where the IRS will go upon an audit of a tax return. For partnerships, the IRS recently produced Pub 5800, the Small Business/Self-Employed Partnership Job Aid. This Pub creates a baseline audit level for IRS field agents and guides them through the most common audit issues. Where to begin in a partnership audit, what types of issues to focus on, and why those issues are significant from an adjustment standpoint. The Pub also lists suggested Information Document Request (IDR) items, interview questions for common and recurring tax issues and provides suggested action steps, legal analyses using simple terms, and explanations as to why these steps should be taken.

Pub 5800 specifics. The Pub is divided by topic into seven separate sections, and each section begins with suggested IDR items for common and recurring partnership tax issues to be sent to the taxpayer or taxpayer's representative at the onset of a partnership audit. The seven topic sections are:

1. Partnership agreement, legal status, and description of activity.
2. Tax allocation and substantial economic effect.
3. Partnership liabilities.
4. Partners' limits on claiming losses.
5. Self-employment tax.
6. Disposition of partnership interest and operating/liquidating distributions.
7. Reporting and withholding requirements.

Each section has subsections for:

- Why are we asking?
- What do I need to do to get the information?

Given the relative inexperience of the IRS's current audit staff, it appears this Pub will provide a roadmap for any partnership auditor you may encounter.

Domestic filing exception – Item to note. A domestic filing exception applies to Schedules K-2 and K-3 if the entity has no or limited foreign activity. If the exception is met, then no K-2/K-3 must be completed or filed if the K-1 includes a statement that no K-2/K-3 is included and no one has requested a K-3 before the 1 month before the partnership actually files the return.

If a request comes in after the 1-month in advance date and no one else has requested a K-3, the partnership does not have to furnish the K-2/K-3 to the IRS but they must give a K-3 to the requesting partner by the later of the actual filing date of the return or 1 month after the partner has requested it.

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Partnerships are required to file Form 1065 and related forms and schedules electronically if they file 10 or more returns of any type during the tax year, including information, income tax, employment, and excise tax returns.

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Partnership Elections Grid

Adapted from "The Tax Adviser," April 2005 updated through 2026.

Election	Method of Making Election	Date for Making Election	Authority	Explanation
Initial Return Elections				
Organization Costs-**Deduction**	None Required just deduct	With return	§709(b)(1)(A)(ii)	Allows initial expensing of up to $5,000 of organizational costs by deducting them on original return
Organization Costs-**Amortization**	Capitalize the expenses and amortize-no election required	Due date of 1st return plus extension	Reg. §1.709-1(b)	Allows amortization of organization costs over 180 months
Election to be excluded from partnership rules	Statement attached to blank 1065 with entity name and FEIN, names, addresses, FEIN of all members and agreement to election, where organization documents are located	Due date of 1st return plus extension	Reg. §1.761-2(b)	Allows certain investing partnerships to be excluded from partnership rules and treat items as if owned directly
Startup Costs-**Deduction**	None required. just deduct	Due date of 1st return plus extension	§195(b)(1)	Allows initial expensing of up to $5,000 of startup costs by deducting them on original return
Startup Costs-**Amortization**	Capitalize the expenses and amortize-no election required	Due date of 1st return plus extension	Reg. §1.195-1	Allows amortization of startup costs over 180 months
Election under §444 for a tax year other than required	File Form 8716	Earlier of 15th day of 5th money following 1st day of election year, or unextended due date of return	§444; Reg. §1.444-3T	Allows taxpayers to adopt September, October, or November year end in normal calendar year entity.
Recurring item election	By deducting items on return in 1st year incurred	Due date of 1st return plus extension where applicable expenses are incurred	§461(h)(3); Reg. §1.461-4(g)(7)	Allows deduction in year expenses are fixed and determinable if performance occurs by earlier of filing date or 8 1/2 months after year end.
Accrual of property taxes	Attach statement to return	Due date of 1st return plus extension where applicable expenses are incurred	§461(c); Reg. §1.461-1(c)	Allows ratable and accrual of real property taxes over period to which they relate

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Election	Method of Making Election	Date for Making Election	Authority	Explanation
Operating Elections				
Step Up Basis Election	Attach statement from authorized partner to return	Due date, without extension, of return for year of transfer of ownership interest	§754; Reg. §1.754-1	Allows step up basis to FMV on interest transfer at purchase, death, or buyout
Adjustment to basis of distributed property	Attach statement to distributee partner's return	Due date of distributee's return, plus extension, for first tax year in which basis of distributed property is relevant	§732(d); Reg. §1.732-1	Adjusts partner's basis of distributed property following a transfer within 2 years of acquiring the property, when no §754 election is in place
Basis proration on liquidation	Attach statement to partner's return	Due date of partner's return, plus extension, for 1st year payments are received	Reg. §1.736-1(b)(6)	Allows a retiring or deceased partner to report gain evenly as opposed to recovering basis first
Designation of Partnership Representative	Form 1065, Schedule B	On timely filed tax return including extension	Reg, §301.6223-1(c)(2)	Designates PR
Termination of §444 election to use special year end	Attach statement to return for short period resulting from election	Due date, plus extension, of short period return	Reg. §1.444-1T	Allows taxpayers to change back to a permissible tax year
Allocation of single non-recourse liability among multiple properties	None required-Allocate in any reasonable and consistent manner	N/A	Reg §1.752-3(b)	Allows a partnership to allocate a single liability among multiple properties
Grouping activities	Attach identifying statement to return when changing, additions and dispositions	Due date plus extension of first return where grouping is made	Reg. §1.469-4	Allows one or more trades, businesses, or rentals to be treated as one activity for passive loss purposes
Selection of §704(c) pre-contribution gain allocations	None required-apply the method and include it in the partnership agreement	Due date of return plus extension for 1st return with pre-contribution gain issues	Reg. §1.704-3	Determines allocation of pre-contribution gain, loss, depreciation, and amortization
Election to override interest-tracing rules	No guidance; categorization on return appears sufficient	Due date of return plus extension for 1st use of debt proceeds	§163; Reg. §1.163-8T(c)(4)	Allows a partnership to treat an expenditure from any account, within 30 days of depositing debt proceeds into that account, as a disbursement of such proceeds. The character of the interest expense is determined by the nature of the expenditure.

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Qualified Opportunity Zones (QOZs) – §1400Z; NPRM REG-116506-25

Qualified Opportunity Zone (QOZs) Highlights and Important Changes

$ QOZs made permanent.

$ QOZ definition changed to include rural, not just low-income, communities.

$ QOZ deferred gains are taxed five years after gain deferral and only 90% of the gain is taxable (70% for rural QOZ investments).

$ All appreciation of QOZ investment is tax exempt if investment is held ten years or longer.

$ Rural QOZ investments are substantially improved if 50% or more of original price is invested within 30 months of acquisition.

Qualified Opportunity Zones Overview (§1400Z-1) - Overview

Qualified Opportunity Zones (QOZs) were originally added to the tax code in response to the devastation in the New Orleans area from Hurricane Katrina. Several years later, the Tax Cuts and Jobs Act (TCJA) of 2017 temporarily made the QOZs rules and the related Qualified Opportunity Fund (QOF) rules apply to low-income areas throughout all the United States. The OBBBA made the TCJA's QOZ and QOF rules, with certain modifications permanent. The OBBBA changes take effect on January 1, 2027. The TCJA and the OBBBA versions of QOZs are often referred to as QOZ 1.0 and QOZ 2.0, which will be used here to differentiate the rules.

The IRS announced its intention to issue regulations to address the permanent QOZ 2.0 rules. Until those regulations are issued and finalized, the IRS has issued interim guidance in Notice 2025-50 and Notice 2026-40, which were relied on heavily while writing this text. The chart below summarizes the key differences between versions QOZ 1.0 and 2.0.

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Qualified Opportunity Zones (§1400Z)		
Description	**QOZ 1.0**	**QOZ 2.0**
Applicable dates	Enacted in 2017 and applicable through December 31, 2026. Expires after 2026.	Enacted in July 2025 and takes effect January 1, 2027. New rules are permanent.
Designating qualifying locations	Governors nominated low-income census tracts in their state in the fall of 2018.	Governors will nominate potential QOZs every 10 years starting in fall/winter of 2026.
Qualifying locations	Low-income census tracts in a state. Up to 25% of census tracts may qualify. Small number of contiguous tracts also qualified.	Low-income census tracts in a state. Up to 25% of census tracts may qualify. Rural communities may also qualify in 2027 and beyond. Contiguous tracts no longer qualify.
Gain deferral benefits	Reporting of current capital gains deferred until 2026	Reporting of current capital gains deferred five years
Basis step-up on current capital gain	10% basis step-up for assets sold if QOZ property is held for 5 years, 15% step-up if held 7 years.	10% basis step-up if QOZ property is held for 5 years, 30% if QOZ property is held for 5 years and is qualified rural OZ property.
QOZ gain exclusion	Permanent exclusion if QOZ property held at least 10 years	Permanent exclusion if QOZ property held at least 10 years
QOZ tax free appreciation period	Ends December 31, 2047	Rolling 30-year period
QOF substantial improvement requirements for existing property	QOF has 30 months to invest 100% or more of the adjusted basis of property purchased	Same as QOZ 1.0 except qualifying property acquired in new “rural area,” the investment requirement is 50%, not 100%

Preparer note. This text emphasizes the Qualified Opportunity Zone rules as amended by OBBBA (QOZ 2.0). For the most part, the OBBBA rules take effect for QOZ property acquired after December 31, 2026. Rules specific to QOZ 1.0 will be noted when discussed.

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Primary Terms and Abbreviations Definitions (Notice 2026-40)

Before we go further, it is important to note there are multiple terms and abbreviations used throughout the QOZ law, explanations, and guidance. Before we dive into the details, below is a list of the most important terms and abbreviations:

- **Qualified Opportunity Funds (QOFs).** A QOF is an investment vehicle organized as a corporation or partnership for the purpose of investing in eligible property located in designated Qualified Opportunity Zones (QOZs). A QOF generally must hold at least 90% of its assets in Qualified Opportunity Zones (Under IRC §1400Z-2(d).

- **Qualified Rural Opportunity Funds (QROFs).** A QROF is an investment vehicle organized as a corporation or partnership for the purpose of investing in qualified rural opportunity zone business property.

- **Qualified Opportunity Zones (QOZs**). A QOZ is a designated low-income or rural census track certified by the U.S. Treasury. Investors do not receive Opportunity Zone tax benefits merely by purchasing property located in a QOZ. Instead, the investment generally must be made through a Qualified Opportunity Fund (QOF) that satisfies the statutory requirements for investing in Qualified Opportunity Zone Property. Thus, a QOZ is the geographic area receiving the designation, while a QOF is the investment vehicle through which taxpayers generally make qualifying Opportunity Zone investments.

- **Qualified Opportunity Zone Property (QOZP).** QOZP is property that is qualified opportunity zone stock (QOZ stock), qualified opportunity zone partnership interest (QOZ partnership interest), or qualified opportunity zone business property (QOZBP).

    1. **QOZ Stock** – defined as any stock in a domestic corporation if: (i) the stock was acquired by a QOF at its original issue from the corporation solely in exchange for cash after the applicable date; (ii) the corporation was a (QOZB) (or newly organized for such purpose) at the time the stock was issued; and (iii) for 90% of the QOF's holding period of such stock, the corporation qualified as a QOZB.

    2. **QOZ Partnership Interest (QOZPI)** – is defined as any capital or profits interest in a domestic partnership where: (i) the interest was acquired by a QOF from the partnership solely in exchange for cash after the applicable date; (ii) the partnership was a QOZB (or newly formed for such purpose) at the time the interest was acquired; and (iii) for 90% of the QOF's holding period of such interest, the partnership qualified as a QOZB.

    3. **Qualified Opportunity Zone Business Property (QOZBP)** – is defined as tangible property used in a trade or business of the QOF if: (i) such property was acquired by the QOF by purchase after the applicable date, (ii) the original use of such property in the QOZ commences with the QOF or the QOF substantially improves the property, and (iii) during substantially all of the QOF's holding period of the property, substantially all[1] of the use of such property was in a QOZ.

[1] At least 70% (by value) of the tangible property owned or leased by the trade or business must be QOZBP.

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- **Qualified Opportunity Zone Business (QOZB).** QOZB is a trade or business in which substantially all the tangible property owned or leased in connection with the trade or business is QOZBP. The trade or business must also satisfy the following requirements (as per (§1397C(b)(2), (4), and (8)):

    1. At least 50% of the total gross income of the entity must be derived from the active conduct of a trade or business in the QOZ;
    2. A substantial portion of the intangible property of such entity must be used in the active conduct of a trade or business in the QOZ; and
    3. Less than five percent of the average of the aggregate unadjusted bases of the entity's property must be attributable to non-qualified financial property; and
    4. May not be a trade or business to provide (including the provision of land) for any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

How It All Works – A Step-by-Step Synopsis

While the Opportunity Zone 1.0 provisions didn't seem to receive a lot of attention, it is the author's opinion that the OBBBA enhancements will create significantly more interest in QOZ 2.0. Congress believes the law, as amended, provides significant incentives to encourage investment in rural and low-income communities. Let's look at this law using a step-by-step approach.

- **Step 1:** Every 10 years, governors of each state nominate low-income and rural communities in their respective state to be designated as "Qualified Opportunity Zones" (QOZs). After reviewing the nominating data, the Secretary of Treasury certifies which nominated tracts will be designated as QOZs. Once certified, the designated QOZs retain their status for 10 years (through December 31, 2026, for QOZ.01 designations).

- **Step 2:** Eligible taxpayers, including individuals, partnerships, corporations, etc., realize a qualified capital gain (triggering event) and elects to defer tax on that capital gain.

- **Step 3:** Taxpayer finds or creates a "Qualified Opportunity Fund (QOF) and invests the capital gain in the QOF within 180 days of the date the gain was realized. Starting in 2027, QOFs include Qualified Rural Opportunity Funds (QROFs).

- **Step 4:** The QOF or QROF, directly or indirectly, operates a qualified trade or business in a qualified opportunity zone (QOZ).

- **Step 5:** The taxpayer continues to hold the QOF investment for at least five years, at which point the taxpayer may apply a 10% basis step up to the original gain. Effectively this means the taxpayer only pays tax on 90% of the original deferred gain. QROFs are allowed a 30% basis step up, leaving 70% of the original gain taxable.

- **Step 6:** If the taxpayer continues to hold the QOF or QROF investment for at least 10 years, any appreciation is tax-free. The tax-free appreciation only lasts through Dec. 31, 2047, for QOZ 1.0 and for 30 years (a rolling 30-year period) for QOZ 2.0 investments.

