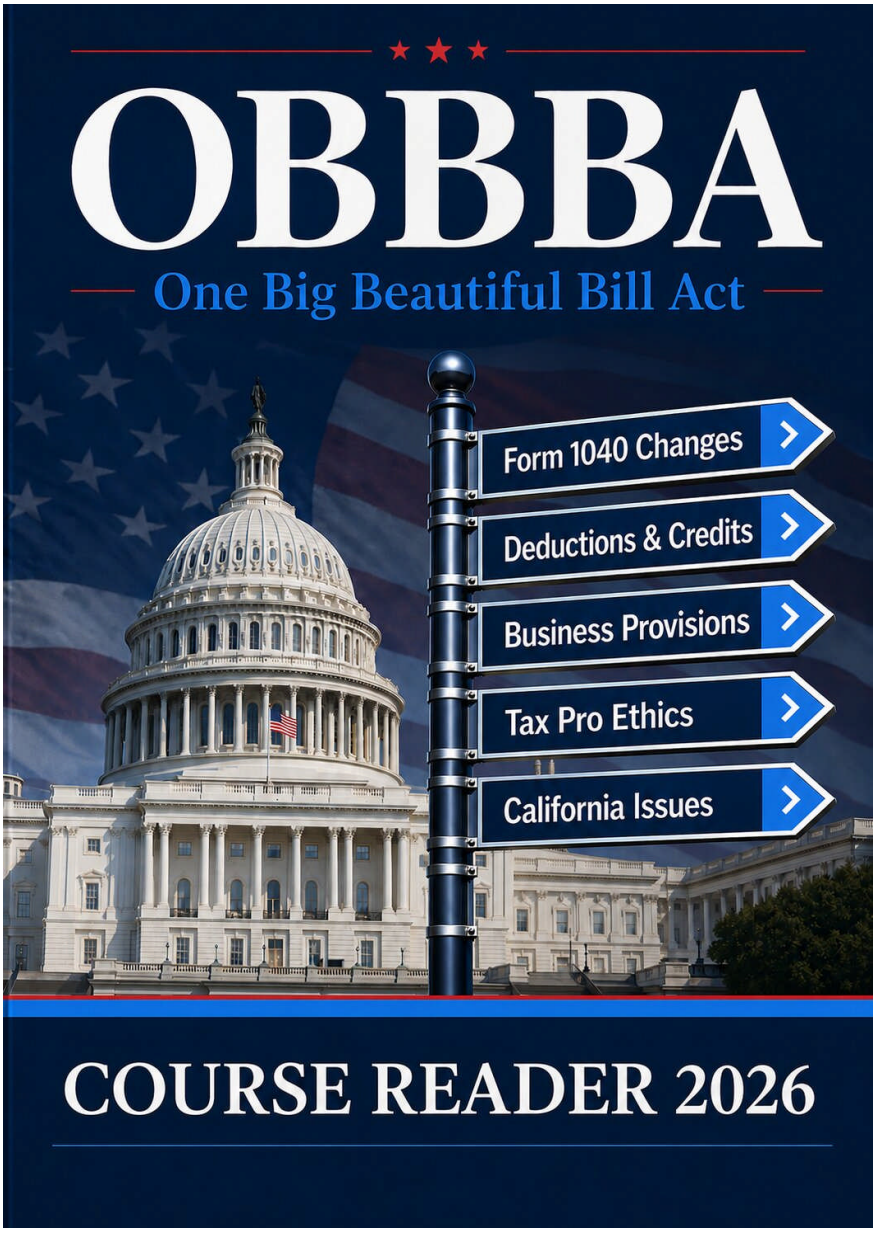
OBBBA
One Big Beautiful Bill Act
Form 1040 Changes
Deductions & Credits
Business Provisions
Tax Pro Ethics
California Issues
COURSE READER 2026

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PREFACE

SELF-STUDY = COURSE CONTENT + EXAM

This book (the "Course Reader") is the teaching tool that presents the subject matter for the CTEC and IRS continuing education (CE) program offered by the California Tax School (CTS). Our CE program is a self-study course that consists of (1) this Course Reader and (2) an open-book exam with multiple-choice test questions. The Course Reader is available as a printable PDF file, a website flipbook, an audio book, or a physical book (purchased from a third-party vendor). To browse through these other formats, visit https://www.caltaxschool.org/6109KyjvUKQP.htm using your desktop computer, laptop, tablet, or smartphone. You are more than welcome to use multiple versions of the Course Reader on one or more devices.

TAKE THE OPEN-BOOK EXAM WHILE READING THIS BOOK

Just a friendly reminder that our course includes an open-book exam. That means students are permitted to glance at a test question then find the answer in this Course Reader. We do not require our students to answer test questions from memory, as that would make it very difficult for them to pass.

Our study tip for you is to read the question first. Then, read this book and browse around for that topic. When you find the test question's topic in this Course Reader, read that section carefully to ascertain the correct answer. After recording your test answer, repeat the strategy for the next test question. Fortunately, the exam questions are lined up with the content in the Course Reader. In other words, all of our test topics are discussed in sequential order in the Reader, so you won't have to zigzag from one part of the book to the other when searching for exam answers.

Students have three options for recording and then submitting final exam answers. To learn more about these options, please do one of the following:

- Refer to your Exam Booklet.
- Visit https://www.caltaxschool.org/6202-submit-final-exam-answers.htm.
- Scan the QR code below with your mobile device.

WHO DETERMINES THE LENGTH OF THIS BOOK?

CTEC and the IRS require education providers to comply with word count formulas. These word count formulas determine the legitimate number of credit hours for a self-study course. CTEC and the IRS expect students to do a minimum amount of reading for approved courses, and this usually entails reading the entire program textbook.

In the end-of-course Evaluation Form, students occasionally suggest that "this course is too long" and that CTS should "use less words in the Reader," or "make answers easier to find by highlighting the relevant sections in the textbook." CTS has to comply with CTEC and IRS rules regarding word counts and prohibited gimmicks that help students bypass the minimal reading requirements.

Because of the CTEC/IRS word count formula, our bundled 20-hour CE programs have historically been about the same length (within a 3% variance). It's worth noting, however, that even when two courses have the same number of words, the page count could be different depending on the font size and the usage of graphics.

WHO DETERMINES THIS BOOK'S LEVEL OF DIFFICULTY?

Albert Einstein once said that, "The hardest thing to understand in the world is the income tax." The US tax system is complicated by default, so every tax course is presented with the challenge of simplifying this convoluted system, and trying to explain tax laws in plain English.

Moreover, creating a tax course is a delicate balancing act where the authors must consider the interests of two different groups: (1) government oversight agencies; and (2) students. We sincerely want ALL of our students to succeed in this educational program. However, CTS must comply with the rigorous educational standards imposed by CTEC and the IRS.

After our efforts to translate complex tax matters into plain English, and after meeting the benchmarks set by government agencies regarding the level of difficulty for continuing professional education, the pass ratio for participants in our most recent program (in 2025) was 96%.

We are confident that, with diligence and focus, you will succeed in this program.

Part A. Federal Tax Law Overview (10 CE Hours)

Chapter 1. INTRODUCTION TO THE OBBBA

Learning objectives: This chapter introduces the OBBBA, the major federal tax reform legislation enacted in 2025. After completing this chapter, students will be able to: (1) recognize the different names for the OBBBA, (2) describe how it extends TCJA individual income tax rates, and (3) explain how the OBBBA modified AMT exemptions.

Chapter Topics

- What's in a name? Backstory to the "OBBBA"
- OBBBA transforms the Internal Revenue Code
- OBBBA's first tax provision: Keeping low tax rates
  - » OBBBA extends the TCJA's lower tax rates
- OBBBA did not repeal the AMT
  - » Background
  - » Alternative minimum taxable income (AMTI)
  - » [AMTI – AMT exemption] × tax rate = tentative tax
  - » How does the OBBBA affect the AMT?
- "Part A" will explore other tax provisions in OBBBA

WHAT'S IN A NAME? BACKSTORY TO THE "OBBBA"

The 2025 tax law discussed in this Course Reader started its journey in Congress as House of Representatives Bill 1 (HR 1). A bill is a formal ***proposal*** for a new law that undergoes debate, possible amendment, and a vote.

HR 1 was processed through budget reconciliation, which allows certain budget-related legislation to pass the US Senate with a simple majority of 51 votes (instead of the 60-vote threshold). During the legislative process, the full official title of HR 1 became "An act to provide for reconciliation pursuant to title II of House Concurrent Resolution 14." The short title became the "One Big Beautiful Bill Act." The shorter name reflects President Trump's specific request for a singular, comprehensive bill to enact his second-term agenda rather than multiple smaller pieces of legislation.

While the "One Big Beautiful Bill Act" is widely used by the public and media, the Senate removed this short title from the final version before passing it 51 to 50. Despite having no official short title, "One Big Beautiful Bill Act" remains the commonly accepted name among the public and tax professionals. It is rare for a law's short title to be stripped by the Senate yet stay popular in common usage.

When HR 1 was signed into law on July 4, 2025, it became the 21st public law enacted by the 119th Congress. Upon enactment, it became Public Law 119-21 (PL 119-21) — the official legal citation.

The 2025 law is referred to in today's tax literature in different ways. You may encounter these designations:

● HR 1. "HR 1" is the original bill number. The problem with this label is that an HR 1 bill has been introduced in every two-year session of Congress because bill numbers reset, meaning there have been over 100 bills with this title in US history.

● Public Law 119-21 or PL 119-21. This is the unique, no-frills name used for formal legal writing.

● 2025 Budget Reconciliation Act. The law is frequently referred to in official reports (by the Congressional Research Service and the Congressional Budget Office) as the FY2025 Reconciliation Law or the 2025 Budget Reconciliation Act.

● One Big Beautiful Bill or OBBB. Initially, many organizations — including the IRS — used "OBBB." It was the preferred shorthand in government resources, such as the White House's official legislative documents.

● Working Families Tax Cut or WFTC. A few government entities, such as the US Treasury and the Centers for Medicare & Medicaid Services, refer to the law as "WFTC."

● One Big Beautiful Bill Act or OBBBA. Although the "One Big Beautiful Bill Act" is not the official statutory short title, the catchy name (and its acronym, OBBBA) quickly spread through the tax community. Organizations such as H&R Block, TurboTax, the Tax Foundation, Tax Policy Center, the National Association of Tax Professionals, and the AICPA adopted "OBBBA." By late 2025, it had become the most visible shorthand for Public Law 119-21 in the private sector.

When California Tax School began writing about Public Law 119-21 in mid-2025, we used "One Big Beautiful Bill" or OBBB, following the IRS. Over the past year, "OBBBA" has become more common in the tax world, and the IRS has begun phasing out "OBBB."

In this 2026 Course Reader, we will refer to Public Law 119-21 in a manner consistent with how it's cited in ***most*** tax sources. Therefore, we will use the five-letter acronym "OBBBA" in subsequent references.

OBBBA TRANSFORMS THE INTERNAL REVENUE CODE

Although the OBBBA includes border enforcement provisions and social spending cuts, its central focus is tax reform. This legislation encompasses a myriad of tax provisions, including the permanence of several existing measures, the repeal and modification of various others, and the introduction of new tax provisions.

The OBBBA is essentially a "sequel" to the Tax Cuts and Jobs Act (TCJA) of 2017, but with some unique twists. Notably, it makes many TCJA provisions permanent, ending the "sunset" uncertainty. Moreover, the new law introduces a $6,000 above-the-line deduction for taxpayers age 65 and older. Additionally, it establishes temporary deductions — expiring in 2028 — for tips, overtime pay, and interest on car loans pertaining to vehicles assembled in the United States. Another update is the creation of

new children's tax-deferred savings accounts, with a $1,000 government contribution for those born between 2025 and 2028.

OBBBA Tax Policy	Start Date	End Date
No tax on tips	1/1/2025	12/31/2028
No tax on overtime	1/1/2025	12/31/2028
No tax on car loan interest	1/1/2025	12/31/2028
$6,000 deduction for seniors	1/1/2025	12/31/2028
Enhanced deduction for state & local taxes (SALT)	1/1/2025	12/31/2029
$2,200 child tax credit	1/1/2025	None; permanent
Increased standard deduction	1/1/2025	None; permanent
Increase in Section 179 expensing	1/1/2025	None; permanent
Enhancement of adoption credit	1/1/2025	None; permanent
100% bonus depreciation	1/20/2025	None; permanent
More education expenses for 529 plans	7/4/2025	None; permanent
Termination of personal exemptions	1/1/2026	None; permanent
Extension and enhancement of deduction for QBI	1/1/2026	None; permanent
Itemized deduction for home mortgage interest	1/1/2026	None; permanent
Itemized deduction for disaster loss	1/1/2026	None; permanent
Termination of miscellaneous itemized deductions	1/1/2026	None; permanent
Overall limitation on itemized deductions	1/1/2026	None; permanent
Deduction or exclusion for military moving expenses	1/1/2026	None; permanent
Improvements to ABLE accounts	1/1/2026	None; permanent
Student loans discharged due to death or disability	1/1/2026	None; permanent
Reduced income tax rates for individuals	1/1/2026	None; permanent
Extension of paid family and medical leave credit	1/1/2026	None; permanent
Employer-provided childcare credit	1/1/2026	None; permanent
$7,500 for the dependent care assistance program	1/1/2026	None; permanent
Child and dependent care tax credit	1/1/2026	None; permanent
Exclusion for employer payments of student loans	1/1/2026	None; permanent
Up to $20,000 from 529 plans for K-12 expenses	1/1/2026	None; permanent
Above-the-line deduction for charitable contributions	1/1/2026	None; permanent
Floor & ceiling on itemized deduction for donations	1/1/2026	None; permanent
Limitation on excess business losses	1/1/2026	None; permanent
Increased AMT exemption amounts	1/1/2026	None; permanent
No exclusion for bicycle commuting reimbursement	1/1/2026	None; permanent
US Treasury deposits $1,000 in Trump accounts	7/4/2026	12/31/2028

OBBBA'S FIRST TAX PROVISION: KEEPING LOW TAX RATES

OBBBA EXTENDS THE TCJA'S LOWER TAX RATES

Various tax systems around the world are labeled "flat tax." The defining characteristic of a flat tax system is the existence of a single tax rate, other than zero. Countries using a flat tax system include Romania (10%), Kazakhstan (10%), and Hungary (15%).