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Preparer note. It is very important to make the mental distinction between "Qualified Opportunity Funds" (QOFs) or "Qualified Rural Opportunity Funds" (QROFs), and "Qualified Opportunity Zones" (QOZs). Each of these terms have separate definitions and rules, and it is easy to mix them up.

Tax Benefits Related to Investing in Opportunity Zones (§1400Z-2; §1.1400Z2)

The tax benefits available to QOZ investors are focused on three areas:

1. Temporary deferral of tax on current year realized capital gains.
2. A portion of the deferred gains are permanently excluded from taxation.
3. Any appreciation in a QOZ investment held at least 10 years is tax free.

1. Temporary tax deferral on realized capital gains (§1.1400Z2-(a)-1)

Taxpayers may elect to defer tax on any qualified realized capital gain by reinvesting some or all the capital gain in a QOF. The taxpayer may elect to defer tax on all, some, or none of the gain. ***Only the gain must be reinvested to defer tax, not the basis of the property sold.*** For QOZ 2.0, any deferred gain is included in the taxpayer's taxable income in the tax year that is the earlier of the date there is an "inclusion event" (generally the date reinvestment property is sold) or five years after the date the reinvestment in the QOF was made. For QOZ 1.0 property, the investment was included in the taxpayer's income the earlier of when there was an inclusion event or the year ended Dec. 31, 2026.

Example. Evan sells a small apartment complex on December 15, 2027, for $2,500,000 and realizes a §1231 gain of $1,000,000. Evan reinvests the $1,000,000 gain in a QOF on or before June 12, 2028 (180 days from the date of the sale) and elects to defer the tax on the $1,000,000 gain. Evan retains the $1,500,000 return of basis with no tax consequences and his investment in the QOF has no basis.

Example - continuation. Evan reinvests $500,000 in OppFund, Inc. a QOF, on March 15, 2028, and invests the remaining $500,000 gain in OppToo, Inc., a different QOF, on June 1, 2028. Separate investments are allowed if the total investment occurs within 180 days of the date the capital gain was realized. Evan's entire $1,000,000 gain is excluded from his 2027 return.

Inclusion events (§1.1400Z2(b)-1(c)). In the event there is an "inclusion event," the taxpayer must immediately recognize the deferred gain and include it in its taxable income in the year the inclusion event occurs. Inclusion events include:

- In general, an event is an inclusion event if, and to the extent that:
  - The event reduces an eligible taxpayer's direct equity interest in the qualifying investment;
  - An eligible taxpayer receives property in the event with respect to its qualifying

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investment and the event is treated as a distribution for Federal income tax purposes, whether the receipt reduces the eligible taxpayer's ownership of the QOF;
  - An eligible taxpayer claims a loss for worthless stock under §165(g) or otherwise claims a worthlessness deduction with respect to its qualifying investment; or
  - A QOF in which an eligible taxpayer holds a qualifying investment loses its status as a QOF.

- Termination or liquidation of the QOF or the QOF owner.

- Transfer or a QOF investment by gift or by divorce.

Example. Courtney sold ranchland for $3 million in June 2027 and realized a long-term capital gain of $1,000,000. She invested timely in a XZY LLC, a QOF, and elected to defer tax on the capital gain. Her tax basis in XZY was zero. In September 2029, Courtney sold 40% of her XZY interest for $600,000.

The sale is an inclusion event, so Courtney is required to recognize a portion of her previously deferred gain. Because she only disposed of 40% of her QOF interest, only $400,000 (40% of the original $1,000,000 deferred gain) becomes taxable. Courtney recognizes the gain on her 2029 tax return and the $400,000 retains its original tax attributes – it is a long-term capital gain.

Courtney continues to own 60% of her original XZY investment, allowing her to continue to defer tax on the remaining $600,000 until there is another inclusion event or the five-year holding period ends in 2032.

Note – for simplicity we've kept Courtney's XZY's basis at zero. If she had basis, the gain calculation would be changed as distributions to the extent of basis generally do not create an inclusion event.

QOF Investments, Decedents and Trusts (§1400Z-2(e)(3); §691))

Deferred gain is income in respect of a decedent. Transfers by reason of death terminate the owner=s qualifying §1400A-2 investment. In most such circumstances, the qualifying investment is transferred to an heir of the owner=s estate or it may be transferred by operation of law to a named beneficiary. In either case the owner=s qualifying investment is terminated.

It's not an inclusion event. However, the IRS has concluded that neither the distribution of a qualifying investment to the deceased owner=s estate nor to the beneficiary of the estate is an inclusion event for purposes of §1400Z-2(b) (i.e., the gain need not be recognized by the estate or the beneficiary). This includes:

- Transfers to the decedent's estate;
- Distributions of the QOF interest to the estate;
- Transfer to a surviving spouse a jointly owned interest in a QOF; and
- Other death related transfers required by the law.

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Similarly, neither the termination of grantor trust status by reason of the grantor's death nor the distribution by that trust to a trust beneficiary by reason of the grantor's death is an inclusion event. In such cases, the estate or the estate beneficiary qualifies as a QOF investor who continues to defer the tax on the original gain under the same rules as the decedent. The estate or beneficiary is bound by all the QOZ recognition rules and the IRD rules (§691) to include the deferred gain in gross income in the event of any subsequent inclusion event (e.g., any further disposition by that recipient.).

Example. George realized a capital gain of $1,000,000 in July 2027 and elected to defer the gain by investing $1,000,000 in Foremost, Inc. a QOF, in December 2027. George passed away in February 2031 and left his investment in Foremost to his daughter Amy. George's estate is not required to report the $1,000,000 deferred gain on his final return. Instead, Amy inherits George=s Foremost stock, but she does not receive a stepped up basis on the stock. Amy's basis in Foremost is $100,000 (10% after five years) and she reports the $900,000 gain on her 2032 return. Amy continues to hold the Foremost stock until 2040, more than 10 years, so she will receive an additional basis step-up when the property is sold and not report any further taxable gain.

Some death related transfers may create an inclusion event. They include:

- Deceased estate sold, exchanged, or otherwise disposed of the QOF interest.
- Disposition by an heir of the inherited QOF interest.
- Any disposition by a joint owner or other recipient who received the QOF interest at the decedent's death due to the law.

QOF investments made before 2027. Under QOZ 1.0, taxpayers who timely invested an eligible capital gain in a QOF could generally defer recognition of that gain until the earlier of an inclusion event or the tax year ending December 31, 2026. As a result, investors who haven't already recognized a pre-2027 deferred capital gain must do so in 2026, even if he or she continues to hold the QOF investment.

Gains retain their original character when they are ultimately realized (§1.1400Z2(c)-1(ii)). Deferred gains retain their character when realized. For example, if a taxpayer uses a QOF investment to defer tax on a short-term gain, when the gain is recognized 5 years later it will still be taxed as a short-term gain. The time the QOF is held does not tack on to the original investment. But, if the tax laws or rates have changed since the gain was realized, the tax is calculated using the tax law applicable in the year of recognition.

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2. Portion of realized capital gains permanently excluded (§1400Z-2(b))

Taxpayers who hold their QOZ investments for at least 5 years are allowed to reduce the taxable portion of the originally deferred gain. Significant changes were made to these rules between QOZ 1.0 and QOZ 2.0. This means the first step is to distinguish between QOZ 1.0 and QOZ 2.0 transactions.

QOF investments made after 2026 – Rolling Five-Year Deferral. QOZ 2.0 substantially restructured the gain-deferral provisions for QOF investments made after December 31, 2026. Rather than requiring all deferred gains to be recognized on a common date, electing taxpayers are now allowed a rolling five-year deferral period that begins on the date the qualified investment is made in the QOF. Deferred gains are included in income the earlier of an applicable inclusion event or five years after the date the QOF investment was made (which may be up to 180 days after the capital gain was realized). If more than one QOF investment is made, each qualifying investment has its own five-year deferral period.

New five-year basis step up calculation. A taxpayer who holds the QOF investment for at least five years may increase basis in the investment by an amount equal to 10% of the deferred gain. The basis increase is treated as occurring before the deferred gain is included at the end of the five-year deferral period. Accordingly, the 10% basis adjustment effectively results in permanent exclusion of 10% of the originally deferred gain.

Example 1. Olivia realizes a $1,000,000 eligible capital gain on September 30, 2027, and invests the entire $1,000,000 in a QOF on January 30, 2028, well within the 180-day reinvestment window. Assuming there is no inclusion event, the realized gain is deferred until 2033, five years from the reinvestment date, not the sale date. Olivia receives a $100,000 basis increase immediately before the deferred gain is recognized, reducing her taxable gain to $900,000.

Enhanced 30% basis step up for Qualified Rural Opportunity Funds (QROFs). Taxpayers who invest qualifying capital gains into a QROF and who hold the QROF investment for at least 5 years are allowed a basis step-up of 30% of the deferred gain (instead of 10% for other gains).

Example 2. Assume the same facts as Example 1 above except Olivia invests $1,000,000 of eligible gain in a qualifying QROF. Assuming Olivia satisfies the five-year holding requirement, the basis increase attributable to the deferred gain would be $300,000 (30% of $1,000,000). Assuming no other adjustments or inclusion events, Olivia would pay tax in 2033 on a taxable gain of $700,000.

Preparer note. Any basis step up allowed under this provision is basis for all purposes. For example, if the QOF were a partnership and the partner had losses suspended due to lack of basis, any basis allocation from this provision could be used to deduct suspended losses.

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3. Any appreciation in a QOF investment held at least 10 years is tax free (§1400Z-2(c)).

Taxpayers who continue to hold the QOF or QROF investment for 10 or more years step up the basis of their investment in the QOF or QROF upon the sale of the QOF or QROF to either:

1. For investments held longer than 30 years, the fair market value of the investment 30 years after the date of the original investment, or

2. For investments held less than 30 years, the fair market value of the investment on the date it is sold.

Effectively, this allows the investment to be sold and up to 30 years of appreciation is tax-free.

Example. Continuing with the facts in the Olivia example 1 above, assume Olivia continues to hold her investment in the QOF fund for 15 years, at which point the QOF sells the underlying QOZ investment for $3.5 million. The QOF has no other investments, so Olivia liquidates the QOF. Olivia steps up her basis in the QOF investment to $3.5 million. This means she effectively pays no tax on the sale of the QOF investment. After all is said and done, Olivia realized a gain of $1,000,000 when she sold capital gain property in 2027, she recognized $900,000 of the gain in 2033, 5 years after the sale, the remaining $100,000 of the realized gain was exempted from tax, and finally she realized a gain of $2.5 million on the sale of her QOF investment and paid no tax. Essentially, Olivia realized gains of $3,500,000 over 15 years and paid tax of roughly $215,000 (approximately 6.1% total tax).
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Now We Know Why – Let's Talk About Who, What and When.

WHO – "eligible taxpayers" (§1.1400Z-2(b)(13)). An "eligible taxpayer" is a person that is required to report gains during the taxable year for Federal income tax purposes. The term "person" includes individuals, C corporations (including RICs and REITs), exempt organizations subject UBI tax, partnerships, S corporations, trusts, and most decedents' estates.

Election available at the owner level for pass-through entities (§1.1400Z2(c)(8)). Partnerships who elect to defer tax on eligible gains exclude the deferred gains from each partner's allocable share of income. If the deferral election is made, the eligible gain is initially excluded from each partner's share of allocable income and reported in each partner's respective share of income when the partnership recognizes the gain(s). If, however, the partnership chooses not to defer the gain recognition in the year the gain is realized, each partner's share of income that year will include the recognized gain. If this happens, the partner may individually elect to defer tax on his or her share of eligible gain by personally investing in a QOF. This rule applies to all other pass-through owners and beneficiaries (e.g., S corporation shareholders, etc.) (§1.1400Z-2(c)(9)).

Example. Tom, Jerry, and Sidney are equal partners in HB LLC. In 2027, HB LLC realizes a §1231 gain of $6,000,000 from the sale of a building. Tom and Jerry wish to take the money, pay the tax, and move on. Sidney would like to reinvest the gain in a QOF and defer the tax under

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§1400Z-2. Sidney is out-voted and her HB LLC K-1 includes her $2,000,000 share of the gain from the building sale. Sidney individually may elect to defer the gain on her personal tax return if the gain otherwise meets the rules for the deferral election.

See below for special timing rules for partners, shareholders, etc. of passthrough entities.

WHAT – Eligible gains (§1400Z-2(a); §1.1400Z2(a)-1(b)(11)). Taxpayers may elect to defer tax from the sale of "qualified gains," which are defined as:

1. Capital gains or qualified §1231 gains (but not any ordinary income gain under §1245 or §1250) for Federal tax purposes, not considering any losses;

2. That would be recognized for Federal tax purposes; and

3. Arise from the sale or other transfer to an unrelated party[2].

Qualified gains include capital gains from actual or deemed sales or exchanges, or any other gains that are required to be included in a taxpayer's computation of capital gain income. Qualifying gains include short- and long-term capital gains, net §1231 capital gains (including unrecaptured gain from the sale of §1250 property), collectible gains, and net capital gains from §1256 contracts. Gains taxed at ordinary income tax rates (e.g., recapture gains under §1245 and §1250) do not qualify.

Installment sale gains (§1.1400Z2(b)(11)(viii). Gains from installment sales are eligible for deferral if the gains otherwise meet the definition of an eligible gain. For installment sales that took place before 2018, the 180-day QOF reinvestment period begins on the day the installment payment is received. For sales that took place after 2017, the taxpayer may elect to either:

1. Choose to have a single 180-day period to make one or more investments in a QOFs. If the taxpayer chooses this option, the first day of the 180-day period is the last day of the tax year in which the sale occurred. One election is made to defer gain on the sale up to the amount that is invested in the QOF. This option effectively elects out of installment sale treatment on the sale.

2. Choose to have a separate 180-day period for each installment payment. Each reinvestment period begins on the day the installment payment is received, and the gain with respect to each payment is deferred to the extent that an amount is invested in a QOF.

WHEN – 180-day time limit (§1400Z-2(a)(1)(A); §1.1400Z2(a)-1(c)). To qualify to make the election to defer tax on some or all an eligible capital gain, the taxpayer must invest the gain within 180 days. The 180-day period begins on the date the capital gain would have been recognized by the taxpayer. However, the following exceptions were provided in the regulations:

- Net §1231 capital gains are, by operation of law, calculated on the last day of the

[2]Related parties for this purpose are defined in §267(b) or §707(b)(1), except that "20%" is substituted for "50%" in each place it occurs in such sections.