The US federal income tax for individuals is not one flat rate. Instead, the US uses a progressive tax system, meaning that as your income increases, you pay a higher tax rate. A tax bracket is a row in a table of tax rates that applies to an individual's taxable income.

The TCJA reduced statutory tax rates at almost all levels of taxable income and adjusted the thresholds for several income tax brackets. The TCJA retained the seven individual income tax brackets. The top rate fell from 39.6% to 37%, while the 33% bracket dropped to 32%, the 28% bracket to 24%, the 25% bracket to 22%, and the 15% bracket to 12%. The lowest bracket remained at 10%, and the 35% tier was unchanged.

The lower TCJA tax rates were scheduled to expire after December 31, 2025. Without updates from Congress, individual income tax rates would have reverted to pre-TCJA levels on January 1, 2026.

The OBBBA makes permanent the income tax rate schedules for individuals, trusts, and estates enacted by the TCJA. The new law prevented the "tax cliff" scheduled for the end of 2025 by making the TCJA's lower rates permanent. So, the current seven-bracket structure remains in place, with rates of 10%, 12%, 22%, 24%, 32%, 35%, and 37%.

Bracket	Before 2018	TCJA: 2018 – 2025	OBBBA: After 2025
Highest tax bracket	39.6%	37%	37%
Bracket #6	35%	35%	35%
Bracket #5	33%	32%	32%
Bracket #4	28%	24%	24%
Bracket #3	25%	22%	22%
Bracket #2	15%	12%	12%
Lowest tax bracket	10%	10%	10%

The OBBBA maintains the TCJA's practice of adjusting bracket thresholds for inflation, helping avoid "bracket creep," where cost-of-living pay raises move taxpayers into higher brackets without increasing real purchasing power.

2026 FEDERAL INCOME TAX BRACKETS				
Tax rate	**Single filers**	**Married couples filing jointly**	**Married couples filing separately**	**Head of household**
10%	$12,400 or less	$24,800 or less	$12,400 or less	$17,700 or less
12%	$12,401 to $50,400	$24,801 to $100,800	$12,401 to $50,400	$17,701 to $67,450
22%	$50,401 to $105,700	$100,801 to $211,400	$50,401 to $105,700	$67,451 to $105,700
24%	$105,701 to $201,775	$211,401 to $403,550	$105,701 to $201,775	$105,701 to $201,750
32%	$201,776 to $256,225	$403,551 to $512,450	$201,776 to $256,225	$201,751 to $256,200
35%	$256,226 to $640,600	$512,451 to $768,700	$256,226 to $384,350	$256,201 to $640,600
37%	Over $640,600	Over $768,700	Over $384,350	Over $640,600
Source: IRS Revenue Procedure 2025-32				

OBBBA DID NOT REPEAL THE AMT

BACKGROUND

Because some wealthy taxpayers had been so successful in legally minimizing their tax bills, Congress devised another way to tax them: the alternative minimum tax (AMT). The AMT aims to ensure that taxpayers with substantial income do not entirely escape taxation by using legitimate exclusions, deductions, and credits.

The AMT acts as a tax floor. Once this floor is reached, the AMT prevents further reduction in tax liability.

The AMT was enacted in 1969 to prevent wealthy taxpayers from using loopholes to pay little to no taxes. Over the years, the AMT has evolved due to changes in tax laws and inflation, leading to its application to a broader range of taxpayers. Even middle-class taxpayers might be subject to AMT nowadays if they earn income above a certain level and/or from specific sources (e.g., incentive stock options).

The AMT is a separate tax system that requires some taxpayers to compute their income tax liability twice: once under the regular method and again under the AMT method. The AMT computation is performed on Form 6251. An individual will be subject to the AMT if their AMT liability is more than their regular tax liability for the year.

ALTERNATIVE MINIMUM TAXABLE INCOME (AMTI)

Taxpayers typically look for deductions, exclusions, and other ways to reduce their taxable income. However, under the AMT, taxpayers can't take as many deductions or other tax breaks, so their taxable income will likely be higher.

The AMT has its own definition of taxable income: "alternative minimum taxable income" (AMTI). AMTI increases taxable income by adding back tax-exempt items under the

regular tax system and disallows many deductions available under the standard rules. Below are ***some*** items that must be added back to regular taxable income to find AMTI:
● The standard deduction;
● Itemized deductions for state and local taxes (SALT);
● The deduction for investment interest expenses;
● The deduction for a net operating loss (NOL);
● Passive losses from nonfarming activities; and
● Addition of certain income from incentive stock options (ISOs).

After adding back the disallowed deductions, such as the above items, the taxpayer will arrive at their AMTI.

Example. Ruth exercises incentive stock options (ISOs) during the year. Her regular taxable income in 2026 is $200,000, excluding the spread on the exercised ISOs valued at $50,000. Ruth would be required to include the $50,000 spread in her AMTI. She would also have to add back her standard deduction of $16,100. Whereas Ruth's regular taxable income was $200,000, her AMTI is $266,100 ($200,000 plus $50,000 plus $16,100).

[AMTI – AMT EXEMPTION] × TAX RATE = TENTATIVE TAX
Once taxpayers have that AMT version of their taxable income, they will subtract the AMT exemption amount. Similar to standard deductions under the regular tax system, a taxpayer can exempt (subtract) the following amount from their AMTI in 2026:
● $90,100 for singles; and
● $140,200 for married couples filing jointly.

The AMT exemption amounts begin to phase out — reducing by 25 cents for each dollar of income — once a taxpayer's AMTI exceeds a certain income threshold. For the 2026 tax year, this exemption starts phasing out at $500,000 in AMTI for single filers and $1 million for married taxpayers filing jointly. Depending on an individual's AMTI, their AMT exemption could be either reduced or eliminated, with any remaining amount subject to the AMT rate.

AMT EXEMPTION AMOUNTS IN 2026			
Filing status	**Exemption Amount**	**Phaseout Threshold (Starts)**	**Complete Phaseout (Ends)**
Married Filing Jointly / Surviving Spouse	$140,200	$1,000,000	$1,280,400
Unmarried Individuals (Single / HOH)	$90,100	$500,000	$680,200
Married Filing Separately	$70,100	$500,000	$640,200

AMTI minus the AMT exemption equals the alternative minimum tax base. If the result of this subtraction is negative (because the AMT exemption is more than the AMTI), the

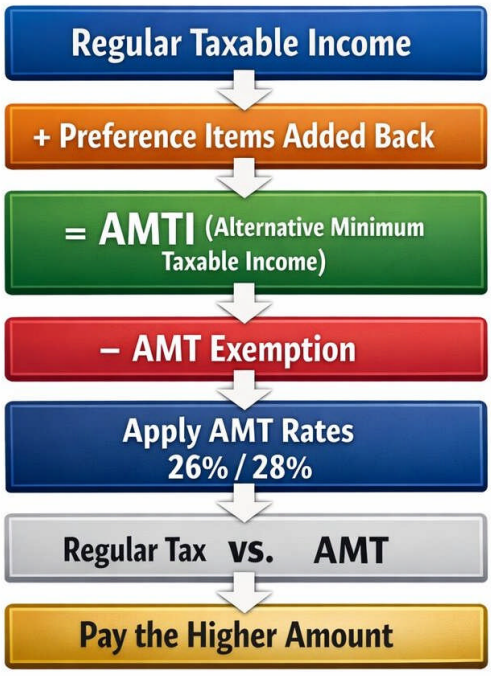
taxpayer can stop here and enter their regular income tax. They are not subject to the AMT.

Suppose AMTI minus the AMT exemption equals a positive number (because AMTI is more than the AMT exemption). In that case, the taxpayer must multiply their alternative minimum tax base by the appropriate AMT tax rate. There are seven tax brackets for ordinary income and a few tax rates for capital gains. However, only two rates exist for AMT purposes. The tax rate is 26% when the AMT base is $244,500 or less, and 28% on amounts above that threshold for most individual taxpayers. The dividing line is at $122,250 for married taxpayers who file separately.

AMT TAX BRACKETS IN 2026	
Filing status	**26%/28% Dividing Line**
Married Filing Jointly / Surviving Spouse	$244,500 of AMTI
Unmarried Individuals (Single / HOH)	
Married Filing Separately	$122,250 of AMTI

The AMT calculation results in a tentative minimum tax. After calculating the tax liability under the regular and the alternative systems, the taxpayer pays the higher amount. If the tentative minimum tax exceeds the regular tax, the difference is added to:

- Schedule 2 (Line 2); and
- Form 1040 (Line 17).



Example 1. Casey is a single filer. His regular income tax is $39,606. Using the AMT rules, Casey determines his AMTI to be $208,100. Then, Casey subtracts $90,100 (the AMT exemption) from his AMTI. Casey's AMT base is $118,000 ($208,100 – $90,100). Now he multiplies the AMT base by 26% to arrive at his tentative minimum tax of $30,680. In this case, the AMT is lower than the regular tax, so Casey should pay the regular income tax (of $39,606) because it is higher than the tentative minimum tax (of $30,680).

Example 2. Julia's regular income tax is $47,000. When she calculates her tax using the AMT rules, Julia comes up with $58,000; that means she will pay $11,000 of AMT on top of the $47,000 of regular income tax. The AMT is calculated on Form 6251, and the extra tax of $11,000 is transferred to Schedule 2 before landing on Form 1040.

SCHEDULE 2 (Form 1040)
Department of the Treasury
Internal Revenue Service

Additional Taxes

Attach to Form 1040, 1040-SR, or 1040-NR.
Go to *www.irs.gov/Form1040* for instructions and the latest information.

OMB No. 1545-0074

Attachment Sequence No. **02**

Name(s) shown on Form 1040, 1040-SR, or 1040-NR: **Julia Young**

Your social security number: **987-65-4321**

Part I Tax

1	Additions to tax:			
a	Excess advance premium tax credit repayment. Attach Form 8962	1a		
b	Repayment of new clean vehicle credit(s) transferred to a registered dealer from Schedule A (Form 8936), Part II. Attach Form 8936 and Schedule A (Form 8936)	1b		
c	Repayment of previously owned clean vehicle credit(s) transferred to a registered dealer from Schedule A (Form 8936), Part IV. Attach Form 8936 and Schedule A (Form 8936)	1c		
d	Recapture of net EPE from Form 4255, line 2a, column (l)	1d		
e	Excessive payments (EP) from Form 4255. Check applicable box and enter amount. (i) ☐ Line 1a, column (n) (ii) ☐ Line 1c, column (n) (iii) ☐ Line 1d, column (n) (iv) ☐ Line 2a, column (n)	1e		
f	20% EP from Form 4255. Check applicable box and enter amount. See instructions. (i) ☐ Line 1a, column (o) (ii) ☐ Line 1c, column (o) (iii) ☐ Line 1d, column (o) (iv) ☐ Line 2a, column (o)	1f		
y	Other additions to tax (see instructions): _____	1y		
z	Add lines 1a through 1y		1z	
2	Alternative minimum tax. Attach Form 6251		2	$11,000
3	Add lines 1z and 2. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 17		3	$11,000

Part II Other Taxes

4	Self-employment tax. Attach Schedule SE		4	
5	Social security and Medicare tax on unreported tip income. Attach Form 4137	5		

Julia's tax and AMT entries on Form 1040

Tax and Credits	16	**Tax** (see instructions). Check if any from Form(s): 1 ☐ 8814 2 ☐ 4972 3 ☐	16	$47,000
	17	Amount from Schedule 2, line 3	17	$11,000
	18	Add lines 16 and 17	18	$58,000
	19	Child tax credit or credit for other dependents from Schedule 8812	19	

HOW DOES THE OBBBA AFFECT THE AMT?

In 2017, before the TCJA, the AMT exemption phaseout threshold was $160,900 for married couples ($120,700 for singles and HOH filers). In other words, once a joint filer's AMTI exceeded $160,900 in 2017, the AMT exemption was reduced by 25 cents for each dollar above that threshold, until it was fully phased out (at $498,900).

In 2025, under the TCJA framework, the AMT exemption began to phase out at $1,252,700 for married couples filing jointly and $626,350 for all other filers.

While the OBBBA retains the increased AMT exemption amounts from the TCJA, it significantly lowers the income levels at which the exemption begins to phase out. Starting in 2026, the thresholds at which the exemption begins to disappear will decrease to $500,000 for single filers and $1 million for joint filers (from 2025 levels of $626,350 and $1,252,700, respectively). As a result, high-income taxpayers will see their AMT exemption reduced more quickly under the OBBBA, than under the TCJA.

"PART A" WILL EXPLORE OTHER TAX PROVISIONS IN OBBBA

The following chapters in Part A of this year's Course Reader will review the OBBBA changes that apply to individuals, families, students, investors, and business owners. The overarching question to be answered in this first part of our bundled CE program is "how will the new federal tax rules be applied to your clients' 2026 tax returns (to be filed by April 15, 2027)?"

REVIEW QUESTIONS

1. The highest marginal individual income tax rate under the OBBBA:
{A}. stays at 37%
{B}. is decreased to 35% beginning in 2026
{C}. is increased to 39.6% beginning in 2026
{D}. is repealed and replaced with one flat tax rate of 21% for all taxpayers

2. The OBBBA retained the AMT and made higher exemption amounts permanent. Which of the following statements regarding AMT rates is correct?
{A}. AMT applies a flat 28% rate
{B}. AMT applies capital gains rates only
{C}. AMT uses the same seven rates as the regular tax system
{D}. AMT applies 26% up to an income threshold and 28% above it

Part E reveals the correct answers to all end-of-chapter review questions while providing feedback on both correct and incorrect responses.

Chapter 2. TAX BENEFITS FOR EDUCATION AND YOUTH

Learning objectives: By the end of this chapter, you should be able to identify and explain the OBBBA tax rules that support education and youth. This includes Trump Accounts, ABLE accounts, and 529 plans; tax rules for employer student loan payments and forgiven student loan debt; the new federal SGO credit and Pell Grant changes; the updated SSN requirement for education credits; and the expanded educator expense deduction.

- Tax-advantaged savings vehicles
    - » Trump Accounts
    - » ABLE Accounts
    - » 529 Plans
- Student Loan-Related Tax Provisions
    - » Exclusion for Employer Payments of Student Loans
    - » Tax Exclusion of Forgiven Student Loan Debt
- Scholarships and Grants
    - » Section 25F SGO credit
    - » Pell Grants
- New SSN requirement for both education credits
- Educator Expense Deduction
    - » Background
    - » OBBBA expands the deduction in three ways
- Family-focused tax benefits to be discussed later

TAX-ADVANTAGED SAVINGS VEHICLES

This section covers three savings options: Trump Accounts, which help families start saving early for children; ABLE Accounts, which let people with disabilities and their families save for disability costs without losing certain public benefits; and 529 Plans, which offer tax benefits for education savings. Understanding how these accounts work — including contribution limits, tax rules, and allowed uses — can help families plan for the future.

TRUMP ACCOUNTS

The OBBBA creates “Trump Accounts” under IRC Section 530A, which are special savings accounts to help families save money for children over the long term.

Families can contribute up to $5,000 per year per child (indexed for inflation after 2027). Contributions to Trump Accounts are not deductible on the contributor’s tax return, and there are no income limits or phaseouts that restrict who may contribute. Contributions cannot begin before July 4, 2026.

Employers may also contribute up to $2,500 per year to Trump Accounts on a tax-free basis, with those contributions excluded from the employee’s taxable income. Current IRS guidance suggests that this $2,500 exclusion applies per employee rather than per

child, and that employer contributions remain subject to the overall annual contribution limits.

Funds in a Trump Account generally cannot be withdrawn before the beneficiary turns 18; early withdrawals are prohibited except in limited circumstances, such as the beneficiary's death or disability. During the "growth period," funds must generally be invested in diversified, low-cost index funds or similar investment options. The growth period ends on January 1 of the year the child turns 18; from that point, the beneficiary can begin taking distributions for designated purposes under rules that mirror traditional IRA distribution rules, including the application of the 10% early-distribution penalty to nonqualified withdrawals.

When the child becomes an adult, the account balance can be used for certain purposes, such as paying for college, buying a first home, or starting a business, without a penalty if the withdrawal is qualified. Nonqualified withdrawals may still be taxed as income and face a 10% penalty on the taxable part.

As a pilot program, the Treasury Department will add $1,000 to any qualifying child's Trump Account if the child is a US citizen born between January 1, 2025, and December 31, 2028, and an account is opened for them. This government contribution does not count toward the family's $5,000 annual limit. Even though new government-seeded accounts will stop after 2028, Trump Accounts are meant to be long-term savings tools that families and employers can keep using to help with children's future financial needs.

Tax treatment of distributions. Under IRC Section 530A(a), a Trump Account is treated as an individual retirement account under Section 408(a), except as otherwise provided. In practical terms, this means that Trump Accounts function much like traditional IRAs, which include both nondeductible (after-tax) contributions and untaxed amounts.

Trump Accounts may receive several types of contributions, including after-tax contributions from families, employer contributions, and government seed contributions. Contributions made by parents, family members, or the beneficiary using after-tax dollars create basis in the account and are returned tax-free when distributed.

Money that does not count as basis includes investment earnings, the $1,000 from the government, and employer contributions that were not taxed as income. These amounts are taxed when taken out.

When money is taken out after the child turns 18, the withdrawal is split between the tax-free basis and the taxable part, just like with traditional IRAs that have after-tax contributions.

The return-of-basis portion is excluded from gross income. The taxable portion, representing earnings and other non-basis amounts, is included in gross income and taxed at ordinary income rates, not capital gains rates.

For example, suppose a beneficiary withdraws $10,000 for college tuition at age 20, and 60% of the account balance is basis, and 40% is earnings at the time of distribution. In that case, $6,000 is a tax-free return of basis, and $4,000 is includible in gross income at ordinary rates, with no 10% penalty because the distribution is for qualified higher-education expenses.

Qualified withdrawals from Trump Accounts avoid the 10% penalty, but the earnings are still taxed as income. This is different from 529 plans, where qualified education withdrawals are completely tax-free.

ABLE ACCOUNTS

The TCJA made three big changes to Achieving a Better Life Experience (ABLE) accounts:

- Increased contribution limits through the ABLE to Work provision;
- Limited rollovers from 529 plans to ABLE accounts; and
- Eligibility of ABLE contributions for the Section 25B saver's credit.

First, the TCJA created the ABLE to Work additional contribution rule under IRC Section 529A(b)(2)(B). This provision allows an employed ABLE beneficiary to make additional contributions above the standard annual ABLE contribution limit, up to the lesser of:

- The federal poverty line for a one-person household; or
- The beneficiary's compensation.

This additional contribution is available only if, for that year, the beneficiary does not make contributions to a qualified retirement plan, 403(b) plan, or governmental 457(b) plan (or another plan treated the same way for this purpose).

Second, the TCJA allowed limited rollovers from a 529 plan to an ABLE account for the same designated beneficiary or a qualifying family member. A "family member" is defined in Section 529 and generally includes siblings, parents, children, and certain other relatives. These rollovers can occur without tax or penalty as long as the rollover amount, together with other non-ABLE-to-Work contributions for the year, does not exceed the annual ABLE contribution limit. Rollovers count toward this standard annual limit; ABLE to Work contributions are in addition to that limit. To qualify as a nontaxable rollover, the distribution from the 529 account must be contributed to the ABLE account within 60 days.

Third, the TCJA made it so people with ABLE accounts can get the Section 25B saver's credit for money they put into their own ABLE accounts. Only the account owner can claim this credit on their tax return, not others who put in money. This credit is for people with low or moderate incomes who save for retirement, and now it also covers ABLE contributions.

All three TCJA enhancements for ABLE accounts were originally scheduled to expire after December 31, 2025.

OBBBA changes to ABLE accounts. The OBBBA permanently extends the following provisions that were previously scheduled to expire:
- The ABLE to Work additional contribution rule;
- The ability to roll over funds from a 529 plan to an ABLE account (subject to annual limits); and
- The rule that ABLE contributions qualify for the Section 25B saver's credit.

Because of the OBBBA, the standard annual ABLE contribution limit for 2026 is $20,000. This is the first year the ABLE limit is no longer tied to the gift tax exclusion. The ABLE limit now uses 1996 as its inflation reference year, while the gift tax exclusion uses 1997. As a result, the ABLE limit will increase faster over time.

For SSI, up to $100,000 in an ABLE account is usually not counted as an asset, so these higher limits let families save more money without losing SSI benefits.

With the ABLE to Work rule, people living in the continental US can put in up to $15,650 extra (or their total pay for the year, whichever is less). This means the total could be $35,650 ($20,000 regular limit plus $15,650 extra). The limits are higher in Alaska and Hawaii.

Under current law, the Section 25B saver's credit for retirement plan and IRA contributions is available through December 31, 2026. Beginning in 2027, the SECURE 2.0 saver's match replaces this credit for most retirement savers, providing a federal matching contribution equal to 50% of the first $2,000 contributed (maximum $1,000).

The OBBBA preserves a separate saver's credit for ABLE accounts, so that after 2026 ABLE contributions will continue to qualify for a tax credit even as most retirement accounts shift to the saver's match structure. Beginning in 2027, the annual contribution base eligible for the ABLE saver's credit will increase to $2,100, with a maximum credit of $1,050 (the actual credit amount still depends on the taxpayer's adjusted gross income and filing status).

While the OBBBA solidified the financial benefits of these accounts, the ABLE Age Adjustment Act, effective January 1, 2026, significantly expanded the pool of eligible individuals by increasing the age of disability onset eligibility from 26 to 46. It is estimated that increasing the age from 26 to 46 makes an additional 6 million Americans eligible for ABLE accounts.

YEAR	CHANGE
2025	OBBBA enacted; TCJA ABLE provisions made permanent and contribution limit increased (by changing the inflation base year)
2026	ABLE Age Adjustment Act takes effect; ABLE limit increases to $20,000
2027	Saver's match replaces saver's credit for retirement accounts; ABLE retains its own saver's credit with increased contribution base

SECTION 529 PLAN

IRC Section 529 authorizes tax-advantaged education savings accounts that allow parents, relatives, friends, and other contributors to save for a child's future education expenses. Earnings in a 529 plan grow tax-deferred. Withdrawals are tax-free when used for qualified education expenses but are subject to income tax and a 10% penalty on the earnings portion if used for nonqualified purposes.

Before 2017, 529 plans were exclusively used for college-related expenses, and only Coverdell ESA funds could be used for primary and secondary expenses. Qualified higher education expenses included:

- Tuition;
- Fees;
- Books;
- Supplies;
- Equipment;
- Computers;
- Internet access;
- Room and board (if enrolled at least half-time).

529 plans are allowed by federal law, but they are run by states. Each state can set its own rules and offer different incentives, which may differ from the federal guidelines. For example, many states outside of California offer a state income tax deduction or credit for contributions.

There are no income limits for 529 plan owners, so anyone can contribute and get tax benefits, even high earners. IRC Section 529 also does not set a specific dollar limit on contributions. However, if someone gives more than $19,000 in a year ($38,000 for a married couple), it may be subject to the federal gift tax and must be reported on Form 709. Each state also sets a lifetime account limit. For example, California's ScholarShare 529 plan has a total contribution limit of $529,000 per beneficiary.

IRC Section 529 allows contributors to "superfund" a 529 account by making up to five years' worth of annual exclusion gifts at once. For example, a single taxpayer may contribute up to $95,000 in 2026 ($190,000 for married couples) and elect to treat the contribution as made over five years for gift-tax purposes. The five-year election is made once, on the Form 709 filed for the year of the contribution, not for each of the five years. The donor files a single Form 709 for the year of the contribution and checks the box to elect five-year averaging. That one election covers the entire five-year period. If

the contributor dies during the five-year election period, a prorated portion of the gift may be included back in the contributor's taxable estate.

A 529 plan is similar to a Roth IRA in some ways. Contributions to a 529 plan are not reported on federal tax returns, and earnings are not taxed when used for qualified education expenses. While there is no federal tax deduction for contributions, the money grows tax-free if used for education.

One of the most flexible aspects of 529 plans is the ability to change beneficiaries. If the original beneficiary does not use the funds, the account owner may change the designated beneficiary to another eligible family member without triggering tax consequences. Eligible family members include (but are not limited to) a spouse, sibling, parent, child, or first cousin of the original beneficiary [IRC Section 529(e)(2)].

Withdrawals used for nonqualified expenses are subject to ordinary income tax on the earnings portion and generally a 10% penalty. The 10% penalty on earnings is waived if the beneficiary receives a scholarship (up to the scholarship amount), attends a US military academy, or dies or becomes disabled — though ordinary income tax on the earnings portion still applies.

The same expenses cannot be used both for a tax-free 529 withdrawal and another education tax benefit. In other words, taxpayers cannot "double dip" by using the same expenses for both a tax-free 529 withdrawal and an education tax credit, such as the American Opportunity tax credit or the lifetime learning credit. Also, qualified expenses must be reduced by tax-free aid, such as employer tuition assistance, VA benefits, and tax-free scholarships.

Changes made by the TCJA (2017). In 2017, the definition of a "qualified education expense" was broadened to include the costs of kindergarten through 12th grade (K-12) education.

The TCJA allowed annual tax-free withdrawals of up to $10,000 per beneficiary for K-12 private and religious school tuition. Unlike distributions for qualified higher education expenses (which may include books, supplies, and so on), K-12 withdrawals could be used only for tuition. Under the TCJA, K-12 withdrawals could not be for homeschooling or tutoring (these restrictions were lifted by the OBBBA in 2025).

Changes made by the SECURE Act (2019). Before the SECURE Act, student loan payments weren't qualified expenses. The SECURE Act amended IRC Section 529 to allow student loan payments for the account beneficiary and their siblings (such as a brother, sister, stepbrother, or stepsister). A 529 account can distribute a student loan payment to a sibling of the designated beneficiary without changing the account's designated beneficiary. There is a lifetime maximum of $10,000 per individual when using 529 funds for student loan debt. So, if a designated beneficiary and her two siblings had student loans, up to $30,000 could be withdrawn penalty-free for the three borrowers ($10,000 per borrower).

Example. An account owner has a 529 plan for their eldest daughter. The daughter has $8,000 in outstanding student loans. Her two younger brothers also have $12,000 in student loan debt each. The SECURE Act allows a lifetime maximum of $10,000 per individual for student loan repayments made with 529 funds, including for the beneficiary and each of their siblings. In this scenario, the account can pay $8,000 for the daughter and $10,000 for each of the two brothers (the brothers' individual $12,000 loans are capped at the $10,000 per-person limit). The total tax-free withdrawal would be $28,000.

The SECURE Act also allows 529 plan beneficiaries to use the funds for qualified expenses — like fees, books, supplies, and equipment — related to an apprenticeship program approved by the US Department of Labor. Apprenticeships combine paid work with classroom learning to prepare people for jobs such as nurse aides, dental assistants, pharmacy technicians, carpenters, and electricians.

Changes made by SECURE 2.0 (2022). SECURE 2.0 amended IRC Section 529 so taxpayers could transfer funds from an underused education savings plan to a Roth IRA. The Roth receiving the funds must be in the name of the 529 plan beneficiary. The rollover must be completed as a trustee-to-trustee transfer; the beneficiary may not take possession of the funds.

The 529 plan must have been open for at least 15 years to move money to a Roth IRA without a penalty. Also, any money put into the 529 plan in the last 5 years cannot be moved tax-free to a Roth IRA.

Beneficiaries can roll over a maximum of $35,000 throughout their lifetime. However, rollovers are subject to the annual contribution limits for Roth IRAs. Because rollovers are subject to the annual IRA contribution limit (currently $7,500), reaching the $35,000 lifetime maximum will generally take at least five years.

The beneficiary must have earned income in the year they move money from a 529 to a Roth IRA. The amount moved cannot be more than what the beneficiary earned that year or the yearly IRA limit, whichever is less. For example, if the beneficiary earned $5,000 in a year, they can only move $5,000, not $7,500.

There is ongoing uncertainty among tax practitioners about whether changing the beneficiary resets the 15-year clock. The IRS has not issued formal guidance on this point.

Changes made by the OBBBA (2025). The old $10,000 limit for K-12 expenses is now $20,000 per year. This $20,000 limit is for each child, not each account. If a child has two accounts (like one from a parent and one from a grandparent), the total K-12 withdrawals cannot go over $20,000.