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taxpayer's year. Accordingly, the 180-day reinvestment period for any net capital gain from §1231 property begins on the last day of the taxable year, even if only one §1231 gain was realized during the year.

- Net §1256 capital gains are, by operation of law, calculated on the last day of the taxpayer's year. Accordingly, the 180-day reinvestment period for any net capital gain from §1256 property begins on the last day of the taxable year.

- If a partnership realizes an eligible gain, it has 180 days to reinvestment in a QOF. However, if the partnership chooses not to reinvest the gain, a partner has three reinvestment options (§1.1400Z2(a)-1(c)(8)):

    1. The partner's gain reinvestment period begins on the last day of the partnership's taxable year.

    2. The partner may elect to treat her or his own 180-day period as being the same as the partnership's 180-day period (i.e., use the date the underlying asset was sold by the partnership to start the 180-day period).

    3. The 180-day period begins on the due date of the partnership's tax return, without extensions, for the taxable year in which the partnership realized the gain.

The partner rule described here is applicable to other pass-through entity owners/beneficiaries (i.e., S corporations, trusts, and estates).

Example. Mark, Cindy, Shelly, Ron, and Jessi each own 20% of PBB, a partnership. PBB has a calendar tax year. On January 17, 2027, PBB sells a building and realizes a capital gain of $10,000,000. PBB decides it does not want to reinvest the gain in a QOF. However, Mark and Cindy each want to reinvest their $2,000,000 allocable gains in a QOF and defer the related tax.

Mark invests $2,000,000 in a QOF in February 2028. Mark may elect to defer the tax on his $2,000,000 gain as he made his QOF investment within 180 days of PBB's year-end (December 31, 2027). Cindy decides to make the election to use the same 180-day period as PBB and invests $2,000,000 in a QOF in June 2027. Cindy also meets the 180-day requirement as her 180-day reinvestment period that ended July 15, 2027 (180 days after January 17, 2027). The remaining partners would pay tax on their respective shares of gain.

The 180-Day Rule and Transition to New OBBBA Rules (§1400Z-2(b)).

Under QOZ 1.0, the law was set to expire as of December 31, 2026. All gains deferred under these provisions are set to be recognized as of December 31, 2026. The result was that a taxpayer who deferred gain under the QOZ rules were required to recognize the gain, less any applicable basis step up, in 2026. This included gains that were realized and invested in a QOF in 2026.

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Example 1. Cruz realized a capital gain of $1 million in March 2026. Cruz elected to invest the gain into a QOF. Cruz is required to recognize the gain as of December 31, 2026. While Cruz did not get any basis step up when he recognized the original gain, if he holds his investment for 10 or more years, any future appreciation will be tax free.

QOZ 2.0 transition (Notice 2026-40). QOZ 2.0 extends the QOZ provisions, with modifications, permanently effective January 1, 2027. This means that the 180-day capital gain reinvestment period could stretch into 2027 for taxpayers realizing gains in 2026. Taxpayers who timely reinvest an eligible 2026 gain in a QOF on or after January 1, 2027, may elect to defer the recognition of that gain. The gain deferred to 2027 must be included in gross income in the taxable year that includes the earliest of:

- The date on which such qualifying investment is sold or exchanged;
- The date on which an inclusion event other than a sale or exchange occurs with respect to such qualifying investment; or
- Five years from the date the qualifying investment in the QOF was made.

Example 2 – variation. Assume that Cruz in the previous example didn't realize the $1 million capital gain until September 30, 2026. Cruz has until March 28, 2027, 180-day reinvestment window, to reinvest in a QOF. If Cruz waits until January 1, 2027 to reinvest, he will be allowed to use the 5-year deferral, the 10% basis step up at 5 years, and the tax free appreciation in the replacement investment if he holds for 10 or more years.

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Clarifying example for these concepts. BCA, a partnership, realizes a $4 million long-term capital gain March 1, 2027. Under the partnership agreement, $2 million of the gain is allocated to Jessi. BCA decides not to reinvest in a QOF. Jessi, however, is entitled to make her own decision about deferring the gain and personally investing in a QOF. This is true even if BCA does not distribute any cash to Jessi. She may use other available cash to complete the QOF investment.

Jessi decides to personally defer tax on the $2 million gain allocated to her by BCA. The partner special timing rules allow Jessi to begin her reinvestment period either 1) March 1, 2027 (date of the sale), 2) December 31, 2027, the last day of the partnership's tax year, or 3) March 15, 2028, the original due date of the partnership's Form 1065.

Jessi and a business associate find property in a QOZ they are convinced is at least 25% undervalued. Jessi believes the property will sell quickly so she and her associate establish a partnership that will be a QOF. Jessi transfers $2,000,000 into the partnership and the partnership opens an escrow to complete the purchase of the QOZ property. Jessi knows she won't be able to complete the purchase by September 11, 2027, the end of the 180-day period based on the date the capital gain was generated by the partnership. She is also aware that any property owned by a partnership or corporation prior to the gain recognition cannot be QOZBP.

If Jessi waits to use either of the two alternate 180-day investment periods, the purchase of the property will close before the 180-day investment period begins so Jessi decides to move ahead with the 180-day investment period that ends on September 11, 2027. She must invest in a QOF before the deadline expires. The QOF then has a reasonable amount of time to use its operating capital to purchase QOZP. Jessi is allowed to defer tax on the $2,000,000 capital gain in 2027 by investing in the QOF and, assuming she continues to hold her interest in the QOF for at least 5 years, she won't have to report any capital gain until 2032. And, when she does report the gain, she will only be taxed on $1,800,000 (after the 5 year basis step-up).

QOFs – The Details (§1400Z-2(d); Notice 2026-40)

As mentioned above, eligible gains must be invested in a Qualified Opportunity Fund (QOF) to defer tax on the sale and realize tax free appreciation. A QOF is any investment vehicle organized as a corporation or partnership (including LLCs):

1. To invest in "qualified opportunity zone property" (QOZBP);

2. In the 50 states, District of Columbia, or a U.S. territory; and

3. At least 90% of its assets are qualified opportunity zone business property (the 90% test).

The entity's organizing documents must state that the entity's purpose is investing in qualified opportunity zone business property (QOZBP), and the documents should include a description of the qualified opportunity zone business(es) that the QOF expects to engage in. The taxpayer=s interest in the QOF may include preferred stock in a corporation or a partnership interest that receives special allocations. Debt instruments do not qualify. The entity must annually self-certify that it satisfies the QOF requirements (see discussion of Form 8996 below).

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Investments in QOFs are made by transferring cash or other property to the QOF in exchange for stock or a partnership interest, regardless of whether the transfer results in a recognized gain or loss on the property transferred.

Pre-existing entities (§1.1400Z2(d)-1(a)(1)(iii)). Pre-existing partnerships or corporations are eligible to become a QOF as long as the entity satisfies all the requirements of §1400Z-2 and related regulations, including the qualified opportunity zone business property (QOZBP) requirements.

Preparer note. There must be an entity to establish a QOF. QOFs cannot be a sole proprietorship or simply an individual taxpayer purchasing an asset located inside of a QOZ. ***If there is no entity, there is no QOF.***

Preparer note. Services rendered to a QOF are not qualified transfers. Taxpayers may acquire a qualified interest in a QOF from the QOF itself or from a person.

Qualified Opportunity Zone Property (QOZP) (§1400Z-2(d)). The definition of a QOF requires that the fund must invest in QOZP. QOZP is property that is either:

1. **QOZ Stock** – is defined as any stock in a domestic corporation if:
    a. The stock was acquired by a QOF at its original issue from the corporation solely in exchange for cash after the applicable date;
    b. The corporation was a Qualified Opportunity Zone Business (QOZB) (or newly organized for such purpose) at the time the stock was issued; and
    c. For 90% of the QOF's holding period of such stock, the corporation qualified as a QOZB.

2. **QOZ Partnership Interest (QOZPI)** – is defined as any capital or profits interest in a domestic partnership where:
    a. The interest was acquired by a QOF from the partnership solely in exchange for cash after the applicable date;
    b. The partnership was a QOZB (or newly formed for such purpose) at the time the interest was acquired (see definition below); and
    c. For 90% of the QOF's holding period of such interest, the partnership qualified as a QOZB.

3. **Qualified Opportunity Zone Business Property (QOZBP)** – is defined as tangible property used in a trade or business of the QOF if:
    a. Such property was acquired by the QOF by purchase after the applicable date;
    b. The original use of such property in the QOZ commences with the QOF or the QOF substantially improves the property; and
    c. During substantially all the QOF's holding period the property, substantially all of the use of such property was in a QOZ.

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Preparer note. Under the regulations, for an entity's trade or business to satisfy the "substantially all" requirement for 3.c. above, at least 70% (by value) of the tangible property owned or leased by the trade or business was in a QOZ.

Qualified Opportunity Zone Business (§1400Z-2(d)(3)). Drilling down one more level, both a QOZ stock and a QOZ partnership interest must invest in a qualified opportunity zone business (QOZB) for the corporation or partnership to qualify as QOZP. QOZB is a trade or business in which substantially all the tangible property owned or leased in connection with the trade or business is qualified opportunity zone business property (QOZBP). The trade or business must also satisfy the all following requirements (§1397C(b)):

1. At least 50% of the total gross income of the entity must be derived from the active conduct of a trade or business in the QOZ (see discussion below);

2. A substantial portion of the intangible property of the entity must be used in the active conduct of a trade or business in the QOZ;

3. Less than 5% of the average aggregate unadjusted bases of the entity's property must be attributable to non-qualified financial property; and

4. The trade or business cannot operate as, or provide land for, a:

    a. Private or commercial golf course or country club;
    b. Massage parlor;
    c. Hot tub facility;
    d. Suntan facility;
    e. Racetrack or other facility used for gambling; or
    f. Any store for which the principal business is the sale of alcoholic beverages for consumption off premises.

Preparer note. For these purposes, tangible property that ceases to be a QOZBP continues to be treated as QOZBP for the lesser of 1) 5 years after the date on which such tangible property ceases to be so qualified, or 2) the date the tangible property is no longer held by the QOZB.

Application of the 50% test (§1.1400Z-2(d)-1(d)(3)). A trade or business meets the 50% test if it satisfies any of the following four criteria:

1. **Hours test** - at least 50% of the hours of service performed for the business were performed in the QOZ. Hours of service includes all hours performed by partners, employees, independent contractors, and employees of independent contractors.

2. **Services paid test** - at least 50% of the amount paid for services (including payments for services provided by employees, independent contractors, or employees of independent contractors) were paid for services performed in the QOZ.

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3. **Necessary tangible property and business functions test** - the tangible property of the trade or business located in a qualified opportunity zone and the management or operational functions performed in the qualified opportunity zone are each necessary for the generation of at least 50% of the gross income of the trade or business, regardless of where the income is earned.

4. **Facts and circumstances test** - based on all the facts and circumstances, at least 50% of the gross income of a QOZ business is derived from the active conduct of a trade or business in the QOZ.

Example 1. Softech LLC is a software development company whose sole campus is in a QOZ. Softech sells its software globally via internet download and less than 1% of its sales are to customers located in a QOZ. Softech's software is developed by employees who all work at the QOZ campus and independent contractors who work from locations throughout the U.S. At the end of its taxable year, based on payroll and contractor contracts, Softech determines that its employees spent more than 200,000 hours and its independent contractors spent approximately 110,000 hours working for Softech. The 50% hours test is met and Softech is a QOZ business.

Example 2. AWEG, Inc. is a landscaping business with headquarters in a Kentucky QOZ. AWEG's officers and employees manage the daily operations of the business (within and without the QOZ) from the headquarters, which is also where all its equipment and supplies are stored. AWEG does not meet the hours or the services paid tests. However, the activities occurring and the storage of equipment and supplies in the QOZ are, taken together, a material factor in the generation of 100% of the income of the business. AWEG meets the Necessary Tangible Property and Business Function test. AWEG is a QOZ business.

Example 3. GEWA is a competing landscape business that was organized under Kentucky law in the same QOZ where AWEG is headquartered. GEWA establishes a PO Box within the QOZ and the mail it receives at the PO Box is fundamental to the income and operations of the landscaping business. GEWA does not meet the hours or the services paid tests. Other than the PO Box and an occasional job in the QOZ, GEWA has no business or management activities in the QOZ. GEWA does not meet any of the business functions tests and it is not a QOZ business.

QOFs and the 90% Asset Test

QOF 90% Asset Test. To meet the requirements of a QOF, the entity must hold at least 90% of its assets in QOZP. The 90% asset test is determined using the average percentage of qualified opportunity zone property held by the QOF on: 1) the last day of the first 6-month period of the QOF's taxable year (June 30th for calendar year fund) or certification; and 2) on the last day of the QOF's taxable year (December 31st for calendar year fund).

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Example 1. Sara sells bare land on December 10, 2027, and realizes a gain of $5,000,000. Sara forms ITU, a corporation, on January 1, 2028, and contributes the $5,000,000 in exchange for 100% of ITU's outstanding stock. Sara intends for ITU to be a QOF, and she plans to defer the tax on the $5,000,000 gain from the land sale. ITU uses $4,500,000 of its cash to purchase bare land located in a QOZ on June 1, 2028, and immediately begins construction of an apartment complex on the land it purchased. ITU uses debt to fund the apartment complex construction. ITU has no other assets. For 2028, ITU's assets are summarized for purposes of the 90% test:

	June 30th	December 31st	Average
Cash	$ 500,000	$ 500,000	$ 500,000
Buildings (in progress)	$2,500,000	$ 7,500,000	$ 5,000,000
Land	$4,500,000	$ 4,500,000	$ 4,500,000
Total assets	$7,500,000	$12,500,000	$10,000,000

As all the assets are qualified opportunity zone business property ITU meets the 90% test and qualifies as a QOF.

Applying the 90% asset test. The 90% of assets test applies to all corporations and partnerships that are certified as QOFs. Newly formed corporations or partnerships may be certified as a QOF beginning on any day it chooses. For first year entities, the average percentage of qualified opportunity zone business property held is determined using the assets held: 1) the last day of the first 6-month period of the QOF's existence or certification; and 2) the last day of the QOF's taxable year. After the first year, entities must continue to test to ensure the 90% test is met.

Example 2. Assume the same facts as above except ITU became certified as a QOF in July 2028 at which time Sara reinvests the $5,000,000 gain. Because the end of the fiscal year occurs before it is possible for a 6-month period to end, the assets are not averaged. The asset values at year end are used to determine if the 90% test is met.