The OBBBA expands the definition of qualified higher education expenses to include additional K-12 educational expenses (including in the homeschooling context) such as

curriculum materials, books or other instructional materials, online educational materials, educational therapies, fees for college admission examinations, and certain tutoring expenses. Tutoring costs are qualified only if the tutor or instructor is not related to the student and also meets one of these criteria:

- Licensed as a teacher by a state;
- Has taught at an eligible institution; or
- Is a subject matter expert.

Example. In 2026, the child attends a private K-12 school with a total tuition of $18,000 and requires $4,000 in specialized tutoring from a licensed subject matter expert. Under the OBBBA, the annual limit for K-12 expenses was increased to $20,000 per beneficiary. While the total expenses ($18,000 tuition + $4,000 tutoring) equal $22,000, the tax-free withdrawal is capped at the $20,000 statutory limit.

The new law allows tax-free withdrawals from 529 plans for on-the-job training and continuing education programs. This includes tuition, fees, books, exam costs, and supplies for approved programs. To qualify, the credential program must be authorized by the Workforce Innovation and Opportunity Act or listed in the Veterans Benefits Administration's Web Enabled Approval Management System.

The OBBBA also makes permanent (by removing the previous 2025 sunset) the TCJA's allowance of tax-free rollovers from a 529 plan to an ABLE account, subject to the standard ABLE account contribution limit, provided that the accounts have the same designated beneficiary (or the designated beneficiaries of the two accounts are members of the same family).

The OBBBA expansions described above take effect on the date of enactment (July 4, 2025). However, the increase in the K-12 expense limit (from $10,000 to $20,000) begins on January 1, 2026.

STUDENT LOAN-RELATED TAX PROVISIONS

EMPLOYER PAYMENTS TOWARD EMPLOYEE STUDENT LOANS

Traditional Section 127 Educational Assistance. IRC Section 127 was enacted in 1978 as a temporary provision to encourage employer-provided educational assistance and was repeatedly extended before the American Taxpayer Relief Act of 2012 made it permanent.

If an employer maintains a written educational assistance plan that satisfies the requirements of IRC Section 127, employees may exclude up to $5,250 of employer-provided educational assistance from gross income each year. The exclusion applies only when the payments are made under a formal employer plan, not when employees pay their own costs. The plan must be written, cannot offer employees a choice between cash and education benefits, and must be communicated to employees.

The $5,250 cap on employer-provided tuition assistance was set in 1986. Because the exclusion was not indexed for inflation, its real value eroded significantly over the past 40 years. Adjusted for inflation, the 1986 cap of $5,250 would be worth approximately $14,500 today.

Employer payments made under a qualified Section 127 plan are generally deductible as ordinary and necessary business expenses. For employees, the Section 127 fringe benefit offers the following advantages:

- There are no enrollment status restrictions, so part-time students would qualify for this educational benefit.
- Unlike education benefits provided under IRC Section 132(d), educational assistance under Section 127 does not need to be job-related. Qualified expenses do not require that the courses be work-related or part of a degree program.
- Employer-provided educational assistance can apply to both undergraduate and graduate-level education.
- The exclusion is available for an unlimited number of years.
- There are no income phaseouts associated with employer-provided educational assistance, and the Section 127 exclusion does not expire.

Employer-provided tax-free payments may be used for tuition, fees, books, supplies, and equipment, but equipment and supplies qualify only if they are used for educational purposes. Items that students retain after course completion — other than textbooks — do not qualify. Other costs that do not qualify for tax-free status include meals, lodging, and transportation. Before 2020, the employer's help paying down a student loan debt did not qualify for tax-free status.

A qualified expense must be "reasonable" and "necessary" for the education. Courses involving sports, games, or hobbies do not qualify unless:

- They are job-related; or
- They are part of a degree program.

Section 127 describes who can (or cannot) benefit from the provision. Spouses and dependents cannot receive Section 127 benefits unless they are also employees. Also, the program cannot favor highly compensated employees, and no more than 5% of total benefits may be provided to shareholders or owners owning more than 5% of the business.

Employees cannot use the same qualified expenses for both the Section 127 exclusion and the American Opportunity tax credit or the lifetime learning credit for the same academic period.

The CARES Act expansion for student loan repayment. For decades, Section 127 applied only to traditional educational expenses such as tuition and books. Congress expanded the provision significantly during the COVID-19 pandemic. Through the CARES Act of 2020, Congress recognized that millions of Americans struggle with

significant student loan debt and sought to encourage employers to help address the problem through workplace benefit programs.

The CARES Act expanded Section 127 by allowing employers to make tax-free payments toward employees' student loan debt. CARES amended Section 127 to allow employers to pay up to $5,250 toward student loans as part of an educational assistance program. Employer payments may be applied toward either principal or interest on a qualified education loan (they can be made to the employee or the lender).

Student loan repayment assistance must be provided under a workplace program that meets the requirements of Section 127. For instance, the funds must be applied to the employee's student debt and not the education loan of the employee's spouse or dependents.

If the employer's program satisfies Section 127 requirements, neither the employer nor the employee owes federal payroll taxes on qualifying payments. Moreover, employees will not be subject to federal income taxes that would otherwise apply. However, if an employer pays the loan, the employee cannot also claim a student loan interest deduction on their taxes for that same amount.

Example. Under a qualified Section 127 plan, an employer pays $2,129 directly to an employee's student loan servicer in 2026. The payment is applied entirely to the loan principal. The employee also pays $2,050 of their own money toward loan interest during the same year. The general rule is that when an employer pays a student loan under a qualified Section 127 program, the employee cannot claim a student loan interest deduction for that same amount. However, the employee is still entitled to deduct the interest they personally paid, up to the standard limits, provided the other deduction requirements are met.

The tax advantage of a qualified Section 127 plan can be illustrated with a simple example. Let's say an employer paid an employee $5,250 in student loan repayment assistance outside a qualified program. In this case, the employer and the employee would each have to pay about $402 in payroll taxes (assuming typical Social Security and Medicare tax rates). Additionally, assuming the employee is in the 22% federal marginal income tax bracket, they must pay $1,155 in federal income taxes. In this scenario, the employer's cost would be approximately $5,652 ($5,250 payment plus $402 in payroll taxes), while the employee would receive only $3,693 after federal income and payroll taxes. In contrast, if the same payment is made under a qualified

program, the employer would pay $5,250, and the employee would receive a benefit of $5,250.

The $5,250 limit applies in the aggregate to all educational assistance and student loan repayments provided to an employee in a year. Thus, an employer could pay $3,000 towards an employee's Master's degree and another $4,000 of the same employee's student loan payments. However, the maximum amount that will be tax-free to the employee is $5,250.

The CARES Act amended Section 127 to include student loan repayment assistance as a qualified educational expense from March 27, 2020, through December 31, 2020. The Consolidated Appropriations Act of 2021 extended the availability of this provision until December 31, 2025.

OBBBA makes the student loan repayment benefit permanent. The new law removed the 2025 "sunset" date, making the student loan repayment benefit a permanent part of the Tax Code. As a result, employers will continue to have the option to contribute up to $5,250 annually toward employees' student loans on a tax-favored basis beyond the previous expiration date of December 31, 2025.

The OBBBA not only extended the student loan repayment benefit but also improved it. The $5,250 cap will be indexed for inflation for tax years beginning after December 31, 2026. After remaining stagnant for nearly four decades, the $5,250 cap will finally be adjusted for inflation starting in 2027, helping the exclusion keep pace with rising education costs. The indexing provision applies to the overall exclusion, not just the loan component.

TAX EXCLUSION OF FORGIVEN STUDENT LOAN DEBT

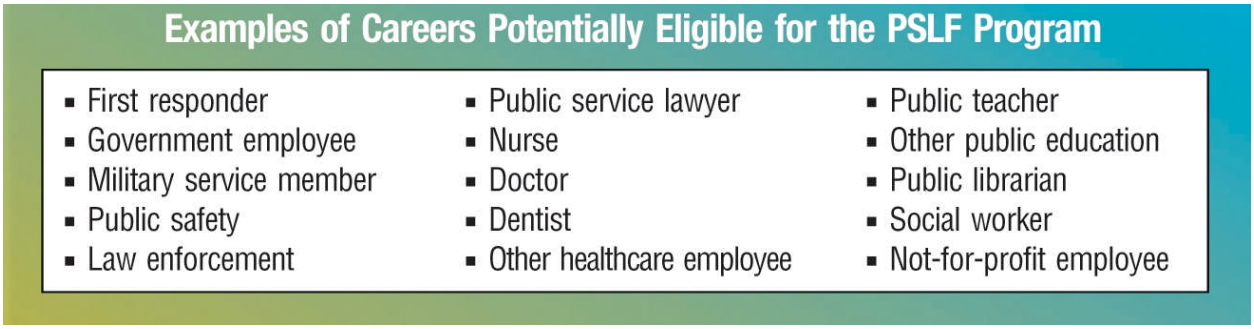
General rule: COD income. Under Section 61, a borrower generally recognizes cancellation-of-debt (COD) income when a loan they are obligated to repay is forgiven, unless a specific exclusion applies. For example, if a borrower earning $40,000 has $30,000 of debt forgiven and no exclusion applies, their gross income would increase to $70,000 for that year. Lenders typically report canceled debt on Form 1099-C unless a statutory exclusion applies.

IRC Section 108(f): Service-contingent exclusions. The first exclusion for forgiven student loans was added to the Internal Revenue Code in 1984. The initial student loan exclusion that Congress enacted applies to loans canceled under service-contingent forgiveness programs — that is, programs requiring borrowers to work for a specified period in certain professions for any of a broad class of employers. When these conditions are met, and the program qualifies under Section 108(f), the forgiven amount is excluded from the borrower's federal gross income.

For decades, Section 108(f) has allowed certain service-based loan forgiveness programs to be excluded from gross income. Examples include:

- Public Service Loan Forgiveness (PSLF) Program;

● Loan forgiveness programs for teachers;
● Loan forgiveness programs for nurses, doctors, and veterinarians;
● Loan forgiveness programs for public interest law.



Example 1. After Joel finishes his medical residency, he is legally contracted to practice medicine for four years in a remote Alaskan town in exchange for forgiveness of his medical school loans. When Joel's loan is forgiven, he will not have to include the resulting COD income on his tax return (assuming the loan program meets the requirements of IRC Section 108(f) and applicable regulations).

Example 2. Sofia accumulates $40,000 of student loan debt. After graduating from college, she serves as a science teacher at an inner-city high school. After five consecutive academic years of service, $17,500 of Sofia's student loan balance is forgiven under the Teacher Loan Forgiveness Program. The forgiven amount is excluded from Sofia's gross income under IRC Section 108(f)(2).

TCJA: Death and disability exclusion. The TCJA left in place rules that allowed qualifying borrowers to exclude cancellation of student loan debt from income. The TCJA also added a temporary provision [under Section 108(f)(5)] that student loan debt forgiveness due to the borrower's death or total and permanent disability (TPD) could be excluded from income. For discharges of indebtedness after December 31, 2017, and before January 1, 2026, student loan cancellations due to the borrower's death or TPD are excluded from gross income.

ARPA: Broad temporary exclusion. Congress expanded the Section 108(f) exclusion significantly in 2021. Under the American Rescue Plan Act (ARPA), most discharges of qualifying student loans occurring between January 1, 2021, and December 31, 2025, were excluded from federal gross income, whether the forgiveness was tied to public service, income-driven repayment (IDR), school closure, or other grounds, as long as the loan met the statutory definition in Section 108(f). This broad exclusion applied to many federal, state, institutional, and private loans used to finance postsecondary education.

OBBBA: Permanent targeted exclusions. Congress revisited the issue in 2025. The OBBBA amends Section 108(f)(5) to remove the prior sunset date, making the death and disability exclusion permanent. A new OBBBA requirement is that taxpayers must include their SSN on the tax return to claim the exclusion for death or TPD discharges

occurring after December 31, 2025; this requirement applies only to the death/TPD exclusion, not to service-contingent forgiveness.

OBBBA does not extend the broad ARPA exclusion, which expired at the end of 2025. Student loan debt forgiven after December 31, 2025, is generally considered taxable income at the federal level.

IDR forgiveness (typically after 20 to 25 years) was tax-free only through 2025 under ARPA. For borrowers whose loans are forgiven under IDR after 2025, the forgiven balance will generally be taxable, potentially creating a substantial "tax bomb" and resulting in thousands of dollars in tax liability.

Example. Shana has been making IDR payments on her federal student loans for 22 years. In 2026, Shana's remaining balance of $45,000 is forgiven under an IDR plan. No service-contingent forgiveness program applies, and Shana is solvent. The broad ARPA exclusion expired December 31, 2025, and the OBBBA did not extend it. IDR forgiveness after 2025 is generally taxable as COD income unless another exclusion applies.

Even after the broader ARPA exclusion expires, some types of student loan forgiveness will remain tax-free at the federal level (such as PSLF and loan forgiveness programs for teachers, doctors, and other professions). Borrowers who no longer qualify for a student loan exclusion may still avoid tax under:

- The insolvency exception [IRC Section 108(a)(1)(B)]; or
- The bankruptcy discharge [IRC Section 108(a)(1)(A)].

When COD income is excluded due to insolvency or bankruptcy, borrowers typically file Form 982. Insolvency is common for long-term low-income IDR borrowers. Also, regarding the bankruptcy discharge, guidance from the DOJ and the Department of Education in 2022 made it easier for borrowers to satisfy the "undue hardship" standard without full litigation.

Through 2025, most student loan forgiveness was tax-free under ARPA. Beginning in 2026, the tax treatment reverts to the pre-ARPA framework: service-contingent forgiveness (including PSLF) remains tax-free, and OBBBA permanently excludes discharges due to death or total and permanent disability. All other forms of forgiveness — including IDR forgiveness — will generally be taxable unless another exclusion applies.

Federal tax benefits related to student loans	Scheduled end date
Tax deduction for student loan interest	None (Permanent)
529 plans allow tax-free distributions (up to $10,000) to pay down student loan debt	None (Permanent)
Broad tax exclusion for canceled student loan debt (ARPA)	12/31/2025 Not renewed by OBBBA
Narrow tax exclusion for canceled student loan debt due to death or disability	Permanent (Extended by OBBBA)
Tax-free employer repayment of employee's student loan debt under Section 127	Permanent (Extended & indexed by OBBBA)

SCHOLARSHIPS AND GRANTS

SECTION 25F SGO CREDIT

The OBBBA created a new federal tax credit under IRC Section 25F for contributions to Scholarship Granting Organizations (SGOs). This provision represents the first federal tax credit scholarship program specifically designed to fund K-12 scholarships through private nonprofit organizations. Contributions are made to nonprofit SGOs, which then distribute scholarships to eligible students.