Preparer note. Investments made before the QOF is certified are not eligible for deferral. Any election made to defer a reinvested gain is invalid. For example, if Sara from the last example reinvests her $5,000,000 gain in exchange for ITU stock in May 2028, and ITU is certified as a QOF in July 2028, the gain deferral rules do not apply, and the entire $5,000,000 gain would be taxable on Sara's 2027 tax return.

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Entity fails the 90% of assets test - now what? An entity that fails the 90% of assets test continues to be treated as a QOF. However, whenever the 90% test is failed, the entity must pay a penalty with its tax return. The penalty is calculated monthly on Form 8996. The penalty is calculated using the QOZBP assets and the non-QOZBP assets for each month of the taxable year. For any month where the ratio of QOZBP to all assets is less than 90%, a penalty is calculated for that month on the difference. The monthly penalties are then added together to arrive at the total penalty for the year.

Preparer note. The critical point here is that even if the 90% of QOZBP test was failed, the entity retains its status as a QOF. The penalty continues to be paid until the entity is brought back into compliance but the investor who deferred tax doesn't have to recognize the deferred gain if the QOF fails the 90% QOZBP test if the transaction is not abusive.

Preparer note. Pre-existing entities may qualify as a QOF. To do so the entity must satisfy all the previously discussed requirements, including the 90% qualified opportunity zone business property test. Any QOZBP must be acquired after December 31, 2017.

Methods used to value assets for the 90% test (§1.1400Z-2(d)(1)(b)). For purposes of the 90% asset test, a QOF may annually choose one of two methods to value its assets, : 1) the applicable financial statement valuation method; or 2) the alternative valuation method. The method chosen must be consistently applied to the valuation of all assets.

1. **Applicable financial statement valuation method.** Under this method the value of each QOF owned or leased asset is the value of that asset as reported on the QOF's applicable financial statement[3] for the relevant reporting period. This method may only be used if the applicable financial statement is prepared according to U.S. generally accepted accounting principles (GAAP) and requires an assignment of value to leased assets.

2. **Alternative valuation method.** Under this method the value of each QOF owned asset is the QOF's unadjusted cost basis[4] of the asset. The QOF value for leased assets equals the present value of the leased asset (see additional discussion of the present value calculation in the regulations).

Excluding recently contributed property. A QOF may choose to exclude from the 90% asset test recently acquired property that was:

1. Received by the QOF partnership or corporation solely in exchange for a partnership interest (§721 property) or corporate stock (§351 property), respectively;

2. Contributed within 6 months before the test from which it is being excluded; and

[3]Applicable financial statement for this purpose is defined in '1.475(a)-(4)(h), and generally means a financial statement provided to the SEC or any other Federal agency other than the IRS or is a certified audited financial statement.

[4]As defined under '1012 (generally the unadjusted cost basis).

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3. Between the date of the contribution and the date of the asset test, the amount was held continuously in cash, cash equivalents, or debt instruments with a term of 18 months or less.

QOZB Working Capital Exception (§1400Z-2(d)(3))

Non-qualified financial property exception (§1.1400Z2(d)-1(d)(5)(iv)). A QOZB is required to maintain less than 5% of its average aggregate unadjusted bases in non-qualified financial property. The term non-qualified financial property excludes reasonable amounts of working capital held in cash, cash equivalents, or debt instruments.

Working capital[5] safe harbor (§1.1400Z2(d)-1(d)(5)(v)). The regulations provide a safe harbor where working capital is reasonable if:

1. **Designated in writing.** The amount is designated in writing for the development of a trade or business in a qualified opportunity zone, including the acquisition, construction, and/or substantial improvement of tangible property.

2. **Reasonable written schedule.** There is a written schedule consistent with the ordinary start-up of a trade or business and the working capital is expected to be, and is, spent within 31 months.

3. **Property consumption consistent.** The working capital assets are used in a manner that is substantially consistent with the written plan. Delays beyond the plan or 31 months that are due to governmental action (or inaction as the case may be) do not cause the taxpayer to fail the safe harbor.

[5]For this purpose, working capital is defined under §1397C(e) as cash, cash equivalents, or debt instruments with a term of 18 months or less.

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Example. McDoos Inc, a QOF, was created to open and operate a fast-food restaurant in a QOZ. Ron acquired all the equity of McDoos in exchange for cash. McDoos has a written plan with a 20-month schedule that shows that Ron's contributed cash will be used to establish the restaurant. Specifically, the cash is to be used to identify favorable restaurant locations in the QOZ, leasing a suitable building, furnishing the building with appropriate equipment and furniture, obtaining a franchise and local permits, and the hiring and training of kitchen and wait staff. Not-yet-disbursed amounts were held in cash, cash equivalents, or debt instruments with a term of 18 months or less.

McDoos's use of the cash qualifies for the working capital safe harbor.

Real Property and QOZ Business Property

General requirements for QOZ Business Property (§1400Z-2(d)(2)(D)). As mentioned above, QOZBP is defined as tangible property used in a trade or business of a QOF. These requirements generally include:

- the property must be acquired by purchase within the applicable statutory period;
- the original use of the property in the QOZ must commence with the QOF, or the QOF must substantially improve the property; and
- during substantially all the QOF's holding period, substantially all the property's use must be within a QOZ (the geographic-use requirement means at least 70% of the property's use is in QOZ during at least 90% of the QOF's or QOZB's holding period).

Real property rental is a trade or business (§1.1400Z2(d)-1(d)(3)(iii)). Solely for the purpose of establishing whether an activity is a QOZ trade or business, the ownership and operation (including leasing) of real property is the active conduct of a trade or business. However, merely entering a real property triple-net-lease for real property owned by the taxpayer may not be the active conduct of a trade or business by such taxpayer.

Buildings purchased in the qualified opportunity zone (§1400Z-2(d)(2)(D)(ii); §1.1400Z2(d)-2; Rev. Rul. 2018-29). If a QOZ business purchases a building located on land within a QOZ and begins using the building for its business, the building does not qualify as a QOZ business property because it does not meet the original use test. However, the original use can be met if existing tangible property (building) located in a QOZ is substantially improved. For this purpose, "substantially improved" is defined as spending an amount equal to or greater than the unadjusted basis in the property i.e., 100% of the original basis). Only the building's basis is considered. The basis of the underlying land is excluded from the substantial improvement test.

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Example 1. BZW, LLC purchases a building in a QOZ for $8,000,000 in July 2027. BZW appraised the building and determined that $4,800,000 of the purchase price is allocable to land and the remaining $3,200,000 is allocable to the building. The building was previously a factory, but BZW intends to convert it into residential rental property. Within 24 months of buying the building BZW invests an additional $4,000,000 to convert the building to residential rental property. The building has been substantially improved within a 30-month period and therefore qualifies as QOZBP.

Example 2. BZW, LLC purchases a building in a QOZ for $8,000,000 in July 2027. BZW appraised the building and determined that $4,800,000 of the purchase price is allocable to land and the remaining $3,200,000 is allocable to the building. While BZW plans to spend $500,000 to upgrade and remodel the existing building so it can be used for a factory and offices for a QOZB. Even though the land value of $4,800,000 is excluded from the calculations, BZW's improvements are nowhere near 100% of the building's original cost basis and, therefore, the building does not qualify as QOZ business property.

New Rules for Rural Opportunity Zone Investments. OBBBA changed the term "substantially improved" for investments in Qualified Rural Opportunity Funds from 100% of the building costs to an amount equal to 50% of the unadjusted basis of the property (i.e., 50% of the original basis). The 50% substantial improvement threshold went into effect on July 4, 2025, when The OBBBA was signed into law.

Example 3. Assume the same facts as in Example 1 above, except the building BZW, LLC purchased was in a Qualified Rural Opportunity Zone. BZW had the building appraised and determined that $4,800,000 of the purchase price is allocable to land and the remaining $3,200,000 is allocable to the building. The building was previously a factory, but BZW spends $1,700,000 to remodel it to make is work for BZW's factory operations. Because BZW's building is in a QROZ and because it spent more than 50% of the building's original cost ($3,200,000 x 50% = $1,600,000), the building was substantially improved and therefore qualifies as QOZBP.

Special rule for unimproved land (§1.1400Z2(d)-2(b)(4)(iv)(B)). Unimproved land located within a QOZ and acquired by purchase is generally not required to be substantially improved. Betterments to land may be added to its basis and included as QOZBP if the betterments are paid for by the eligible entity. Simply purchasing vacant land in a QOZ does not automatically produce QOZ property. The bare land must be used in a trade or business. This means that purchasing vacant land and passively holding it for future appreciation without meaningful business activity (i.e., land banking) would generally not qualify. The regulations specifically state that unimproved or minimally improved land that, when it was purchased, the QOF or QOZB had an expectation, intention, or view not to improve the land by more than an insubstantial amount within 30 months after the purchase, does not qualify as QOZBP. This means that the investor's development plans and intent at the time of acquisition are important in establishing QOZ qualifications.

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Example. Garnin Partners, a QOF, establishes Land Ho LLC, a QOZB to purchase 100 acres of unimproved land for $2 million. The land is in a QOZ and is purchased from an unrelated seller. The QOZB intends to develop the land into an industrial facility. During the 30 months following the land acquisition, the QOZB spent $8 million constructing the facility. The QOZB does not have to spend another $2 million to "substantially improve" the land itself. Assuming the building and related activity constitutes an active trade or business, and the remaining requirements are met, the land and improvements are QOZ business property.

Example – variation. Assume the same fact as in Example 1, except Garnin purchases the land to simply hold it for 10 years in anticipation that economic development in the surrounding Opportunity Zone will increase its value. Garnin is not expecting any significant development, construction, or other improvement to the property. In this case, the general exception for unimproved land would not apply and the land would likely not be deemed to be QOZBP.

Real property straddling a qualified opportunity zone. If real property is located partially in a QOZ and partially outside a QOZ, the real property may still qualify as QOZ business property. The taxpayer must determine whether the square footage or the property located within the QOZ is substantial when compared to the square footage located outside of the QOZ. The real property outside of the QOZ must also be contiguous to the real property located inside the QOZ. If these tests are met, then all the property is deemed to be located within a QOZ. But, if the land is unimproved or minimally improved and the QOF has no or little expectation or intention of improving the land by more than an insubstantial amount within the 30 months after the date of purchase, it does not qualify.

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Investments Not Equal to Deferred Gain – Mixed Funds

What if the taxpayer invests an amount different than the gain - mixed funds? Taxpayers may choose to invest any amount they wish into a QOF. They are not required to invest 100% of a gain and they may also invest a more than the eligible gain into one QOF. Lastly, the investor may invest in the same QOF at different times.

Example. Josh sold his business in 2027 for $5,000,000 and realized a capital gain from the sale of $1,000,000. Josh invests $600,000 in OppFund LLC, a QOF, and elects to defer the tax on that part of the gain. Josh's $600,000 investment in OppFund LLC receives all the same tax benefits discussed above. The difference is that the remaining $400,000 gain is taxable on Josh's 2027 tax return and the tax on the $600,000 reinvestment is deferred. If Josh holds the investment for 5 years, he will be allowed to step up his basis in OppFund LLC by $60,000 (10% of the deferred gain) and pay tax on the remaining $540,000 gain. Only the portion of his gain that was invested in OppFund is considered.

Mixed-funds investments - qualified and non-qualified (§1.1400Z2(b)-1(a)(2)(v)). Mixed-funds investments occur when a taxpayer has one or more qualifying investment(s) and one or more non-qualifying investment(s) in the same QOF. A mixed-funds investment will result if the taxpayer makes:

1. A qualifying contribution to a QOF of property that has a fair market value more than the property's adjusted basis; or
2. A contribution to a QOF in an amount that exceeds the amount of the deferred gain.

In each instance, the excess (that is, the excess of fair market value over adjusted basis, or the excess of the investment amount over eligible gain, as appropriate) is treated as a separate investment.

FIFO method generally required for mixed-fund investments (§1.1400Z2(a)-1(b)(6)). If a taxpayer holds investment identical interests in a QOF that were acquired on different days and if, on a single day, the taxpayer disposes of less than all of these interests, then the first-in-first-out (FIFO) method must be used to identify which interests were disposed of. Such interests may be equivalent shares of stock in a corporation or partnership interests with identical rights. The FIFO method determines:

- Whether an investment was sold or exchanged, regardless if a gain deferral election was made;
- The attributes of any gain subject to a deferral election; and
- The extent of an increase in the basis of an investment interest that was disposed of.

Pro-rata method may be necessary. If, after application of the FIFO method, the taxpayer still has deferred and non-deferred gains that are undistinguishable, then a proportionate allocation must be made to determine which interests were disposed of (pro-rata method).

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Example. Josh sold his business in 2027 for $5,000,000 and realized a capital gain of $1,000,000. Josh invested $1,500,000 in OppFund LLC. Josh elects defer tax on the full $1,000,000 capital gain. The remaining $500,000 Josh invested in OppFund LLC is not subject to any tax benefits – no stepped up basis at either 5 years or 10 years. If Josh holds the QOF investment for 5 years, he will get a basis step up of $100,000 (10% of $1 million). Assuming Josh sells the QOF investment in 2040 for $3.5 million. Josh will realize a gain of $2,000,000, of which $666,000 is taxable:

Attributable to	**100% Total**	**66.7% Deferred Gain**	**33.3% Josh Gain**
Sale price	$ 3,500,000	$2,333,333	$1,166,667
Basis on original purchase	($ 500,000)	($ - 0 -)	($ 500,000)
Basis at 5 year point	($1,000,000)	($1,000,000)	($ - 0 -)
Gain on sale	$ 2,000,000	$1,333,333	$ 666,667
Exclude gain due to basis step up	($1,333,333)	($1,333,333)	($ - 0 -)
Taxable gain	$ 666,667	$ - 0 -	$ 666,667

The portion of the gain derived from the non-capital gain investment in OppFund LLC is fully taxable. Of course, presumably Josh could start over and invest the $666,000 in a new QOF!

Additional basis info. Basis is increased by the amount of gain recognized on the investment (Code Sec. 1400Z-2(b)(2)(B).

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10-Year Appreciation Basis Step-up Rule Revisited (§1400Z-2(c); §1.1400Z2(c)-1)

As previously discussed, taxpayers who have had a QOF investment for at least 10 years may elect to increase basis in the QOF to an amount equal to the fair market value of the investment on the date of disposition. The election may only be used to step-up the basis on the portion of the QOF investment that results from a gain deferred under §1400Z-2 and is allowed regardless if the QOF designation has expired.

Example. Chris sells bare land in July 2027 for $5,000,000, realizing a long-term capital gain of $3,000,000. Chris invests $2,000,000 in RAF, Inc., a QOF organized as an S corporation, in December 2027 (180-day test met) and elects to defer the tax on the gain from the land sale. On December 31, 2032, Chris recognizes the $1,800,000 ($2,000,000 deferred gain less $200,000 (10%) step up) capital gain that was deferred in 2027. In July 2040 Chris sells 100% of his interest in RAF, Inc. for $3,400,000, realizing a gain of $1,400,000 on his original $2,000,000 investment. Chris may elect to increase his basis in the RAF stock to $1,400,000 calculated:

Original basis - investment that was not deferred gain	$N/A-None
Basis step-up for gain recognized in 2032	$2,000,000
Basis step-up for holding QOF for 10 years - gain portion only	$1,400,000
Total basis	$3,400,000

OBBBA QOZ 2.0 change (1400Z-2(c)). For amounts invested in QOFs in 2027 and after, taxpayers who retain their QOZ investment 10 or more years are allowed to elect to treat the basis of the investment as equal to:

1. For investments sold within 30 years of the date of the investment was made, the FMV of the investment on the date it is sold or exchanged; or

2. For investments sold of exchanged more than 30 years after the investment was made, the FMV of the investment on the date that is 30 years after the date the investment was made.

Special Election Makes 10-Year Basis Step-Up Rule Work for Partnerships and S Corporations (§1.1400Z2(c)-1(b)(2))

The problem with the 10-year appreciation rule is that presumably a partner or shareholder would have to dispose of his or her interest in the underlying QOF partnership or QOF S corporation to receive any benefit. However, the regulations include a provision that allows a taxpayer who has held a qualifying investment in a QOF partnership or QOF S corporation for at least 10 years, and the QOF disposes of QOZBP after the 10-year holding period is met, to make an election to exclude some or all of the capital gain arising from the disposition reported on the K-1. The election may also be made for net capital gain income from qualifying §1231 property.

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Example - Facts. Sean realizes a net gain of $3,500,000 when he sells a small apartment complex for $5,800,000 in February 2027. Sean formed JSL Inc. in June 2027, an S corporation, and contributes $3,500,000 in exchange for 100% of JSL's stock. JSL is a QOF and Sean elects to defer the gain when he files his 2027 tax return. Sean may elect to step up the JSL stock basis to current FMV start in June 2037, 10 years after the original investment was made. But to do so he would need to sell his shares of stock in JSL.

Conclusion. JSL never received any capital contributions other than Sean's original contribution. JSL accumulated losses of $100,000 from operating rental real estate activities. Even though Sean was a real estate professional and materially participated in JSL's activities, he didn't have adequate basis to allow him to deduct the rental losses so the entire $100,000 of accumulated losses were suspended. Sean recognized $3,500,000 less the $350,000 (10%) basis step up, on his 2032 individual tax return (five years after investing in the QOF). The basis step up plus the recognized gain created basis for Sean in JSL, which allows him to deduct the $100,000 of suspended losses, leaving him net basis of $3,400,000.

In 2040, when the FMV of its assets is $5,500,000, JSL sells one of its properties and realizes a gain of $2,000,000 which flowed through on Sean's K-1. Sean made the election on his personal return to exclude all the capital gain reported on the JSL K-1 that is attributable to a qualifying investment (QOZBP). Even though he still owned 100% of JSL's stock, Sean is not required to recognize any income from the pass through capital gain.

Making the election. The taxpayer must make the election for the taxable year in which the capital gain is recognized by the QOF partnership or QOF S corporation. The taxpayer may elect to exclude some or all the capital gain reported on the QOF K-1. The election is made by reporting the gain where it normally is reported (e.g., Sch. D or Form 4797). The taxpayer would then report the exclusion on Form 8949 by entering Code Z in Column f and then entering the exclusion as a negative number in Column g.

Special election and REITs (§1.1400Z2(c)-1(e)). Qualifying shareholders who realize capital gain dividends paid by a QOF REIT may to elect to receive tax free treatment. To qualify, the QOF REIT shareholder must receive a capital gain dividend identified with a date[6], the shareholder treats the capital gain dividend as gain from the sale of a qualifying investment on that date, and the shareholder held the qualifying REIT investment at least 10 years.

[6] "With a date" means a capital gain dividend (defined at '857(b)(3)(B)) and a date that the QOF REIT designates in a notice provided to the shareholder not later than one week after the capital gain dividend is so designated. The notice must be mailed or emailed to the shareholder.

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Notification Requirements for S Corporations and Partnerships (§1.1400Z2(b)-1(h))

Notification of deferral election. A partnership or S corporation that makes a deferral election must notify all its partners or shareholders of the deferral election and state each partner or shareholder's distributive share of the eligible gain. Similarly, a partner or shareholder that makes a deferral election must notify the partnership or S corporation in writing of its deferral election, including the amount of the eligible gain deferred.

Notification of deferred gain recognition by indirect QOF owner. If an indirect owner of a QOF partnership or QOF S corporation sells a portion of its partnership interest or S corporation shares in a transaction to which the special mixed fund or S corporation rules apply (see §1.1400Z2(b)-1(c)(6)(iv) and §1.1400Z2(b)-1(c)(7)(iii)) such indirect owner must provide to the QOF owner notification and information sufficient to enable the QOF owner, in a timely manner, to recognize an appropriate amount of deferred gain.

Notification of basis step after 10 years election by QOF partner, QOF partnership, QOF S corporation or QOF S corporation shareholder. A QOF partner or shareholder must notify the QOF partnership or QOF S corporation of an election to adjust the basis of the qualifying QOF partnership interest or S corporation stock that is disposed of in a taxable transaction.

Using QOF Investments as Loan Collateral (§1.1400Z2(a)-1)b)(3)(ii)).

An eligible taxpayer that is an equity owner of a QOF may use the interest in the QOF as collateral for a loan and it will not have any effect on the taxable status of any related deferred gain or the investment in the QOF. This is true regardless if the loan was a part of purchase money borrowing or otherwise.

Designation of QOZs (§1400Z-1); Rev Proc. 2026-14

Along with making the QOZ law permanent, OBBBA significantly changed the process by which areas are designated as "Qualified Opportunity Zones." Beginning in 2027, the OBBBA established a recurring 10-year designation process. Beginning July 1, 2026, and generally every 10 years thereafter, the governor of each state will nominate eligible low-income census tracts for designation as QOZs. The statutory "decennial determination date" is July 1, 2026, and each July 1 occurring 10 years thereafter (so July 1, 2036, July 1, 2046, etc.).

Nomination process. States may nominate up to 25% of its eligible low-income communities as QOZs. If a state has fewer than 100 eligible low-income communities, up to 25 tracts may be designated. OBBBA made the eligibility standards for the new zones more restrictive than those applicable to the original 2018 designations. Generally, an eligible low-income community must satisfy the revised poverty and/or median-family-income requirements of §1400Z-1(c). Treasury has identified the census tracts eligible for nomination for the 2027 designation cycle (US Dept. Of Treasury, Qualified Opportunity Zones). After a governor submits the nominations, the Secretary of the Treasury certifies and designates the qualifying census tracts. For the current cycle, Treasury opened the nomination process on July 1, 2026, with the new designations intended to become effective January 1, 2027.

Designation sunset. Each new QOZ designation remains effective for 10 years, beginning on

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January 1 following Treasury's certification and ending immediately before the date that is 10 years after that applicable start date (so December 31, 2036, December 31, 2046, etc.). The process then repeats every 10 years, allowing the QOZ map to be periodically updated to reflect changes in the economic conditions of census tracts.

New QOZ class – Qualified Rural Opportunity Funds (§1400-2(b)(2)(C)). The original QOZ law provided that only low-income census tracts and a small number of contiguous census tracts, even if they were not low-income, were allowed to be nominated as QOZs. Under OBBBA, low-income tracts are still allowed, but contiguous tracts will no longer qualify. Additionally, OBBBA created a new tract class that may be nominated – Qualified Rural Opportunity Funds (QROFs). A QROF holds at least 90% of its assets in QOZP that is:

1. QOZBP substantially all the use of which, during substantially all the QOF's holding period for such property, was in a QOZ comprised entirely of a rural area; or

2. QOZ stock, or a QOZ partnership interest, in a qualified opportunity zone business in which substantially all the tangible property owned or leased is QOZBP and substantially all the use of which is in a QOZ comprised entirely of a rural area.

For this purpose, a rural area is defined as any area other than (1) a city or town that has a population of greater than 50,000 inhabitants and (2) any urbanized area contiguous and adjacent to a city or town that has a population of greater than 50,000 inhabitants.

How Are QOF and QOZ Investments Reported?

Reporting for QOF and QOZ investments are required from two taxpayers. Taxpayers who invest in QOFs are required to report the investment when filing their income tax returns. QOFs entities are required to annually report that the QOF meets the requirements to qualify as a QOF. OBBBA significantly increased the information that must be reported by both investors and QOFs. The draft version (as of August 2026) of Form 8997 has been expanded to 5 pages (the 2025 version was 2 pages). Significant changes are expected to be made to the 2026 version of Form 8996 as well.

Required reporting for taxpayers who invest in QOFs. Taxpayers electing to defer realized gains by making a QOF investment are required to report the property sold on their current year income tax return. The deferred gain is reported on a separate row of Form 8949. If the taxpayer made multiple investments, each investment is reported on its own separate row. The EIN of the QOF is reported in column (a) where the investment was made. Columns (c), (d), and (e) are left blank and a code "Z" is entered into column (f). The amount of the deferred gain is reported as a negative number in column (g).

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Form **8949**

Department of the Treasury
Internal Revenue Service

Sales and Other Dispositions of Capital Assets

File with your Schedule D to list your transactions for lines 1b, 2, 3, 8b, 9, and 10 of Schedule D.
Go to *www.irs.gov/Form8949* for instructions and the latest information.

OMB No. 1545-0074
2025
Attachment Sequence No. **12A**

Name(s) shown on return	Social security number or taxpayer identification number
John Diamond	555-55-5555

Before you check Box A, B, C, G, H, or I below, see whether you received any Form(s) 1099-B, Form(s) 1099-DA, or substitute statement(s) from your broker. A substitute statement will have the same information as Form 1099-B or Form 1099-DA. They will show whether your basis (usually your cost) was reported to the IRS by your broker and may even tell you which box to check.

Part I **Short-Term.** Transactions involving capital assets you held 1 year or less are generally short-term (see instructions). For long-term transactions, see page 2.

Note: You may aggregate all short-term transactions reported on Form(s) 1099-B and Form(s) 1099-DA showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the totals directly on Schedule D, line 1a; you aren't required to report these transactions on Form 8949 (see instructions).

You *must* check Box A, B, C, G, H, or I below. Check only one box. If more than one box applies for your short-term transactions, complete a separate Form 8949, page 1, for each applicable box. If you have more short-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

- ☑ **(A)** Short-term transactions reported on **Form(s) 1099-B** showing basis **was** reported to the IRS (see **Note** above)
- ☐ **(B)** Short-term transactions reported on **Form(s) 1099-B** showing basis **was not** reported to the IRS
- ☐ **(C)** Short-term transactions, other than digital asset transactions, not reported to you on **Form 1099-B** or **Form 1099-DA**
- ☐ **(G)** Short-term transactions reported on **Form(s) 1099-DA** showing basis **was** reported to the IRS (see **Note** above)
- ☐ **(H)** Short-term transactions reported on **Form(s) 1099-DA** showing basis **was not** reported to the IRS
- ☐ **(I)** Short-term digital asset transactions not reported to you on **Form 1099-DA** or **Form 1099-B**

1 (a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed of (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis See the **Note** below and see *Column (e)* in the separate instructions.	Adjustment, if any, to gain or loss If you enter an amount in column (g), enter a code in column (f). **See the separate instructions.** (f) Code(s) from instructions	(g) Amount of adjustment	(h) **Gain or (loss)** Subtract column (e) from column (d) and combine the result with column (g).
99-9999999 (QOF EIN)	06-30-2027	Leave Blank	Leave Blank	Leave Blank	Z	($900,000)	

Preparer tip. The IRS advises taxpayers who are attaching multiple Forms 8949 to their return to attach the Form(s) 8949 that lists code "Z" in column (f) first.

Additional reporting required for investors (Form 8997). Each year a taxpayer holds a QOF investment they must also file Form 8997, Initial and Annual Statement of Qualified Opportunity Fund (QOF) Investments. The form must also be filed if the QOF investment is disposed of during the year. If the taxpayer has held the QOF investment for more than 5 years, additional basis information is required to be reported. The draft 2026 version of Form 8997 has been expanded to 5 pages (only two pages in 2025).

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Form **8997**

Department of the Treasury
Internal Revenue Service

Initial and Annual Statement of Qualified Opportunity Fund (QOF) Investments

Attach to Form 1040, 1040-SR, 1040-NR, 1041, 1065, 1120, 1120-F, 1120-REIT, 1120-RIC, 1120-S, or 990-T.

Go to *www.irs.gov/Form8997* for instructions and the latest information.

OMB No. 1545-0123

2026

Attachment Sequence No. **997**

Name

Taxpayer identification number (TIN) (see instructions)

Part I **Total QOF Investment Holdings Due to Deferrals Prior to Beginning of Tax Year**
If different from last year's ending QOF investment holdings, attach explanation.

(a) QOF EIN	(b) Date QOF investment acquired (MM/DD/YYYY)	(c) Description of QOF investment (for example, 100 shares or 25% interest)	(d) Special gain code	Deferred gain held in QOF (e) Amount of short-term deferred gain remaining in QOF	Deferred gain held in QOF (f) Amount of long-term deferred gain remaining in QOF

1	Enter the totals, if any, from continuation sheet	1	
2	Enter the totals from columns (e) and (f)	2	

Part II **Current Tax Year Capital Gains Deferred by Investing in QOF**

(a) QOF EIN	(b) Date QOF investment acquired (MM/DD/YYYY)	(c) Description of QOF investment (for example, 100 shares or 25% interest)	(d) Special gain code	Deferred gain invested in QOF (e) Amount of short-term deferred gain in QOF	Deferred gain invested in QOF (f) Amount of long-term deferred gain in QOF

1	Enter the totals, if any, from continuation sheet	1	
2	Enter the totals from columns (e) and (f). See instructions for reporting on Form 8949	2	

Applicability of Special Rules Regarding the Waiver of Certain Treaty Benefits

Are you a foreign eligible taxpayer? See instructions for more information.

☐ **Yes.** You may not elect to defer tax on an eligible gain by investing in a QOF unless you check "Yes" in response to the next question.

☐ **No.** Skip the next question and go to Part III.