IRC Section 25F and Section 139K, introduced by the OBBBA for tax years after 2026, work together to create a federal tax credit scholarship program for elementary and secondary education. Section 25F provides a nonrefundable tax credit for donors making contributions to SGOs, while Section 139K provides that qualified scholarships funded through SGOs are excluded from the recipient's gross income. After December 31, 2026, scholarships received from SGOs are excluded from the recipient's gross income.

The new provision takes effect for the 2027 tax year, so the first credits may be claimed on 2027 federal tax returns. Taxpayers will claim the new credit through a new Form 1040 Schedule (to be drafted in 2027).

There are no income phaseouts for the credit. Individuals may claim a nonrefundable federal tax credit of up to $1,700 for cash contributions to SGOs. The $1,700 limit is per taxpayer, not per return — meaning joint filers may each claim the credit, for a potential combined credit of $3,400. The statute imposes no national aggregate cap on credits, unlike many state scholarship tax-credit programs.

The OBBBA includes several anti-abuse rules. Amounts used to claim the Section 25F credit cannot also be claimed as charitable deductions under Section 170. In addition, if a taxpayer receives a state tax credit for the same contribution, the federal credit must be reduced by that amount. For example, if a taxpayer contributes $1,700 and receives a $500 state credit, their maximum allowable federal credit under Section 25F would be $1,200 ($1,700 minus $500).

Because the credit is nonrefundable, it can reduce the donor's federal tax liability but cannot generate a refund. Unused credits may be carried forward for up to five years.

Example. In 2027, Haley contributes $1,700 to an approved SGO. Her federal tax liability is $1,200. She uses $1,200 of the credit to reduce her tax bill to zero and carries forward the remaining $500 to her 2028 tax return. Haley cannot deduct any portion of the contribution as a charitable deduction.

To qualify, an SGO must be a 501(c)(3) organization (that is not a private foundation) and certified by a participating state. For contributions to an SGO to be eligible for this credit, the SGO must be listed on a state list, meaning the state must first elect to participate and submit a list of qualifying SGOs to the IRS. Scholarships funded by certified SGOs must go to students whose household income does not exceed 300% of the area median income (updated annually by the Department of Housing and Urban Development). Also, donors cannot direct funds to a specific school or student.

Residents of nonparticipating states can still claim the credit for contributions to SGOs certified by other states. While donors can be from nonparticipating states, the students receiving the scholarships typically must reside in a participating state (or attend a school in one).

IMPLEMENTATION TIMELINE	
2025	OBBBA enacted.
2026	States certify SGOs and submit lists to the IRS; Treasury issues additional guidance.
2027	Credits available to taxpayers; SGO scholarships distributed and recipient income exclusion begins.

PELL GRANTS

The OBBBA makes the most significant structural changes to the Pell Grant program in more than a decade. Notably, the law allows Pell Grants to be used for certain short-term, workforce-aligned training programs rather than limiting eligibility to traditional degree or longer-term certificate programs.

Historically, Pell Grants were generally restricted to programs lasting at least 600 clock hours and 15 weeks. Under the new Workforce Pell category, students may use Pell funding for shorter programs that lead to recognized postsecondary credentials and employment in high-demand fields. Programs must meet earnings thresholds, completion benchmarks, state approval, and provider reporting requirements. Eligible programs generally must be between 150 and 599 clock hours and last roughly 8 to 15 weeks. Students cannot receive both a traditional Pell Grant and a "short-term Pell" in the same payment period.

Beyond Workforce Pell, the OBBBA includes a few changes that tighten Pell eligibility:
● Student Aid Index (SAI) cap. The OBBBA also closes the "Pellionaire" loophole by tightening eligibility for students with unusually low reported income but substantial assets. The new rule prohibits Pell awards for students whose SAI exceeds twice the maximum Pell award (currently $14,790 limit).
● Foreign income inclusion. The OBBBA requires foreign earned income to be included in AGI for Pell purposes, closing a loophole that previously allowed some high-income expatriates to qualify.
● Full-ride scholarship restriction. Students whose non-federal grants or scholarships already cover their full cost of attendance are not eligible to receive additional Pell funds.

The OBBBA includes a couple of changes that expand Pell eligibility. For instance, family-owned businesses and farms with 100 or fewer employees no longer need to be reported on the Application for Federal Student Aid, which is a favorable change for many Pell applicants.

Moreover, a unique OBBBA provision allows students who already have a bachelor's degree to access a Workforce Pell Grant if they are retraining for a high-demand field. Before OBBBA, students with a bachelor's degree could only receive a Pell Grant to enroll in certain teacher certification programs. Workforce Pell for bachelor's holders generally applies only to the short-term workforce programs, not traditional Pell programs.

Most Pell changes (SAI cap, foreign income, asset handling) apply first to the 2026-2027 award year. Workforce Pell becomes available starting July 1, 2026, but final implementation details depend on Department of Education rulemaking and state approval processes. Some higher education groups are advocating for a delay to July 1, 2027, to allow institutions more time to comply with the new requirements.

Pell taxation (unchanged by OBBBA). Although the OBBBA expands Pell eligibility, it does not change the federal tax rules governing Pell Grants. Under IRC Section 117 and related regulations, Pell Grants are treated as scholarships. They are tax-free to the extent they are used for qualified tuition and related expenses by an individual who is a candidate for a ***degree*** at an eligible educational institution.

Workforce Pell recipients in ***non-degree*** programs may raise questions under Section 117, which historically applies to scholarships received by candidates for a degree. Treasury or IRS guidance may clarify whether Workforce Pell awards qualify for the same tax-free treatment.

Qualified tuition and related expenses include tuition and mandatory fees required for enrollment or attendance, as well as books, supplies, and equipment required for courses of instruction. Amounts used for room, board, travel, and other living expenses do not qualify and are includible in gross income.

NEW SSN REQUIREMENT FOR BOTH EDUCATION CREDITS

Stricter identification requirements now apply to education tax credits. The OBBBA requires taxpayers claiming the American Opportunity tax credit (AOTC) or the lifetime learning credit (LLC) to provide valid Social Security numbers (SSNs) for all relevant individuals. Beginning with tax years starting in 2026 (returns filed in 2027 and later), the taxpayer, the taxpayer's spouse (if filing jointly), and the student for whom the credit is claimed must each have an SSN issued by the Social Security Administration.

In addition, the SSN must be valid for employment and must be issued on or before the due date of the tax return (including extensions). A valid SSN for employment means one not issued solely for non-work purposes (for example, to nonresident dependents). If the SSN is not issued by the due date for the return, the credit cannot be claimed — even on an amended return filed later.

Under prior law, taxpayers with an Individual Taxpayer Identification Number (ITIN) could claim education credits if they otherwise met the eligibility requirements. The OBBBA eliminates this possibility by requiring work-authorized SSNs for the taxpayer, spouse (if applicable), and student. As a result, taxpayers who file using ITINs are no longer eligible to claim either the AOTC or the LLC. This change particularly affects mixed-status households in which one or more family members use ITINs.

BEFORE AND AFTER OBBBA	
Before	***After***
ITIN filers could claim AOTC or LLC if otherwise eligible.	● Only individuals with SSNs valid for employment qualify; ITINs and non-work SSNs no longer count. ● All three parties (taxpayer, spouse, student) must have work-authorized SSNs.

Example. Idalia and her husband Jairo file a joint return for 2026. Idalia has a valid SSN; Jairo has an ITIN. Their daughter, a qualifying student, also has a valid SSN. The OBBBA requires valid work-authorized SSNs for the taxpayer, the spouse (if filing jointly), and the student. Because Jairo has only an ITIN, the couple cannot claim either education credit on their joint return.

Failure to provide the required SSNs will be treated as a mathematical or clerical error, allowing the IRS to disallow the credit automatically without a formal audit.

For the AOTC, taxpayers must now report the Employer Identification Number (EIN) of the educational institution where qualified tuition was paid.

EDUCATOR EXPENSE DEDUCTION

Congress expanded the educator expense deduction in response to longstanding concerns that teachers frequently pay for classroom materials out of pocket. While the

deduction primarily benefits staff rather than students directly, it still falls within the broader category of education-related tax policy.

BACKGROUND

Before 2026, eligible educators could claim an above-the-line deduction of up to $300 for unreimbursed classroom expenses. The deduction could be up to $600 for joint filers when both spouses were educators.

This deduction reduces adjusted gross income (AGI) and can be claimed even by taxpayers who take the standard deduction. To qualify, a taxpayer must:

- Work as a teacher, instructor, counselor, principal, or classroom aide;
- Work in a K-12 school;
- Work at least 900 hours during the school year (not a calendar year); and
- Pay unreimbursed expenses for classroom materials or professional development.

Preschool teachers, day-care workers, camp counselors, college faculty, and homeschool parents are ineligible.

Qualified expenses generally include:

- Books and classroom supplies;
- Computer equipment and software used for instruction;
- Classroom equipment and materials; and
- Professional development related to teaching.

No miscellaneous itemized deductions were allowed for additional classroom expenses because the TCJA suspended the old 2%-of-AGI miscellaneous deduction category through 2025.

OBBBA EXPANDS THE DEDUCTION IN THREE WAYS

The IRS has published a 2026 inflation-adjusted limit of $350 for the above-the-line deduction [Revenue Procedure 2025-32].

Expenses above the $350 cap can be itemized. Starting in 2026, the OBBBA adds a new itemized deduction on top of the current above-the-line deduction. The first $350 ($700 for married teachers filing together) is still above the line and available to all eligible teachers. Any extra qualifying expenses can be deducted with no limit as an itemized deduction on Schedule A. Educators should check if their total itemized deductions are more than the standard deduction to make sure they get a tax benefit.

The TCJA got rid of the 2%-of-AGI miscellaneous deduction from 2018 to 2025, and the OBBBA does not bring it back. Instead, there is a new itemized deduction just for educator expenses. This change means teachers can now deduct classroom expenses above the $350 limit.

Example. Kaila is a high school teacher who spends $1,500. She is a single filer who meets the 900-hour threshold and works at a state-recognized K-12 institution. On IRS

Form 1040, Schedule 1, Kaila claims $350 as an above-the-line deduction. On Schedule A, she itemizes the remaining $1,150. Unlike previous versions of miscellaneous deductions, this write-off is not subject to the 2% of AGI floor.

Expanded qualifying expenses. Eligible unreimbursed education costs include books, supplies, classroom materials, equipment, and professional development related to the curriculum or student instruction.

The law also expands the types of settings where qualifying expenses may be incurred. Pre-OBBBA, the IRS wording focused on materials used "in the classroom" (including certain health and physical-education supplies). Under the OBBBA, eligible itemized educator expenses can include materials used in non-traditional settings such as labs, workshops, or field-based instruction, as long as they are part of student instruction.

Expansion of eligible educators. The law now lets some school athletics staff claim the new itemized deduction. Besides regular classroom teachers, the itemized deduction now covers:

- Interscholastic sports coaches; and
- Sports administrators working in K-12 schools.

In order to qualify, the individual must work at any K-12 school for at least 900 hours during the school year as a teacher, instructor, counselor, principal, aide, interscholastic sports coach, or sports administrator. Previously, a "coach-only" role generally did not qualify.

The OBBBA does not expand the above-the-line definition of "eligible educator." Only the itemized portion expands to coaches and sports administrators.

Example. Coach Rivera is a high school basketball coach who works 930 hours during the school year solely in a coaching capacity. He spends $900 on training equipment for student practices and does not teach any academic courses. He itemizes deductions. Coach Rivera qualifies for the new itemized deduction because he works at least 900 hours at a K-12 school in an eligible role. However, he is not eligible for the above-the-line deduction, which is not expanded to coaches. His $900 of qualifying expenses is deductible as an itemized deduction.

Category	Pre-OBBBA (Before 2026)	Post-OBBBA (Starting 2026)
Above-the-line deduction limit	$300 (2025 limit)	$350 per educator ($700 MFJ with two educators)
Itemized deduction for additional expenses	None (2%-of-AGI miscellaneous deduction was suspended)	New, unlimited itemized deduction for educator expenses exceeding $350 cap
Qualifying expenses	Books, supplies, equipment, professional development, and materials used in the classroom	Now includes materials for labs, workshops, field sites
Eligible educators (above-the-line)	Teachers, instructors, counselors, principals, aides	No change (same eligible roles)
Eligible educators (itemized deduction)	Teachers, instructors, counselors, principals, aides	Now includes interscholastic sports coaches and sports administrators

FAMILY-FOCUSED TAX BENEFITS TO BE DISCUSSED LATER

This chapter has focused on tax provisions that directly support education and youth, spanning tax-advantaged savings vehicles, scholarships and grants, student loan relief, and educator-focused deductions. Although these provisions form a distinct cluster within federal tax policy, they operate alongside a broader set of family-oriented benefits that play an equally significant role in household financial planning.

The Child Tax Credit, the Adoption Tax Credit, and the Child and Dependent Care Credit are addressed separately in later chapters, where their structure and eligibility rules are examined in greater detail. Those chapters also discuss any changes to these provisions enacted by the OBBBA.

REVIEW QUESTIONS

3. The ABLE Age Adjustment Act, effective January 1, 2026, expanded eligibility for ABLE accounts by changing the age of disability onset requirement. Which of the following correctly states this change?
{A}. The age of onset was increased from 18 to 26, making young adults newly eligible.
{B}. The age of onset was increased from 26 to 46, estimated to make 6 million additional Americans eligible.
{C}. The age-of-onset criterion was eliminated, making all disabled individuals eligible regardless of when their disability began.
{D}. The age of onset was increased from 26 to 36, making approximately 3 million additional Americans eligible.

4. A designated 529 beneficiary has a brother and a sister, each with student loan debt. The beneficiary also has student loan debt. What is the maximum total amount that can be withdrawn from the 529 plan penalty-free for student loan repayment for all three individuals?
{A}. $10,000 total, shared among all three borrowers.
{B}. $20,000; $10,000 for the beneficiary and $10,000 combined for the siblings.
{C}. $30,000; $10,000 per individual for the beneficiary and each sibling.
{D}. Unlimited, as long as the funds are used for student loan repayment.