Waiver of Treaty Benefits on Future Inclusions by a Foreign Eligible Taxpayer

Do you hereby irrevocably waive any benefits available under an applicable U.S. income tax convention that would exempt gains that you are deferring by investing in a QOF from being subject to federal income tax at the time of inclusion? See instructions for more information.

☐ **Yes.** Report the deferral of the eligible gain in Part II and on Form 8949.

☐ **No.** You may not elect to defer tax on an eligible gain by investing in a QOF. **Do not report the deferral of any otherwise eligible gain in Part II or on Form 8949.**

Required reporting for entities who purport to be a QOF (Form 8996). A corporation or partnership that is organized and operated as a QOF must file Form 8996 annually with its Form 1120, Form 1120-S or Form 1065. Form 8996 is used to self-certify that the QOF meets the 90% investment standard or to figure the penalty if it fails to do so. ***Form 8996 is not filed by QOZ businesses – only by the QOF.***

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Form **8996**
(Rev. December 2021)
Department of the Treasury
Internal Revenue Service

Qualified Opportunity Fund

▶ Go to *www.irs.gov/Form8996* for instructions and the latest information.
▶ Attach to your tax return. See instructions.

OMB No. 1545-0123

Attachment Sequence No. **996**

Name

Employer identification number

Part I General Information and Certification

1 Type of taxpayer: ☐ Corporation ☐ Partnership

2 Is the taxpayer organized for the purpose of investing in qualified opportunity zone (QOZ) property (other than another qualified opportunity fund (QOF))?

☐ **No. STOP.** Do not file this form with your tax return.

☐ **Yes.** Go to line 3.

3 Is this the first period the taxpayer is a QOF?

☐ **Yes.** By checking this box, you certify that by the end of the taxpayer's first QOF year, the taxpayer's organizing documents include a statement of the entity's purpose of investing in QOZ property and a description of the trade or business(es) that the QOF is engaged in either directly or through a QOZ business. See instructions.

☐ **No.**

4 If you checked "Yes" on line 3, provide the first month in which the fund chose to be a QOF . . . . . ▶ _____

5 Did any investor dispose of, in part or in whole, their equity interest in the fund?

☐ **Yes.** Attach a statement with each investor's name, the date of disposal, and the interest that they transferred during the QOF's tax year.

☐ **No.**

6 ☐ Do not check this box. Reserved for future use.

Part II Investment Standard Calculation

7	Enter the amount from Part VI, line 2, for total QOZ property held by the taxpayer on the last day of the first 6-month period of the taxpayer's tax year. See instructions if Part I, line 3, is "Yes"	7	
8	Total assets held by the taxpayer on the last day of the first 6-month period of the taxpayer's tax year. See instructions if Part I, line 3, is "Yes"	8	
9	Divide line 7 by line 8	9	
10	Enter the amount from Part VI, line 3, for total QOZ property held by the taxpayer on the last day of the taxpayer's tax year	10	
11	Total assets held by the taxpayer on the last day of the taxpayer's tax year	11	
12	Divide line 10 by line 11	12	

Part III Qualified Opportunity Fund Average and Penalty

13	Add lines 9 and 12	13	
14	Divide line 13 by 2.0. See instructions if Part I, line 3, is "Yes"	14	
15	Is line 14 equal to or more than 0.90? ☐ **Yes.** Enter -0- on this line and file this form with your tax return. ☐ **No.** The fund has failed to maintain the investment standard. Complete Part IV to figure the penalty. Enter the penalty from line 8 of Part IV on this line. See instructions	15	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 37820G Form **8996** (Rev. 12-2021)

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Businesses Tax Credits

Business Tax Credits – Overview

The One Beautiful Big Bill Act (OBBBA), Inflation Reduction Act (IRA), the Secure Act, Secure Act 2.0 and other recently enacted legislation introduced multiple new and revised energy-related credits, as well as making changes to existing credits. Many of these credit changes are applicable to businesses and entities. Many credits relate to massive projects that include solar, nuclear, and hydrogen power used to produce electricity and are mostly claimed by large businesses. Other credits are more applicable to small and medium-sized businesses, on which we will put more focus. The purpose of this chapter is to put all the credit changes for businesses in one place for easy reference. And we will also review a few credits that have been around a while but may be overlooked. So, let's do this!

OBBBA Business Tax Credit Changes			
Description	**Pre-OBBBA**	**OBBBA**	**Effect Date**
FICA Tip Credit (§45B)	FICA tip credit allowed for food and beverage industry businesses	FICA tip credit expanded to be available to beauty service industry.	2025
Employer Dependent Care Credit (§45F)	Employers who provide dependent care qualify for 25% credit of up to a maximum of $150,000	Employer dependent care credit increased to 40%, maximum credit of $500,000. Small employers may jointly operate a care facility	2026
Employer Credit for Paid Family and Medical Leave (§45S)	Up to 25% credit for employers who provide paid FMLA to employees	Credit made permanent and modified to allow credit for insurance policies or wages	2026
New Markets Tax Credit (§45D)	Credit for investing in low-income communities through 2025	New Markets Tax Credit made permanent	2026
Low-Income Housing Credit (§42)	Fed funded, state issued credits for low-income housing projects	12% increase in funding higher bond financing requirement	2026
New Energy Efficient Home Credit (§45L)	Credit for contractors who build energy efficient home	Repealed	July 1, 2026
Advanced Manufacturing Production Credit (§45X)	10% credit for manufacturers of US solar, wind, battery, inverters, etc. equipment	Earlier phase-out dates apply to various provisions	Various
Advanced Manufacturing Investment Credit (§48D)	25% credit for advance manufacturing facility investments	Credit increased to 35%	2026
Commercial Clean Vehicle Credit (§45W)	Credit of up to $40,000 for purchase of qualified clean energy commercial vehicle	Commercial Clean Vehicle credit repealed	October 1, 2025

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OBBBA Business Tax Credit Changes			
Description	**Pre-OBBBA**	**OBBBA**	**Effect Date**
Clean Fuel Production Credit (§45Z) Clean Electricity Production Credit Clean Hydrogen Production Credit Carbon Oxide Sequestration Credit Zero-Emission Nuclear Power Credit Clean Electricity Investment Credit (§48E) Qualified Advanced Energy Property Credit	Most of these credits are related to "green" or alternative energy tax credits. Most of these credits have been repealed, or the expiration dates were accelerated. A couple of the credits were modified and will continue for a more extended period of time. Due to the relatively few taxpayers that are expected to claim any of these credits, the author felt no further discussion was warranted. For those who may want additional information, the IRC sections are cited and the internet links should work.		
Alternative Fuel Vehicle Refueling Credit (§30C)	Credit allowed for installation costs of alt fuel refueling site	Credit repealed as of June 30, 2026	June 30, 2026

FICA Tip Credit (§45B)

Overview. Qualified food and beverage employers may claim a credit for Social Security and Medicare taxes paid or incurred by the employer on certain employees' tips. The credit is part of the general business credit and may be claimed within 3 years from the due date of the employer's tax return. The credit may be claimed on the original return or on an amended return.

Form 8846 filing. Partnerships and S corporations are required to file Form 8846 to claim the credit. Other taxpayers who meet both of the following conditions should also file the form:

1. Employers who had employees who received tips from customers for providing, delivering, or serving food or beverages for consumption if tipping of employees for delivering or serving food or beverages is customary.

2. During the tax year, the employer paid or incurred employer Social Security and Medicare taxes on those tips.

Taxpayers whose only credit source is a partnership or S corporation are not required to file the form. These taxpayers will report the K-1 credit directly on Form 3800.

Calculating the credit. The FICA tip credit is equal to 100% of the amount of employer Social Security and Medicare taxes paid or incurred by the employer on tips received by its employees.

Example 1. Sierra receives and reports tips of $450 for October 2026. Beth's Diner, Sierra's employer, will claim a FICA tip credit of $34 ($450 x 7.65%) for the employer share of FICA tax paid on Sierra's tips.

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Minimum wage must be met. Employers may not claim the credit for taxes on any tips that are used to meet the $5.15 Federal minimum wage rate in effect on January 1, 2007 (the 2007 minimum wage is used in the calculation even though the 2026 Federal minimum wage is $7.25 per hour). The amount of tips for any month that are used to figure the credit must be reduced by the amount by which the wages that would have been payable during that month at $5.15 an hour exceed the wages (excluding tips) paid by the employer during that month.

Example 2. Assume the same facts as in example 1, except that Sierra worked 100 hours to earn her $450 in tips in October. Beth's Diner paid Sierra $375 in wages (excluding tips) in October at the rate of $3.75 an hour. If Sierra had been paid $5.15 an hour, she would have received wages of $515. The revised credit would be $24 ($450 tips less $140 ($515 minimum wage less $375 actually paid) = $24). Only $310 of Sierra's tips are considered to calculate the credit.

0.9% Additional Medicare Tax and the FICA tip credit. The Additional Medicare Tax is only imposed on the employee, not on the employer. As there is no employer share of Additional Medicare Tax, there is no FICA tip credit on this amount.

OBBBA expanded definition of FICA tip credit eligible industries (§45B(b)(2)(B)). Starting in 2025, the FICA tip credit qualifying industries include hair and other personal care services:

1. Barbering and hair care;
2. Nail care;
3. Esthetics; and
4. Body and spa treatments.

Preparer note. As part of its guidance for the OBBBA tip deduction, the IRS gave details as to which employees qualify as Food and Beverage Service, and which qualify as Personal Appearance and Wellness. It will be interesting to see how these definitions align with the definitions under the FICA tip credit as more guidance is released.

Employer Dependent Care Credit (§45F)

Overview. The Employer-Provided Dependent Care Credit is available to businesses that help employees cover dependent care costs (such as childcare or care for other qualifying dependents). The credit is equal to 25% of qualified child and dependent care expenses the employer pays on behalf of employees, plus 10% of qualified childcare resource and referral expenses. The maximum is $150,000 per year.

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Qualified childcare expenses. Beginning in 2026, the childcare credit has been greatly enhanced in several areas over the previous version of the credit. The new rules include:

1. Up to 40% (was 25%) of costs associated with acquiring, constructing, rehabilitating, or expanding property used as the taxpayer's qualified childcare facility. No part of an employer's principal residence counts.

2. Up to 40 (was 25%) of costs for qualified childcare facility expenditures are operating expenses made by the taxpayer, including amounts paid to support childcare workers through training, scholarship programs, and providing increased compensation to employees with higher levels of childcare training.

3. Up to 10% of cost for qualified resource and referral expenditures are amounts paid or incurred under a contract to provide childcare resource and referral services to your employees. The provision of the services (or the eligibility to use the services) must not discriminate in favor of highly compensated employees.

4. Regardless of expense type, the credit may not exceed $500,000 ($600,000 for small employers) (was $150,000 in 2025 and prior) per year.

    a. Starting in 2027, these credit limits will be annually adjusted for inflation.

Credit is claimed on Form 8882. Taxpayers calculate and claim the Employer dependent Care credit on Form 8882.

No double dipping. The taxpayer who claims this credit is not allowed to double the benefit. They must reduce:

- The basis of any qualified childcare facility by the amount of the credit reported on line 7 of Form 8882 by the amount allocable to capital expenditures related to the facility; and
- Any otherwise allowable deductions used to figure the credit by the amount of the credit on line 7 allocable to those deductions; and
- Any expenditures used to figure any other credit by the amount of the credit on line 7 allocable to those expenditures (for purposes of figuring the other credit).

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Example. Howlin Jack Manufacturing (HJM) has 25 employees, many of whom are parents to small children. At the beginning of 2026, HJM contracted with a licensed daycare operator to manage and staff a daycare center in a building HJM rents near its manufacturing facilities. During the year, HJM paid:

- $400,000 to the daycare provider for operating the daycare center.
- $60,000 to remodel the building where the day care center is located.
- $40,000 rent and utilities for the daycare building.
- $20,000 to a daycare consulting firm who referred HJM to the day care provider.

HMJ calculates its §45F credit:

- $400,000 cost to contract daycare provider x 50% =	$200,000
- $ 60,000 cost to remodel/improve daycare building x 50% =	$ 30,000
- $ 40,000 cost to operate the daycare building x 50% =	$ 20,000
- $ 20,000 cost to hire consultant to help implement x 10% =	$ 2,000
Total calculated credit	$252,000

As the calculated credit is less than the 2026 $600,000 limit, the full $252,000 is allowed.

Note that HJM will have to reduce its deductions (e.g., daycare, rent, utilities, etc.) by the amount of the related credit.

Dependent care provider credit recapture (§45F(d)). If there is a recapture event with any qualified daycare facility, the taxpayer is subject to credit recapture. The recapture percentage is calculated:

If the recapture event occurs in:	The applicable recapture percentage is:
Years 1–3	100
Year 4	85
Year 5	70
Year 6	55
Year 7	40
Year 8	25
Years 9 and 10	10
Years 11 and thereafter	0.

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For this purpose, a recapture event includes:

- Cessation of the operation of the facility as a qualified childcare facility.
- Change in ownership. This includes the disposition of a taxpayer's interest in a qualified childcare facility on which the credit was claimed, and the new owner refuses to assume recapture liability in writing.

Paid Family and Medical Leave Credit (§45S; IRS FAQs)

Overview. Employers are allowed a tax credit for providing employees with paid family and medical leave. The credit is equal to a percentage of wages they pay to qualifying employees while they're on family and medical leave. To qualify employers must have a written policy in place that provides:

1. At least two weeks of paid family and medical leave (annually) to all qualifying employees who work full time (prorated for employees who work part time); and

2. The paid leave is not less than 50 percent of the wages normally paid to the employee.

Qualifying employee. A qualifying employee is any employee under the Fair Labor Standards Act who has been employed by the employer for one year or more and whose compensation in the prior year didn't exceed 60% of the highly compensated employee (HCE) threshold. To qualify in 2026, the employee's 2025 wages had to be $96,000 or less.

Family and medical leave defined. Family and medical leave is leave for one or more of the following reasons:

1. Birth of an employee's child and to care for the child.
2. Placement of a child with the employee for adoption or foster care.
3. To care for the employee's spouse, child, or parent who has a serious health condition.
4. A serious health condition that makes the employee unable to perform the functions of his or her position.
5. Any qualifying exigency due to an employee's spouse, child, or parent being on covered active duty (or having been notified of an impending call or order to covered active duty) in the Armed Forces.
6. To care for a service member who is the employee's spouse, child, parent, or next of kin.

Family and medical leave is not. If an employer provides paid vacation leave, personal leave, or medical/ sick leave (other than leave specifically for one or more of the purposes stated above), that paid leave is not considered family and medical leave. In addition, any leave required or paid by a State or local government is not employer-provided paid family and medical leave.