5. An employer pays $5,000 toward an employee's student loans under a qualified Section 127 plan. The employer's payment covered both principal and interest. Which of the following is true regarding the student loan interest deduction?
{A}. The employee may claim a student loan interest deduction for the same $5,000.
{B}. The employee may claim a deduction only for the principal portion of the employer's payment.
{C}. The employee may claim a deduction only for the interest portion of the employer's payment.
{D}. The employee cannot claim a student loan interest deduction for amounts covered by the Section 127 benefit.

6. Under the OBBBA, which of the following accurately describes the treatment of a federal tax credit for contributions to a qualifying SGO when the credit exceeds the taxpayer's federal tax liability in the contribution year?
{A}. The excess credit is refunded to the taxpayer as a tax refund.
{B}. The excess credit is lost and may not be used in any future year.
{C}. The excess credit may be carried forward to subsequent tax years.
{D}. The excess credit may be applied to reduce the taxpayer's state income tax liability.

Part E reveals the correct answers to all end-of-chapter review questions while providing feedback on both correct and incorrect responses.

Chapter 3. NON-ITEMIZED DEDUCTIONS IN THE OBBBA

Learning objectives: This chapter will help learners understand the non-itemized deductions available under the OBBBA, including the traditional Schedule 1 adjustments and the bigger standard deduction, with extra amounts for age and blindness. It also covers the new Schedule 1-A deductions for 2025–2028. Finally, the chapter explains the permanent charitable deduction for non-itemizers.

Chapter Topics

- Selected Schedule 1 deductions under the OBBBA
  - » Modified Adjusted Gross Income (MAGI)
  - » Educator expenses (line 11)
  - » Health Savings Account contributions (line 13)
  - » Moving expenses (line 14)
  - » Student loan interest (line 21)
- The standard deduction
  - » The basic standard deduction
  - » The additional standard deduction
- New Schedule 1-A deductions (2025–2028)
  - » Enhanced deduction for seniors
  - » No Tax on Tips
  - » No Tax on Overtime
  - » No Tax on Car Loan Interest
- Permanent charitable deduction for non-itemizers
  - » Overview and background
  - » Deduction limits and qualifying contributions
- Looking ahead: the Section 199A QBI deduction

SELECTED SCHEDULE 1 DEDUCTIONS UNDER THE OBBBA

Income can come from many different sources, but the federal government does not tax all types of income. As discussed earlier, some amounts are not included in gross income. Once gross income is determined, it may be reduced by deductions.

“Adjustments to income” are shown in Part II of Schedule 1. These deductions are subtracted from an individual's gross income to calculate their adjusted gross income (AGI). They are often called “above the line” because they are deducted before the AGI line on Form 1040.

Schedule 1, top half of Part II

Part II	Adjustments to Income		
11	Educator expenses	11	
12	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106	12	
13	Health savings account deduction. Attach Form 8889	13	
14	Moving expenses for members of the Armed Forces. Attach Form 3903	14	
15	Deductible part of self-employment tax. Attach Schedule SE	15	
16	Self-employed SEP, SIMPLE, and qualified plans	16	
17	Self-employed health insurance deduction	17	
18	Penalty on early withdrawal of savings	18	
19a	Alimony paid	19a	
b	Recipient's SSN		
c	Date of original divorce or separation agreement (see instructions):		
20	IRA deduction	20	
21	Student loan interest deduction	21	

Above-the-line deductions reduce AGI — the key figure used to determine eligibility for many credits, deductions, and phaseouts. Generally, a lower AGI means fewer restrictions on qualifying for other tax benefits, essential to reducing your clients' taxable income and lessening their overall tax burden.

FEDERAL INCOME TAX FORMULA FOR INDIVIDUALS		
1.	Starting point	Income "from whatever source derived"
2.	Minus (–)	Exclusions
3.	Equals (=)	Gross Income
4.	Minus (–)	Above-the-line deductions (on Schedule 1)
5.	Equals (=)	Adjusted Gross Income (AGI)
6.	Minus (–)	Below-the-line deductions (QBI, itemized or standard deduction)
7.	Equals (=)	Taxable Income
8.	Times (×)	Individual tax rate (10% to 37%)
9.	Equals (=)	Income Tax Due
10.	Plus (+)	Other taxes (reported on Schedule 2 and carried to Form 1040)
11.	Equals (=)	Gross tax due
12.	Minus (–)	Credits and prepayments (withholdings and/or estimated taxes)
13.	Equals (=)	Net tax payable or refund due

MODIFIED ADJUSTED GROSS INCOME (MAGI)

Modified Adjusted Gross Income (MAGI) is a variation of AGI that adds back certain deductions and exclusions that were subtracted to arrive at AGI. It is not used to determine the standard deduction, but it is central to determining whether a taxpayer may claim, or must phase out, many deductions and credits.

There is no line for MAGI on Form 1040 because there is no single universal MAGI; each provision has its own definition. The add-backs vary by provision, but often include items such as:

- Excluded foreign earned income;
- Excluded foreign housing amounts;
- Tax-exempt interest (e.g., from municipal bonds);
- Excluded savings bond interest used for education.

MAGI functions as an income threshold used to determine whether a taxpayer qualifies for certain tax benefits — and, if so, how much they can claim. If a taxpayer's MAGI exceeds the applicable threshold or phaseout range, the deduction or credit may be reduced or completely disallowed.

EDUCATOR EXPENSES (LINE 11)

One of the most widely used Schedule 1 deductions is the educator expense deduction, available to K-12 educators who work at least 900 hours during the school year. This deduction was introduced in the previous chapter.

Educators may deduct up to $350 ($700 for married educators filing jointly) as an above-the-line deduction on Schedule 1, line 11. The OBBBA creates a second deduction for educators — an itemized deduction on Schedule A — while retaining the original Schedule 1 deduction (as adjusted for inflation). The itemized deduction on Schedule A has no dollar limit and no 2%-of-AGI floor. Taxpayers benefit from the additional itemized deduction only if they itemize rather than claim the standard deduction.

Both the above-the-line and itemized educator deductions can include materials and equipment used as part of instructional activity, including outside traditional classrooms (such as labs, workshops, or field-based instruction), and they continue to include qualifying professional-development course costs.

The itemized deduction on Schedule A expands eligibility to interscholastic sports coaches and sports administrators who work at least 900 hours at a K-12 school. However, this expansion applies only to the itemized deduction, not to the above-the-line deduction on Schedule 1, line 11. The OBBBA did not amend the statutory definition of "eligible educator" for Schedule 1 purposes, so coach-only roles remain ineligible for the above-the-line deduction.

HEALTH SAVINGS ACCOUNT CONTRIBUTIONS (LINE 13)

People who qualify can open and contribute to Health Savings Accounts (HSAs) if they have a High Deductible Health Plan (HDHP). For 2026, an HDHP generally requires a minimum deductible of $1,700 (self-only) or $3,400 (family), with annual out-of-pocket expenses capped at $8,500 and $17,000, respectively.

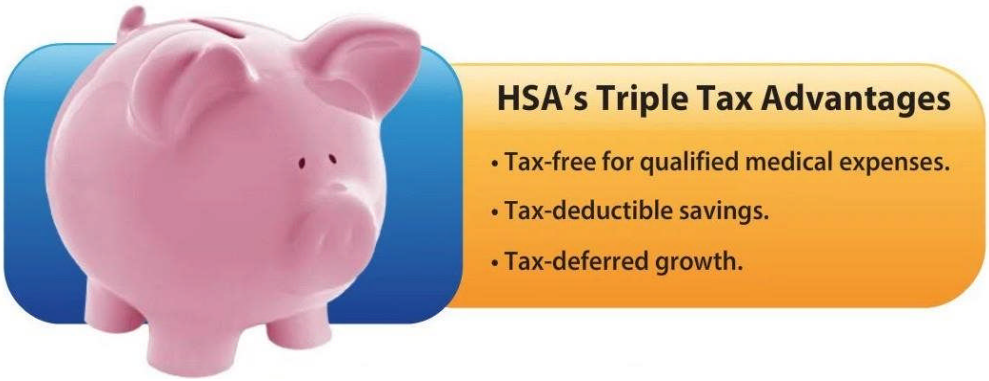
● Contributions. Taxpayers may contribute up to $4,400 (self-only) or $8,750 (family) for 2026. Individuals age 55 or older may contribute an additional $1,000 catch-up amount. Contributions designated for the tax year — including those made by the April 15 filing deadline — are deductible on line 13 of Schedule 1. Taxpayers must also file Form 8889 to report their contributions.

Since HSA eligibility is checked each month, people who join partway through the year can still put in the full yearly amount if they are covered by December 1. However, if they lose eligibility in the next 12 months, they may have to pay back some of the tax benefits.

● Earnings. HSA balances do not have to be used up during the plan year. Unused amounts are carried forward to subsequent years, often accruing interest or other earnings. Earnings in the HSA are tax-free at the federal level. They would only be taxed (and penalized) in the event of a nonqualified distribution.

● Distributions. HSA distributions are either qualified (used for medical expenses) or nonqualified. Distributions from a health savings account used to pay for the HSA participant's qualified medical expenses (including dental and vision) are excluded from the taxpayer's gross income. However, any distribution not used by the HSA participant for qualified medical expenses must be included in the taxpayer's gross income. Not only will the nonqualified distribution be subject to regular taxes, but it will also be subject to an additional 20% penalty assessed on premature withdrawals. The 20% penalty does not apply to distributions made after the account holder's death, disability, or attainment of age 65. Although the 20% penalty no longer applies after age 65, ordinary income tax still applies to non-medical withdrawals, making the HSA function like a Traditional IRA in that respect.

HSAs are often called the best tax-saving account because you get a tax deduction for contributions, your money grows tax-free, and you can withdraw funds for medical expenses without paying tax.



Changes under the OBBBA. The OBBBA made three important changes to HSAs. These updates make it easier for more people to qualify and help clarify some confusing rules. The IRS explained these changes in Notice 2026-05.

● Telehealth made permanent. The OBBBA permanently allows individuals to receive telehealth and other remote care services before meeting the HDHP deductible while remaining eligible to contribute to an HSA, effective for plan years beginning on or after January 1, 2025; this had previously been a temporary COVID-era rule that kept expiring and being renewed.

● Bronze and catastrophic plans now count as HDHPs. Starting January 1, 2026, bronze and catastrophic health plans from an Exchange are considered HSA-friendly, even if they do not meet the usual HDHP rules. This means more people with these

plans can contribute to HSAs. The IRS clarified that these plans don't have to be purchased through an Exchange to qualify.

● Direct Primary Care (DPC) arrangements. Starting January 1, 2026, people who qualify and are enrolled in certain direct primary care services can contribute to an HSA and use HSA funds tax-free to pay DPC fees. The OBBBA set a monthly limit of $150 for an individual and $300 for a family (these amounts will increase with inflation after 2026). If the fees exceed these limits, the person may not be able to contribute to an HSA, but they can still use HSA funds to pay for a qualifying DPC arrangement.

MOVING EXPENSES (LINE 14)

The federal tax deduction for moving expenses has been permanently eliminated for most taxpayers. The OBBBA removed the TCJA's sunset provision, meaning the deduction will not return for civilians in 2026 as originally scheduled. However, the law amended IRC Section 217(g) to extend the moving expense deduction and the exclusion for employer reimbursements to certain members of the Intelligence Community. For all other civilian employees, employer-provided relocation assistance is treated as taxable wages (boxes 1, 3, and 5 of Form W-2).

Only two groups can claim the moving expense deduction in 2026: active-duty military members moving because of permanent change of station (PCS) orders, and certain employees or new hires in the Intelligence Community who must move for their jobs. These “eligible taxpayers” are treated similarly for purposes of the above-the-line deduction and exclusion for employer-provided moving expense reimbursements.

A member of the Armed Forces on active duty who moves because of a permanent change of station may deduct unreimbursed moving expenses. A permanent change of station includes:

● A move from the servicemember's home to their first post location;
● A transfer from one permanent post of duty to another;
● A move from the servicemember's last station to their home or a nearer point in the United States.

Eligible taxpayers can't deduct any moving expenses reimbursed from the government (or paid for directly by the government) that are excluded from income.

The OBBBA did not change the definition of “reasonable” and “necessary” moving expenses under IRC Section 217(b)(1). Eligible taxpayers can deduct the out-of-pocket costs of moving their household goods (including their pet) to their new location and travel expenses (including overnight lodging, but not meals) while on the road for one trip. They can claim a standard mileage rate of 20.5 cents per mile for moving in 2026 or actual vehicle expenses (limited to gas, oil, and similar operating costs) instead of the standard mileage rate.

If the eligible taxpayer and their spouse each drive their own vehicle to their new location, they can both claim the mileage allowance for the trip. For long-distance

moves, servicemembers and IC personnel can deduct the cost of airline and train tickets. They do not have to meet any distance or time test if moving on permanent change of station orders [IRC Section 217(g)(1)].

While the deduction is limited to one trip per person, family members do not need to travel together or at the same time to qualify.

Example. Rocky and Nydia moved from Beale Air Force Base in Yuba County — where Rocky was stationed — to his new duty station at Los Angeles Air Force Base (in El Segundo). Rocky drove a U-Haul truck to Los Angeles. His transportation and moving expenses were $540. One week later, Nydia drove from Yuba County to Los Angeles and used the IRS mileage rate for moving purposes to arrive at her moving expense: 462 miles × 20.5 cents per mile equals $94.71 (rounded to $95 for tax reporting purposes). The couple's above-the-line deduction totals $635 (Rocky's $540 + Nydia's $95).

Deductible moving expenses are calculated using Form 3903. Eligible taxpayers will transfer the deduction amount to Schedule 1 (line 14).

STUDENT LOAN INTEREST (LINE 21)

IRC Section 221 permits qualified student loan borrowers to deduct up to $2,500 of "qualified student loan interest" paid during the year. The Schedule 1 deduction applies only to the portion of the student loan payment allocated to interest. Student loan interest includes interest paid as part of regular required payments as well as interest paid in connection with voluntary prepayments of the loan. The portion dedicated to the principal (the amount originally borrowed) does not qualify.

Student loan interest is the interest paid during the year on a loan used to pay for qualified education costs, such as tuition, fees, books, and room and board. This deduction works for both undergraduate and graduate loans. However, loans from family members or loans from an employer plan do not count.

Only the taxpayer legally obligated to make interest payments under the terms of the education loan can claim the student loan interest deduction [Treasury Regulation 1.221-1(b)(1)]. Parents generally cannot claim interest deductions on payments they make on loans for which their child is the borrower. A taxpayer may not claim the deduction if they can be claimed as a dependent on another taxpayer's return.

The Internal Revenue Code denies borrowers a double tax benefit by disallowing a deduction for interest that has been excluded from income. Accordingly, no deduction is allowed for student loan interest paid by an employer and excluded from the employee's gross income. The OBBBA makes permanent the Section 127 exclusion for employer-paid student-loan repayment assistance, so employees who benefit from such a program should be aware that they cannot also deduct the portion of student loan interest paid by their employer under a Section 127 plan.

Example. Natalya works for a large corporation that maintains a Section 127 educational assistance plan. During 2026, Natalya's employer pays $2,000 directly to her student loan servicer under the plan, which she properly excludes from gross income. Natalya also makes $1,800 in out-of-pocket student loan interest payments during the year. Her MAGI is $72,000, and she files single. Natalya's maximum allowable student loan interest deduction for 2026 is $1,800 — her out-of-pocket interest payments (the employer-paid portion is excluded from income).

Although taxpayers may generally deduct all qualifying interest payments made during the year, the deduction is subject to income-based phaseouts and other limitations. In 2026, the student loan interest deduction is phased out if the taxpayer's MAGI is between $85,000 and $100,000 (or between $175,000 and $205,000 for those who file a joint return), with no deduction available if the taxpayer's MAGI exceeds those thresholds [Rev. Proc. 2025-32]. In addition, taxpayers may not deduct their student loan interest if they file as married filing separately (MFS).

Taxpayers who paid qualifying interest should receive Form 1098-E, Student Loan Interest Statement, from their lender. An institution (such as a bank or governmental agency) that received interest payments of $600 or more during the year on one or more qualified student loans must send Form 1098-E (or an acceptable substitute) to each borrower by January 31 of the following year.

To claim the deduction, a taxpayer should enter the allowable amount (up to $2,500) on Schedule 1, line 21.

THE STANDARD DEDUCTION

After figuring out adjusted gross income (AGI) by reporting gross income and subtracting above-the-line deductions, the next step is to use a second set of deductions that lower taxable income.

Any deduction reported on a line after or below the AGI entry on line 11 of Form 1040 is a “below-the-line deduction.” Below-the-line deductions include the standard deduction and itemized deductions. Personal and dependent exemptions were in the group of below-the-line write-offs until the TCJA removed these benefits from the federal income tax return. The TCJA created the qualified business income (QBI) deduction, a separate below-the-line deduction that now appears where personal exemptions used to be reported under pre-TCJA layouts. Itemized deductions and the QBI deduction will be covered in later chapters.

Taxpayers can choose whichever benefit gives them a bigger deduction — the standard deduction or itemized deductions. The standard deduction and itemized deductions are mutually exclusive — taking both in the same year is not allowed.

The standard deduction is the most common below-the-line deduction on Form 1040. Since the TCJA, almost 90% of tax returns have used it instead of itemizing. Most

people choose the standard deduction because it is easier — they do not have to track every deductible expense. The higher standard deduction amount is often more than what they could claim by itemizing.

THE BASIC STANDARD DEDUCTION

After the TCJA nearly doubled the standard deduction in 2018, the OBBBA made those increases permanent in 2025. These standard deduction amounts will continue to be adjusted annually for inflation.

Filing status	OBBBA's basic standard deduction in 2026
Single	$16,100
Married filing separately (MFS)	$16,100
Head of household (HOH)	$24,150
Married filing jointly (MFJ)	$32,200
Qualifying surviving spouse (QSS)	$32,200
Source: Revenue Procedure 2025-32	

THE ADDITIONAL STANDARD DEDUCTION

Additional amount for age 65+. In certain cases, the standard deduction consists of two parts: the basic standard deduction and an additional standard deduction. Bonus amounts are provided to taxpayers who are senior citizens or legally blind.

The term "senior citizen" in this section means someone aged 65 or older. If a taxpayer is 65 or older and does not itemize deductions, they are entitled to a higher standard deduction.

Most filers are calendar-year taxpayers, so their tax year ends on December 31. Accordingly, to claim the added deduction amount for older filers, a person must have been age 65 on December 31. However, the IRS provides a one-day grace period to help taxpayers who missed the deduction cutoff date. In other words, a taxpayer turning 65 on January 1 after the tax year may claim the additional standard deduction amount for the year ending the day before their birthday.

Example. Eleanor was born on January 1, 1962. She will turn 65 on January 1, 2027. Even though her 65th birthday did not land in the 2026 tax year, Eleanor may still claim to be a senior citizen — for standard deduction purposes — on her 2026 tax return.

Additional amount for legal blindness. An additional standard deduction is allowed for people who are visually impaired. "Legal blindness" can be a confusing term, since most people who are legally blind are not completely blind. To be considered legally blind, a taxpayer's vision needs to be "20/200" or worse (while wearing corrective

lenses), which means they can read an eye chart from 20 feet away as well as someone with normal vision could read it from 200 feet away.

IRC Section 63(f)(4) also defines blindness as having a field of vision of no more than 20 degrees (for a “normally” sighted person, the visual field is approximately 190 degrees without moving one’s head).

If taxpayers are not completely blind, they must get a signed statement from an eye doctor (such as an ophthalmologist or optometrist) to support their claim. If their eye condition is unlikely to improve beyond these limits, the doctor's letter should say so. They must keep the doctor's report in their records.

Suppose a taxpayer's vision can be corrected beyond these limits with contact lenses that they can wear only briefly due to pain, infection, or ulcers. In that case, the taxpayer can take the higher standard deduction for blindness if they otherwise qualify.

Calculating the additional amount. Senior citizens and legally blind individuals receive a two-part standard deduction. The qualifying person's total standard deduction is their basic standard deduction plus extra amounts for age and/or blindness.

Additional standard deduction amounts for 2026 are:
● $2,050 for single or head of household; or
● $1,650 for married filing jointly, married filing separately, or the qualifying surviving spouse status.

A joint filer who is a senior citizen or blind can add $1,650 to their basic standard deduction amount in 2026 ($32,200). Single filers who are blind or senior citizens are eligible for an additional $2,050 standard deduction on top of the $16,100 they receive from the basic amount.

Example. Nadia will use the single filing status on her 2026 tax return. Nadia became partly blind in 2026 as a result of diabetic eye disease. She has a doctor's statement to prove it. Therefore, Nadia's basic standard deduction is the amount for single individuals ($16,100) plus the additional standard deduction of $2,050, totaling $18,150.

Both blindness and age can apply separately, so an individual who is a senior citizen and legally blind at the end of the tax year is allowed two additional standard deduction amounts.

Example. Let's assume that Nadia, in the example above, is 65 years of age or older. Not only would she qualify for an additional standard deduction because of serious eyesight issues, but she is now entitled to an extra amount due to her age. Thus, we take Nadia's basic standard deduction ($16,100) and add $2,050 for legal blindness and another $2,050 for being 65 years of age or older. Nadia's final standard deduction amount is $20,200 ($16,100 + $2,050 + $2,050).

Taxpayers can take the higher standard deduction if their spouse is a senior citizen or blind and they file a joint return. For married couples, the extra amounts are available for each spouse. So, if both are 65, they will get twice the extra amount. Or, if they are both 65 and blind, they will get four times the extra amount.

Example. Patrick and Marla are filing a joint return for 2026. Both are aged 65. Neither is blind. Their standard deduction is the amount for joint filers ($32,200) plus $1,650 for Patrick's age and $1,650 for Marla's age, totaling $35,500.

Filing status	Extra amount added to standard deduction
Single or head of household: Blind **or** 65 or older	$2,050
Single or head of household: Blind **and** 65 or older	$4,100
Married filing jointly or separately: Blind **or** 65 or older	$1,650 per person who falls into one category
Married filing jointly or separately: Blind **and** 65 or older	$3,300 per person who falls into both categories

NEW SCHEDULE 1-A DEDUCTIONS (2025–2028)

Schedule 1-A combines all new OBBBA deductions, such as tips, overtime, car loan interest, and the senior deduction. The total is reported on one line on Form 1040. These deductions are temporary and only apply from 2025 to 2028.

ENHANCED DEDUCTION FOR SENIORS

The OBBBA introduces a separate $6,000 deduction for taxpayers aged 65 or older. This means taxpayers aged 65 or older may benefit from two separate provisions:

- The additional standard deduction discussed in the previous section; and
- The temporary $6,000 Schedule 1-A deduction enacted by the OBBBA.

The new OBBBA deduction does not replace the additional standard deduction for age. It is a separate benefit that can be claimed alongside the additional standard deduction. This deduction appears on Schedule 1-A, which carries over to line 13b on Form 1040 (rather than within the standard deduction line itself).

Form 1040, lines 12e through 16

12e	**Standard deduction or itemized deductions** (from Schedule A) <<< Additional Standard Deduction >>>	12e
13a	Qualified business income deduction from Form 8995 or Form 8995-A	13a
b	Additional deductions from Schedule 1-A, line 38 <<< $6,000 Senior Deduction >>>	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
16	**Tax** (see instructions). Check if any from Form(s): 1 ☐ 8814 2 ☐ 4972 3 ☐	16

Combined tax benefit for non-itemizers age 65+ on Form 1040, line 14				
Filing status	**Basic Standard Deduction**	**Additional Standard Deduction**	**+ Schedule-1A Deduction***	**= Total deduction benefit (standard + Schedule 1-A)**
Single	$16,100	$2,050	$6,000	$24,150
Head of household	$24,150	$2,050	$6,000	$32,200
Married filing jointly (only one spouse at 65 or over)	$32,200	$1,650	$6,000	$39,850
Married filing jointly (both spouses at 65 or over)	$32,200	$3,300	$12,000	$47,500
*Subject to MAGI phaseout.				

The deduction begins to phase out at MAGI of $75,000 for single filers and $150,000 for joint filers. For most seniors, MAGI for this provision will equal AGI, since only taxpayers with foreign income exclusions or US territory income need to make add-backs to compute MAGI for the Schedule 1-A phaseout.

The deduction phases out at 6% of the excess of MAGI over the applicable threshold. For single filers, this eliminates the deduction once MAGI reaches $175,000; for joint filers, once MAGI reaches $250,000. For example, a single filer with MAGI of $130,000 loses $3,300 of the deduction (6% × $55,000 excess), leaving a net deduction of $2,700. For a couple with $200,000 of MAGI, each spouse's deduction is reduced by $3,000 [6% × ($200,000 − $150,000)], leaving a total combined deduction of $6,000.

For married couples filing jointly, the $6,000 deduction applies separately to each qualifying spouse. If both spouses of a married couple filing jointly are age 65 or older, each spouse is eligible for the $6,000 deduction, for a combined total of up to $12,000. Under the OBBBA rules, married couples filing separately are not eligible for the $6,000 senior deduction — a joint return is required.

Example. Zhanna and Xander are married, and both are age 65. Filing jointly, they qualify for two $6,000 deductions, for a Schedule 1-A deduction of $12,000 (before any phaseout). This amount is claimed in addition to the standard or itemized deduction.

Taxpayers do not have to be receiving Social Security benefits to claim the senior deduction, but a valid Social Security number (SSN) is required to claim it.

NO TAX ON TIPS

Under longstanding federal tax law, tips are fully taxable and must be included in gross income under IRC Section 61, including both cash tips and tips received through electronic payment systems. Employees are also required to report tip income to their employers, and such income is subject to income tax withholding as well as payroll taxes.

The OBBBA does not change the basic rule that tips are taxable income. Instead, it introduces a new federal income tax deduction for qualified tips under IRC Section 224. The deduction does not change tip-reporting rules. Employers continue to withhold FICA on reported tips just as before. Tips are still part of gross income and are still subject to Social Security and Medicare taxes. The benefit is only a deduction against federal income tax.

The Schedule 1-A deduction is available whether or not a taxpayer itemizes deductions, but it is only temporary. The deduction starts from January 1, 2025, and ends on December 31, 2028. Unless Congress extends it, the deduction will end after 2028, and no special income tax deduction will apply to tip income.

Taxpayer eligibility requires a valid SSN on the return, and married individuals should file jointly (since MFS filers are ineligible for the deduction).

Limits and phaseouts. IRC Section 224(b)(1) caps the deduction at $25,000, and nothing in the OBBBA text or proposed regulations confirms that married joint filers receive $25,000 each (i.e., $50,000 combined). The $25,000 cap applies per taxpayer, and a married couple filing jointly counts as one taxpayer for these purposes.

The maximum annual deduction is $25,000 per taxpayer, regardless of filing status. It phases out for higher earners based on MAGI, starting at $150,000 for singles ($300,000 for joint filers). The deduction is reduced by $100 for each $1,000 of MAGI above the threshold. For a single filer, the phaseout completes at $400,000 MAGI; for joint filers, at $550,000.

Filing Status	Threshold	Max Deduction	Fully Phased Out
Single	$150,000	$25,000	$400,000
Married Filing Jointly	$300,000	$25,000 (not $50,000)	$550,000

Example. Alain is a server at a Michelin-starred restaurant on the Las Vegas Strip (Joël Robuchon at MGM Grand). He received $120,000 in tip income, but Section 224(b)(1) places a $25,000 ceiling on the deduction (before any phaseout). Alain is a single filer with a MAGI of $175,000. This income exceeds the $150,000 threshold by $25,000.

The phaseout reduces his deduction by $2,500 (25 units × $100 = $2,500), leaving him with a net deduction of $22,500 on Schedule 1-A.

Qualified tips. To be considered a qualified tip, a payment must be voluntary, not subject to negotiation, determined by the payor, and without consequences for nonpayment. Mandatory service charges added by restaurants to large parties, for example, do not qualify.

The proposed regulations specify that "cash tips" include amounts received from customers in cash or through cash equivalents, which include checks, credit cards, debit cards, gift cards, mobile payment applications, and tangible or intangible tokens that can be easily exchanged for cash, such as casino chips. Non-cash items such as event tickets or meals do not qualify.

Tips received through a tip-sharing arrangement or tip pool are also included, provided the other conditions are met.