Calculating the credit. The credit is a percentage of the wages paid to a qualifying employee while on family and medical leave for up to 12 weeks per taxable year. The minimum percentage is 12.5% and is increased by 0.25% for each percentage point by which the amount paid to a qualifying employee exceeds 50% of the employee's wages, up to a maximum credit of 25%. In certain cases, an additional limit may apply. The employer must reduce its wage deduction by the amount of the credit. Any wages considered in determining any other general business credit may not be used in determining this credit (e.g., R&D credit).

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Family and medical leave credit enhanced by OBBBA (OBBBA §70304). Beginning in 2026, OBBBA made several changes to the family and medical leave credit, including:

- The credit was made permanent.
- Employers may claim the credit for a portion of Insurance premiums paid for insurance coverage that pays family and medical leave benefits to qualifying employees. The credit rate is the same as for wages paid – 12.5% to 25%. The tax deduction for the insurance policy premiums is reduced by the amount of any credit claimed.
- Eligible employees must have been employed at least a year (employer may elect to reduce this to 6 months) before becoming eligible for benefits under the family and medical leave program. The employee must also customarily work at least 20 hours per week.
- Aggregation rules require all employers within the same controlled group (see §414(b) and (c)) to be treated as a single employer starting in 2026.

New Energy Efficient Home Credit (§45L)

Overview. Eligible contractors who build or substantially reconstruct qualified new energy-efficient homes may claim tax credits of up to $5,000 per home. The amount of the credit depends on factors including the type of home, its energy efficiency, and the date when the home is acquired.

Preparer note. The credit no longer applies to any energy efficient home acquired from a qualifying contractor after June 30, 2026.

Advanced Manufacturing Production Credit (§45X)

Credit overview. The advanced manufacturing production credit (AMPC) is a tax credit that is calculated with multiple rates and amounts, based on the type of product being manufactured. For example, wind energy components have different rates based on the blades, the nacelle, the tower and if it's offshore. The level of detail is beyond the scope of this text.

OBBBA changes to AMPC (OBBBA §70514). The OBBBA generally accelerated the phaseouts of the credits available through the AMPC. For example, wind energy components no longer qualify for credits after 2027, metallurgical coal components after 2029, etc. The OBBBA also repealed a taxpayer option to transfer the credits to another taxpayer if the potential transferee taxpayer is a specified foreign entity.

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Advanced Manufacturing Investment Credit (§48D; §1.48D-1 through §1.48D-6)

Overview. The Advanced Manufacturing Investment Credit (AMIC) was established by CHIPS Act in 2022. The credit is equal to 25% of the qualified investment in an advanced manufacturing facility of an eligible taxpayer. An advanced manufacturing facility is a facility whose primary purpose is the manufacturing of semiconductors or semiconductor manufacturing equipment. Qualified investment means the basis of any qualified property placed in service by the taxpayer that is part of an advanced manufacturing facility.

Who can claim the credit? Manufacturers of semiconductors and semiconductor manufacturing equipment within the United States that are not a foreign entity of concern and haven't made an applicable transaction (as defined in §50(a) during the tax year.

Qualified property. Qualified property is tangible property placed in service after Dec. 31, 2022, which is subject to depreciation or amortization. The property must be integral to the operation of an advanced manufacturing facility and built or acquired by the taxpayer if the original use of the property begins with the taxpayer. Lastly, the qualified property doesn't include a building or a portion of a building used for offices, administrative services, or other functions unrelated to manufacturing.

Claiming the credit. Form 3468, Investment Credit, is used to calculate and claim the AMIC. Taxpayers may elect to treat the advanced manufacturing investment credit as a payment against tax that is equal to the amount of the credit. For property held directly by a partnership and S corporation, the partnership or S corporation may elect to receive a payment equal to the amount of the credit instead of claiming the credit.

OBBBA amends, but doesn't repeal, the AMIC (OBBBA §70308). OBBBA increased credit percentage for the AMIC from 25% to 35% of the qualified costs of a semi-conductor qualified property placed in service after Dec. 31, 2025. The requirement that construction must begin prior to 2027 was not changed.

Research Credit (§41; Form 6765)

Historical overview. The research & development tax credit, also known as the research & experimentation (R&E) credit, incremental research credit or simply research credit was first introduced in 1981 as a 2-year incentive but is still in the IRC today. Its purpose is to reward U.S. companies for increasing R&E investments. It allows eligible businesses to claim a tax credit for a percentage of their qualified research expenses (QREs) related to developing or improving products, processes, software, or other innovative technologies. In most cases, the research credit equals 20% of the QREs over a base amount plus 20% of the basic research payments plus 20% of amounts paid to an energy research consortium.

The 2015 PATH Act made the research credit permanent and made it available to offset AMT liability for eligible small businesses. The PATH Act also allowed certain businesses to utilize the credit against payroll taxes. The Inflation Reduction Act (IRA) of 2022 increased the amount of the research credit that can be used against a qualified small business's (QSB) payroll tax liability. For amounts paid or incurred in tax years beginning after 2021, the TCJA requires that expenses be SREs as discussed earlier.

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Inflation Reduction Act makes additional changes to R&D credit. Qualified small businesses (QSBs) may elect to apply R&D credits against the employer share of Social Security and Medicare taxes rather than income tax (§41(h)). For this purpose, a QSB is a business with less than $5 million gross receipts for the current tax year and no gross receipts before the 5 tax-year period ending with the current year. Effectively, this provision is only available to start-up businesses that have been around for 5 years or less. IRA 2022 increased the limit that may be claimed against FICA to $500,000 starting in 2023. The previous limit was $250,000.

A QSB that files *annual* employment tax returns claims the research payroll tax credit on its annual employment tax return that includes the 1st quarter beginning after the date on which the business files the return reflecting the election (Notice 2017-23). When a QSB claims a research payroll credit on its employment tax return, it must complete Form 8974, Qualified Small Business Payroll Tax Credit for Increasing Research Activities, and attach it to the return. The election may be made for no more than 5 years and may not be revoked without IRS consent (§41(h)(4)(B)(ii)).

Preparer note. The research payroll tax credit under §3111(f)(1) is not considered for purposes of determining any amount allowable as a payroll tax deduction. In other words, the employer payroll taxes which the research payroll tax credit portion was credited can be deducted as a §162 business expense!

Qualified Research Expenditures

The research credit can be claimed for qualified research expenditures (QREs) conducted as a part of the taxpayer's trade or business. QREs are the sum of in-house research expenses and contract research expenses (§1.41-4). *In-house research expenses* are:

- Wages paid to employees engaged in qualified research or in direct supervision of qualified research.
- Supplies (tangible property other than land or improvements to land and property subject to depreciation) used to conduct qualified research.
- Amounts paid for the use of computers for the conduct of qualified research.
    - Certain in-house software if QRE and satisfies the high threshold of innovation test which means the software is innovative, development involves significant economic risk, and it is not commercially available for use by the taxpayer (§1.41-4(c)(6)).

Contract research expenses are 65% of amounts paid to persons other than employees for qualified research (75% for payments made to a qualified consortium) regardless of the success of the research.

- Qualified research consortium for research credit purposes is a tax-exempt nonprofit scientific organization under §501(c)(3) that is organized and operated primarily to conduct scientific research and is not a private foundation (§41(b)(3)(C)(ii)).

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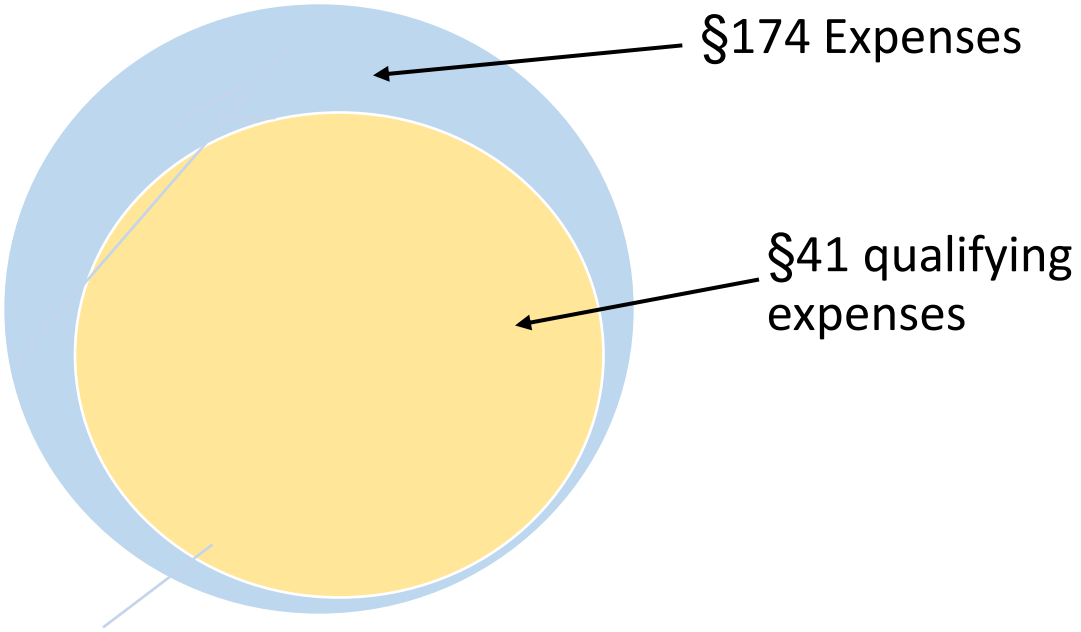
Qualified research – four requirements (§41(d)). Qualified research consists of research and development in the experimental or laboratory sense that meets all four of the following tests (§41(d)):

1. Expenditures qualify as specified research or experimental expenditures per §174 (paid or incurred by the taxpayer during the tax year in connection with the taxpayer's trade or business in an experimental or laboratory sense).

Preparer note. There are two definitions of R&E expenditures: §174 defines which R&E expenses are expensed and capitalized, and §41 defines qualifying expenses for the R&D tax credit. While each IRC section has its own definition of qualifying R&E expenses, it is important to note that the definition under §41 begins with the §174 definition. Only after the §174 rules are met, are the remaining requirements of §41 considered.



2. Research must be undertaken to discover information that is technological in nature. Technological in nature means the process of experimentation fundamentally relies on principles of physical or biological sciences, engineering, or computer science.

    a. A taxpayer may use existing technologies and may rely on existing principles of the physical or biological sciences, engineering or computer science to satisfy this requirement (§1.41-4(a)(4)).

    b. If the process of experimentation used in the research relies on other principles, such as economics, the information is not treated as technological in nature.

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3. Substantially all the research must contain elements of a process of experimentation relating to a new or improved function, performance, reliability, or quality.

    a. Substantially all is satisfied if only at least 80% of a taxpayer's research activities are elements of experimentation (§1.41-4(a)(6)).

    b. Use the quotient of:

    Research activities that constitute elements of a process of experimentation
    ———————————————————————————————————
    Research activities not specifically excluded and whose expenses are deductible under §174.

4. The application of the research is intended to be useful in the development of a new or improved *business component* of the taxpayer. This includes techniques, formulas, and/or inventions to be sold by the taxpayer. This does not include research related to style, taste, cosmetic or seasonal design factors that does not satisfy this requirement (§1.41-4(a)(5)(ii)).

Preparer note. All four tests must be applied to each project or business component separately. There is no crossover from one component to another. But each criterion can be its own rabbit hole once analysis begins. The author believes it's important to remember what we a really trying to figure out is:

1. What was made?
2. What makes it R&D qualified?
3. How much did it cost?

Staying focused on these three questions makes it easier to comply with the complex rules for this credit.

Example. Cheesehead Inc. currently manufactures a large shred version of Packer cheese. Cheesehead wants to modify its current production line to be able to manufacture both large and fine-shred Packer cheese. They have looked everywhere and are unable to find a thinner shredding blade capable of producing a fine-shred version. Thus, Cheesehead must develop a new shredding blade that can be fitted onto its current production line. Cheesehead analyzes various blade designs and materials to determine whether the new blade must be constructed of a material different from its existing shredding blade.

Cheesehead's activities to modify its current production line to develop a new shredding blade meets the requirements of qualified research because substantially all Cheesehead's activities constitute elements of a process of experimentation. Alternatives and the appropriate design were uncertain at the beginning of Cheesehead's research activities.

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Non-qualified expenses. QREs for the research credit **DO NOT** include costs for:

- Research conducted after the beginning of commercial production.
- Research related to adapting an existing product, process, or other business component to a particular customer's need.
- Duplication of an existing product or process – any research related to the reproduction of an existing business component (in whole or in part) from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such business component.
- Efficiency surveys, management activities studies, market research or testing, routine data collection, or routine or ordinary testing or inspection for quality control.
- Computer software, except any research with computer software which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer.
- Research conducted out of the U.S., Puerto Rico, or a U.S. possession.
- Research in the social sciences, arts, or humanities.
- Research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

Agreement for payment must exist. An expense is paid or incurred for the performance of qualified research only if it is paid or incurred under an agreement that (§1.41-2(e)(2)):

1. Is entered into before the performance of the qualified research.
2. Provides that research be performed on behalf of the taxpayer.
3. Requires the taxpayer to bear the expense even if the research is not successful.

Example: BZs develops and manufactures gizmos. BZs wants to change the color of the gizmos from red to blue. BZs obtains various shades of blue paint from several suppliers. BZs paints several sample gizmos and surveys customers to determine which shade of blue is preferred.

BZs activities to change the color of its gizmo are not QREs because substantially all of BNB's activities are not undertaken for a qualified purpose since they only related to style, taste, cosmetic and design factors (§1.41-4(a)(8), Ex. 4).

Preparer note. Since §41 is a subsection of §174, more expenses may end up capitalized under §174 than qualify for the §41 research credit.

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Possible Expenses for Research Credit	
Industry	**Type**
Agribusiness	Hybridizing during the development of new strains of crops, plants, or livestock
	Improving harvesting techniques to increase yield or production efficiency
	Developing or implementing automated processes
	Developing or implementing new ways to protect crops from disease or insects
Apparel	Developing new clothing innovations that could be eligible for utility patents
	Designing and developing product and performance specifications for new fabric and material construction technologies
	Developing a new manufacturing process
	Manufacturing, evaluating, and testing samples and prototypes
Automotive	Developing aftermarket performance products
	Researching improved materials for component parts, such as polymers, alloys, and composites
	Designing and developing vehicle performance improvements, such as for fuel efficiency and handling
	Making improvements to automotive components, i.e., to increase safety
Clean Technology	Pursuing advances in products, materials, and processes to increase efficiencies in energy generation
	Development of alternative fuels
	Development of waste treatment and remediation processes
	Designing and developing hydroelectric or another type of clean energy facility or system
Construction	Designing unique, energy-efficient infrastructure items
	Designing renewable energy infrastructure
	Developing new or improved construction techniques
Food & Beverage	Developing new product flavors, textures, or health benefits
	Developing methods to extend shelf life
	Producing prototype product samples for testing and validation of new recipe formulations
	Designing and developing specialized tools or prototype machines
Healthcare	Software to better manage customer relationships through improved analysis techniques
	Testing to satisfy domestic or foreign regulatory requirements
	Developing new or improved devices, equipment, or technology as well as product improvements

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Possible Expenses for Research Credit	
Industry	**Type**
Media	Developing telecommunications networks to serve customers, i.e., integrating voice capabilities into a mobile application
	Developing software and technology to improve transmission capacity
	Developing network tools to monitor and/or measure network performance
	Designing and constructing physical network improvements
Retail	Researching appropriate materials to account for strength, durability, and cost among other details
	Designing and developing retail fixtures, i.e., displays
	Engineering of new assembly methods
	Prototyping of displays, such as mannequins, etc.
Technology	Developing code for new software
	Developing specialized technologies such as artificial intelligence applications
	Developing functional enhancements for existing applications designed to create a competitive advantage

See:

- Meyer, Borgman, & Johnson, Inc. v. Comm., 8th USCA No. 23-1523, May 6, 2024, where a structural engineering firm that created construction documents of the structural design for building projects was denied QRE treatment.
- Mark and Christine Betz, Dennis and Julia Lincoln v. Comm., TC Memo 2023-84, where CPI, an S corporation, designed and supplied air pollution control systems for which it claimed a research credit. CPI did not use a time-tracking system for its employees' activities and thus was not able to produce adequate documentation to substantiate its R&D claim.
- Ramesh Kapur v. Comm., USTC No. 14017-21, March 12, 2024, where the taxpayer argued unsuccessfully that the R&D credit could be calculated for all projects based on a sampling of most of the projects. The Court noted that "absent an agreement between the parties, project sampling improperly relieves the taxpayer of its burden of proving entitlement to the research credit claimed."
- Robert Eustace et al. v. Comm., 7th USCA No. 02-1367, is an IRS oft cited case where Applied Systems, (ASI), an S corporation, developed and improved software products for sale to independent insurance agencies. Robert Eustace was a shareholder of ASI who claimed a pass-through research and development tax credit on his personal tax return. The IRS determined that this research tax credit is not available for those software development expenses for two reasons:

    1. The "qualified research" was not undertaken to discover information that went beyond the current state of knowledge in the computer science field. ASI undertook

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no research to develop software programs, and neither was anything done through process of experimentation. Simply debugging a computer program does not represent a process of experimentation.

2. ASI did not present sufficient evidence to establish that its activities met the requirements for the research credit. It did not undertake research to discover information beyond the current state of knowledge in the computer science field, and it did not conduct a process of experimentation aimed at eliminating uncertainty about the technical ability to develop the software.

The court ruled in favor of the IRS, noting that the mere industrious development of software through a process of trial-and-error does not constitute "qualified research" as defined in §41(a).

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R&D Credit Computation

The R&D credit is the composite of three different component calculations: 1) the incremental research credit; 2) basic research credit; and 3) energy research consortium credit. There are two methods that may be used to calculate the credit – 1) regular credit method and 2) the alternative simplified method.

Regular R&D Credit Calculation

In general terms, the credit equals 20% of the QREs for the current tax year exceeding the "base amount" (also known as the incremental research credit) for that year, plus 20% of the basic research payments to universities and other qualified organizations (also known as the university basic research credit), plus 20% of amounts paid to energy research consortiums (§41(a)).

1. **Incremental research credit** – The incremental research credit equals 20% of the current year QRE more than the base amount. The base amount equals:

    a. Fixed base percentage[1] x average annual gross receipts of the taxpayer for the four years preceding the credit tax year.

    b. The "base amount" cannot be less than 50% of its QREs for the year (minimum base amount). Thus, no more than half of the current year QREs qualify for the research credit.

[1] The fixed-base percentage depends on whether the entity is an "existing" company or a "start-up" company. A "start-up" company is a taxpayer that had both gross receipts and QRE either: 1) for the first time in a tax year beginning after 1983, or 2) for fewer than 3 tax years beginning after 1983 and before 1989. For this purpose, this means all taxpayers formed after 1988 are start-up businesses. The fixed-base percentage for start-up business up to 5 years old is 3%. For those in existence more than 5 years, there is a formula to calculate the fixed-base percentage (see the Form 6765 instructions). The fixed-base percentage for an existing company (any company that isn't a start-up company) is figured by dividing the aggregate QRE for the tax years beginning after 1983 and before 1989 by the aggregate gross receipts for those tax years. The fixed-base percentage for all companies (existing and start-up) must be rounded to the nearest 1/100th of 1% and can't exceed 16%.

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Example. Roco began incurring QRE in 2022. Roco has gross receipts of $8,000,000 and QRE of $900,000 in 2026. Its prior years amounts were, Roco had:

	Gross Receipts	QRE
2025	$ 7,000,000	$1,000,000
2024	$ 5,000,000	$ 800,000
2023	$ 3,000,000	$1,500,000
2022	$ 2,000,000	$1,200,000
Total	**$17,000,000**	**N/A**
Number of years	**÷ 4**	
Average annual gross receipts	**$ 4,250,000**	**N/A**
Fixed base % (3% in first 5 years)	**x 3%**	
Calculated fixed-base amount	**$ 127,500**	
Minimum fixed-base amount(50% of QRE)	**$ 450,000**	
2026 qualifying QRE ($900,000 - $450,000)	**$ 450,000**	
Incremental credit %	**x 20%**	
2026 Incremental credit	**$ 90,000**	

Assuming Roco did not have any payments to consortiums or universities, the credit is $90,000.

2. **Basic research credit.** The university basic research credit is equal to 20% of basic research payments expenditures paid by corporations (except S corporations, PHCs or service organizations) for basic research if such payment is pursuant to a written agreement, and such basic research is performed by a qualified organization (educational institutions, scientific research organizations, scientific research organizations or grant organizations) over the sum of the minimum basic research amount and the maintenance-of-effort amount (§41(e)(1)(A)). For this purpose, the "minimum basic research amount" is the greatest of:

    a. 1% of the average amount paid for in-house and contract research expenses during the *base period* (3 years before first tax year beginning after 1983),
    b. Contract research expense for the base period, or
    c. 50% of the basic research payments if the taxpayer was not in existence for a full year in the base period.

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Preparer note. Any qualified clinical testing expenses (QCTEs) considered when computing the Orphan Drug Credit (§45C) for a tax year may not be considered for purposes of computing the research credit. However, any QCTEs which are QREs, are considered in determining the base amount research expenses for purposes of applying the research credit to later years (TAM 201740018).

3. **Energy research consortium.** 20% of amounts paid to an energy consortium for energy research. Qualified research consortium for research credit purposes is a tax-exempt nonprofit scientific organization under §501(c)(3) that is organized and operated primarily to conduct scientific research and is not a private foundation (§41(b)(3)(C)(ii)).

Alternative Simplified Credit (ASC) (§41(c)(4)).

Taxpayers may elect to calculate the incremental research component of the R&D credit using an Alternative Simplified Credit (ASC) method instead of the regular credit calculation described above. Under the ASC, the incremental research portion of the R&D credit equals:

- 14% of the amount by which the taxpayer's QRE for the current tax year exceeds 50% of its average QRE for the three preceding tax years; or

- For taxpayers who do not have QRE in all three preceding tax years, 6% of its QRE for the current tax year.

Example. GNR had $75,000 of QRE in 2026. GNR's QRE was $50,000 (2023), $50,000 (2024) and $65,000 (2025), for an average of $55,000 over the prior three years. Assuming GNR didn't make any payments for University Basic Research or Energy Consortium, GNR calculates its R&D using the ASC:

2026 QRE	$ 75,000
Base amount ($55,000 average x 50%)	($27,500)
Allowable QRE	$ 47,500
Credit %	x 14%
2026 R&D credit	$ 6,650

Planning note. The ASC may result in an allowable R&D credit even if QRE is not increased in the current year. This would occur if QRE in the current year exceeded the base amount (50% of the average for the three prior years), even if it wasn't increased over the prior year.

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Example. Using the same facts as above, assume that GNR's 2026 QRE was $45,000, less than what was paid in all three prior years. The R&D credit is calculated:

2026 QRE	$ 45,000
Base amount ($55,000 average x 50%)	($27,500)
Allowable QRE	$ 17,500
Credit %	x 14%
2026 R&D credit	$ 2,450

Preparer note. The ASC replaces the Incremental Research component of the credit. If applicable, those who choose to use the ASC may still add the University Basic Research credit and the Energy Consortium credit components to determine the total R&D credit.

Election to use ASC. The election to use the ASC is made by filing Form 6765 and completing the ASC section. Once made, this election applies for the tax year made and all following tax years unless revoked with IRS consent. The IRS automatically revokes the election if Form 6765 is completed and a method other than ASC is used. The ASC may be claimed on an amended return if the taxpayer has not previously claimed a §41 credit for that tax year on an original or amended return (§1.41-9). The IRS will not allow the ASC election to be revoked on an amended return.

R&D Limitations. The research credit is a component of the general business credits (§38). Use of the general business credit is limited to net income tax (regular tax reduced by most non-refundable non-business credits), less than the larger of 1) the tentative minimum tax or 2) 25% of the net regular tax more than $25,000 (§38(c)). Any unused portion of the research credit may be carried back one year and forward twenty years (§39(a)(1)). If any research credit remains unused at the end of the 20th year, 50% of the unused amount can be deducted in the 21st year, subject to special rules pertaining to the reduced credit (§196(d)).

Recordkeeping. A taxpayer claiming the research credit must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit (§1.41-4(d)).

Reporting. Form 6765 is used to claim the research credit. As mentioned above, Form 6765 is also used to elect the reduced research credit and to elect to claim a certain amount of the research credit as a payroll tax credit. If there is a GBC in addition to the RC (or a carryback or carryforward of the GBC), the research credit is carried to Form 3800, General Business Credit, and if necessary, to Form 8810, Corporate Passive Activity Loss and Credit Limitations. Partners and S corporation shareholders use Schedule K-1 information to prepare their own Form 6765. Form 6765 was significantly modified in 2024.

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Amended returns – The research credit may be claimed on the original return or on an amended return. If claiming a refund or credit on an amended return or an administrative adjustment request (AAR) that includes a research credit that was not reported on the original return or is increased from the amount reported on the original return, the following information must be provided:

1. Identify all business components to which the research credit claim relates for that year.
2. For each business component, identify all research activities performed.
3. For each business component, name the individuals who performed each research activity.
4. For each business component, describe the information each individual sought to discover.
5. Provide the total qualified employee wage expenses, total qualified supply expenses and total qualified contract research expenses paid or incurred for the research credit claim. This item may be done using Form 6765.

Orphan Drug credit. If a taxpayer incurs qualified clinical testing expenses relating to drugs for certain rare diseases, elect to claim the Orphan Drug Credit on Form 8820 for these expenses, not the research credit.

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Glossary

Agricultural Chemicals Security Credit

30% credit available for eligible agricultural businesses for the costs of protecting certain agricultural chemicals

Alcohol Fuel Credit

Comprised of the straight alcohol credit, the alcohol fuel mixture credit, the small ethanol producer credit, and the cellulosic biofuel producer credit; qualifying alcohol includes methanol and ethanol

Alternative Fuel Motor Vehicle Credit

A nonrefundable credit covering five distinct areas of motor vehicles – qualified hybrid vehicles, qualified fuel cell vehicles, qualified alternative fuel motor vehicles and heavy hybrids, advanced lean-burn technology vehicles, and the plug in conversion credit

Biodiesel and Renewable Diesel Credit

Comprised of the straight biodiesel credit, the biodiesel mixture credit, and the small agri-biodiesel producer credit

Business Energy Credit

Available for businesses with costs incurred for alternative energy sources; 30% of costs for solar, fuel cells, and small wind turbines, and 10% of costs for geothermal systems, microturbines, and combined heat and power

Disabled Access Credit

A nonrefundable credit available for small businesses that incur costs to provide access to disabled persons under the 1990 ADA Act

Employer Provided Child Care

A 25% credit for qualified childcare facility expenditures plus 10% of resource and referral expenditures up to a maximum of $150,000 per tax year

Federal Renewable Electricity Production Credit

A per-kilowatt-hour tax credit available for those generating electricity through qualified energy resources and sold by the taxpayer to an unrelated person during the tax year

Fuel Tax Credit

Tax is paid on fuel to provide funds for repairing and replacing highways damaged by the vehicles using the fuel; this credit is typically for those using fuel for off-road purposes (i.e. farming) whose vehicle use does not damage roadways

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Full Time Equivalents

The number of full time employees an employer would have if based upon the hours worked by every employees (up to a maximum of 2,080 per employee) during the year; the hours worked, excluding owners family members, and seasonal employees, is divided by 2,080 to determine the full time equivalents for purposes of the small business health care credit

Indian Employment Credit

Designed to encourage businesses to hire certain individuals who live on or near an Indian reservation

New Hire Credit

Available for businesses that hire unemployed workers that meet certain qualifications; designed to speed of the hiring of the unemployed

New Markets Tax Credit

Available for businesses that made Qualified Equity Investments to acquire stock/capital interest in designated Community Development Entities whose proceeds are invested in qualified low-income community developments

Qualified Plug-In Vehicle Credit

Available for vehicles with GVW under 14,000 lbs, is designed for highway use, and which is propelled significantly by an electric motor drawing power from a battery with a capacity of at least 4 kilowatt hours; you must be able to recharge the battery from an external source

Rehabilitation Credit

A credit available for the rehabilitation or reconstruction of certain buildings; 10% of costs for building place in service before 1936 and 20% of costs for certified historic structures

Research Activities Credit

A complex credit available to businesses that increase their research activities during the year

Small Business Health Care Credit

Credit designed to assist employers with less than 25 employees with providing their employees health insurance; the credit begins to phase out at 11 employees and is completely gone at 25 employees; wage restrictions also apply

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Small Employer Pension Plan Startup

Designed for small businesses to offset the costs of setting up and administering a new qualified employer plan

Tip Credit

Available to food and beverage establishments where tipping is customary; equal to the employer's portion of social security and Medicare taxes paid on tips received by employees

Work Opportunity Credit

Credit to reduce the federal tax of private-for-profit employers; many states also offer similar credits for state taxes

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