The proposed regulations clarify that "qualified tips" do not include tips received while performing a service that is a felony or misdemeanor under applicable law. They also explicitly exclude amounts from prostitution or pornographic activities.

Employees and self-employed individuals may deduct qualified tips that are reported on a Form W-2, Form 1099, or other specified statement furnished to the individual, or reported directly by the individual on Form 4137.

Qualified occupations. The deduction applies only to qualified tip income earned in occupations where tipping is customary. Examples of eligible occupations include servers, bartenders, baristas, hotel bell staff, casino dealers, hairdressers, and similar service-sector roles.

Not all tipped workers qualify. Workers must be employed in an occupation that "customarily and regularly received tips on or before December 31, 2024," as identified by the Treasury Department. In September 2025, the Treasury Department and IRS issued proposed regulations (REG-110032-25) that include a list of 68 qualifying occupations assigned Treasury Tipped Occupation Codes (TTOC), organized across eight industry categories. These categories cover food service, entertainment, hospitality, home services, personal care, personal appearance, recreation, and transportation.

Some entries on the list may surprise tax professionals. Qualifying occupations include some that do not traditionally receive tips, such as chefs and cooks, dishwashers, electricians, plumbers, and appliance installers. Treasury relied on industry-reported data and third-party payment platform records, not traditional assumptions about tipping. The official, current list of qualifying occupations is available at https://www.irs.gov/TippedOccupations.

The deduction is available to self-employed individuals who receive tips in the course of a trade or business and report them on a Form 1099 or Form 4137; this is significant because many gig-economy workers — such as rideshare drivers, delivery workers, and independent beauty professionals — receive tips outside traditional employer-employee structures. For self-employed individuals, the deduction may not exceed the individual's net income (without regard to this deduction) from the trade or business in which the tips were earned.

Example. Tamesha is a self-employed independent hairstylist who receives tips from clients. Her business generates $37,000 in service fees plus $23,000 in tips ($60,000 gross). She deducts $41,000 in legitimate business expenses and shows only $19,000 in net income on Schedule C. The maximum tip deduction Tamesha may claim is $19,000, not $23,000.

The proposed regulations include an anti-abuse rule designed to prevent wages, business profits, or other payments from being incorrectly labeled as tips. This rule targets payments between related parties or payments someone makes to themselves that are disguised as tips. It should not be confused with the separate rule allowing self-employed individuals to deduct qualified customer tips.

An important limit applies to workers in Specified Service Trades or Businesses (SSTBs), which is the same group used in the QBI deduction rules under IRC Section 199A. SSTB fields include health, law, accounting, performing arts, consulting, athletics, and financial services. If an employee works for an employer whose business is an SSTB, any tips received by that employee are not qualified tips, even if the employee's specific job is on the approved list [IRC Section 224(d)(2)(B)]. For self-employed people, the SSTB rule works differently. Their tips are excluded not because of their employer, but because the business they earn tips from is itself an SSTB.

For example, a self-employed comedian would not have qualified tips because performing arts is an SSTB, and tips earned in an SSTB are categorically excluded. However, a pianist employed by a hotel would have qualified tips because the hotel is not an SSTB, and the pianist’s occupation appears on the Treasury list of occupations that customarily receive tips.

Beginning with the 2026 tax year, employers are required to report qualified tips and occupation codes separately on Form W-2. The IRS has released a draft of the 2026 Form W-2, which includes a new Box 14b designated for reporting the “Treasury Tipped Occupation Code” (TTOC).

Summary. Tax preparers helping clients in tipped jobs should check a few things before claiming the deduction:
● Verify that the worker received voluntary tips (not service charges or automatic gratuities).
● Verify that the worker’s MAGI does not push the deduction to zero under the phaseout rules.

● If the worker is self-employed, verify that net income from the tipped business is sufficient to support the claimed deduction.
● Confirm that the worker's occupation appears on the IRS tipped-occupation list.
● Confirm that, for employees, the employer is not an SSTB.

Clients should also be reminded to maintain adequate records to substantiate both their eligibility and the amount of tips received, as the IRS may require documentation. According to White House estimates, the average qualifying worker could see annual tax savings of approximately $1,300 — a meaningful benefit for workers in lower- and middle-income ranges, but one that requires careful verification to claim correctly.

NO TAX ON OVERTIME
Historically, federal tax law has treated overtime pay no differently from regular wages, taxing both as ordinary income.

One of the most talked about parts of the OBBBA is the so-called "No Tax on Overtime" rule. Despite its name, this rule does not completely remove federal taxes from overtime pay; it only gives a limited deduction from federal income tax. Overtime pay is still fully subject to Social Security and Medicare (FICA) taxes. So, even when the deduction applies, taxpayers will still have payroll taxes taken out of their full overtime earnings.

Congress limited the deduction to tax years 2025 through 2028 to evaluate its fiscal impact before deciding whether to make it permanent.

Qualified overtime compensation. A critical technical issue is how "overtime" is defined for purposes of the deduction. Overtime pay, as defined by the Fair Labor Standards Act (FLSA), is typically calculated at 1.5 times an employee's standard hourly rate for hours worked beyond 40 in a given week. However, under the OBBBA, only the premium portion — the extra "half" in time-and-a-half — is deductible. The worker's base hourly rate remains fully taxable. For example, if a worker is normally paid $30 per hour but receives $45 per hour for overtime hours, only the additional $15 premium ($45 minus $30) is deductible — not the full $45 received for those overtime hours. The provision targets the federally mandated overtime premium specifically, not the worker's total earnings during overtime hours [IRC Section 225(c)(1)].

Overtime premiums arising solely from state law (such as California's daily overtime rules) generally do not qualify unless they correspond to FLSA-defined overtime for hours worked beyond 40 in a workweek. So, if a worker in California earns daily overtime but does not exceed 40 hours in the week, none of that premium qualifies for the federal deduction.

Limits and phaseouts. The maximum annual deduction is $12,500 for single filers or heads of household, doubling to $25,000 for married filing jointly. It phases out for higher earners, starting at MAGI of $150,000 (single) or $300,000 (joint), and fully disappears at higher thresholds. The deduction is reduced by $100 for every $1,000 of

MAGI above the threshold. The deduction is entirely unavailable for single filers with a MAGI of $275,000 or more ($550,000 for joint filers).

Taxpayers must include a valid SSN and, if married, file a joint return to claim the deduction (married filing separately is not eligible). The deduction is available to both itemizers and those taking the standard deduction.

Filing Status	Max Deduction	Phaseout Start (MAGI)	Full Phaseout (MAGI)
Single/Head of Household	$12,500	$150,000	$275,000
Married Filing Jointly	$25,000	$300,000	$550,000
Married Filing Separately	Ineligible	N/A	N/A

Eligible workers. Only certain workers can get this deduction. A person must be covered by (and not exempt from) the FLSA for overtime pay to qualify for the deduction. Employees who are exempt under the FLSA's overtime rules — such as executives, administrators, professionals, and highly paid employees — cannot get this deduction. This leaves out many salaried office workers, including most managers.

Because the OBBBA was signed mid-year, employers were not required to separately report qualified overtime compensation on Form W-2 for the 2025 tax year. The IRS issued guidance permitting workers to calculate the deductible amount using pay stubs, year-end payroll summaries, or employer-provided statements. On January 9, 2026, the IRS released the 2026 Form W-2, which includes a new Box 12 code (Code TT) for employers to report the total amount of qualified overtime compensation.

NO TAX ON CAR LOAN INTEREST

Under long-established federal tax principles, interest on personal loans is generally nondeductible unless Congress provides a specific exception. For example, taxpayers may deduct qualified residence interest under IRC Section 163(h) and student loan interest under Section 221, but interest on most consumer debt — such as credit cards, personal loans, and auto loans — has historically been treated as nondeductible personal interest.

The OBBBA creates a new deduction for qualified passenger vehicle loan interest, as an exception to the general rule that personal interest is not deductible under IRC Section 163(h). The “No Tax on Car Loan Interest” rule is mainly found in IRC Section 163(h), in the new paragraph (4).

The “No Tax on Car Loan Interest” rule in the OBBBA represents a significant departure from the traditional rule that personal interest is generally not deductible. Under this new provision, qualified auto loan interest may be deducted, subject to various limits and

eligibility requirements. This deduction offers a modest but meaningful tax benefit to middle-income taxpayers by reducing the cost associated with financing a new vehicle.

The deduction is available whether the taxpayer itemizes or takes the standard deduction. It applies to tax years beginning after December 31, 2024, and before January 1, 2029. Only interest paid during tax years 2025 through 2028 is deductible, even if the loan continues beyond 2028. Unless extended by Congress, the deduction expires after the 2028 tax year.

As with many modern tax benefits, the deduction is subject to both a dollar cap and income-based phaseouts. Under the new law, the deduction is capped at $10,000 per return, rather than per taxpayer or per vehicle. Schedule 1-A includes space for two vehicles in Part IV, and additional vehicles beyond that are noted on an overflow statement (tax software will usually handle the overflow automatically if the taxpayer has more than two vehicles).

Notably, many taxpayers will not reach the statutory cap because typical auto loan interest payments are significantly lower. Typical first-year interest on a $40,000 to $50,000 loan at current rates ranges from $2,500 to $4,000.

Importantly, the deduction applies only to interest — not to principal payments, insurance, maintenance, or other costs associated with vehicle ownership. Nor does it convert auto loans into a business expense. If a taxpayer uses a vehicle for business purposes, the appropriate tax treatment remains governed by separate rules (e.g., depreciation, Section 179 expensing, or standard mileage rates). Taxpayers may not "double dip" by claiming both business deductions and the personal interest deduction on the same portion of a loan.

Example. Valentin is a self-employed taxpayer who purchased a qualifying US-assembled passenger vehicle in 2026. He uses it 75% for personal reasons and 25% for work. He paid $4,000 in interest on the loan in 2026, so $1,000 of that interest is allocable to business use, and $3,000 covers the personal portion. Valentin may deduct $3,000 as personal interest on the new Schedule 1-A. He may not double-dip on the business portion by claiming a $4,000 deduction on Schedule 1-A. The same interest cannot be deducted under both business and personal tax rules.

The deduction phases out for taxpayers with MAGI exceeding $100,000 for single filers or $200,000 for joint filers. It reduces by $200 for each $1,000 (or fraction thereof) above the threshold and is fully eliminated at $150,000 for single filers or $250,000 for joint filers [IRC Section 163(h)(4)(C)(ii)(I)]. MFS taxpayers are ineligible, consistent with several other OBBBA provisions.

To qualify, the vehicle must satisfy several requirements. For example, it must have undergone final assembly in the United States and must have been purchased between January 1, 2025, and December 31, 2028. To claim the deduction, filers must submit the vehicle identification number (VIN) of their qualified vehicle to the IRS. VINs encode

the location of final assembly, making this a key verification mechanism for the domestic manufacturing requirement. Several Toyota, Honda, and BMW models are assembled domestically and would qualify, while others from the same manufacturers would not — making the VIN check essential.

Moreover, an eligible vehicle must be a new (not used) car, minivan, van, SUV, pickup truck, or motorcycle with a GVWR below 14,000 pounds, manufactured for use on public roads [IRC Section 163(h)(4)(D)].

Example. In March 2026, Makenzie, a single filer, purchases a new Ford F-150 assembled in Dearborn, Michigan. She finances $45,000 at 7.5% interest over 60 months. In 2026, Makenzie pays approximately $3,100 in interest. Her MAGI for 2026 is $85,000, so she is well below the $100,000 phaseout threshold. Makenzie takes the standard deduction. On her 2026 return, she claims $3,100 as an interest deduction on Schedule 1-A, reducing her AGI to $81,900. At a 22% marginal rate, this saves Makenzie approximately $682 in federal income tax.

The loan must have originated after December 31, 2024, and must be secured by a first lien on the vehicle. Loans from relatives do not qualify, and lease payments are not included because a lease is not a purchase. Existing loans from before 2025 are not allowed, and taxpayers cannot turn old loans into deductible interest just by refinancing. However, if a taxpayer refinances a qualifying loan from after 2024 (for example, to get a lower rate), the new loan still qualifies.

The provision also creates new reporting requirements for lenders. From 2025 to 2028, auto loan lenders must report loan details to the IRS when they get interest on qualifying vehicle loans. The IRS released a draft Form 1098-VLI in late 2025 (for use starting with 2026 reporting) to report interest of $600 or more on qualified consumer vehicle loans. Borrowers need that statement and the vehicle's VIN to complete Schedule 1-A.

Example. Consider a married couple filing jointly with a MAGI of $180,000 in 2026. They purchase a new US-assembled SUV for personal use in early 2025, financing $40,000 (after a down payment) at 7% interest over 60 months. In their first full tax year (2026), they pay approximately $2,800 in qualified interest (as reported on Form 1098-VLI). Because their MAGI is below the $200,000 phaseout threshold, they can claim the full $2,800 as a deduction on Schedule 1-A (including the vehicle's VIN for verification). Assuming a 22% marginal federal tax rate, this reduces their tax liability by about $616.

Comparison of Selected Federal Interest Deductions			
Feature	**Car Loan Interest**	**Student Loan Interest**	**Home Mortgage Interest**
Where in the Code	§163(h)(4)	§221	§163(h)(3)
Where claimed	Schedule 1-A	Schedule 1	Schedule A
Annual cap	$10,000 per return	$2,500	After 12/15/2017, underlying loan is subject to $750k limit
Income phaseout	Yes	Yes	No
Eligible debt	New, US-assembled personal-use vehicles; first-lien loans	Qualified education loans	Acquisition indebtedness on qualified residence
Business-use interaction	Must allocate; no double dipping	N/A	Must allocate if mixed-use
Reporting	Form 1098-VLI	Form 1098-E	Form 1098

PERMANENT CHARITABLE DEDUCTION FOR NON-ITEMIZERS

OVERVIEW AND BACKGROUND

For decades, the charitable contribution deduction primarily benefited people who itemized. Because most Americans claim the standard deduction, federal tax law gave little incentive for most donors. Congress has sometimes tried temporary above-the-line charitable deductions — most recently during the COVID-19 pandemic — but those measures were modest and short-lived.

Starting with tax years after December 31, 2025, the OBBBA creates a permanent deduction under new IRC Section 170(p) for most taxpayers who use the standard deduction (about 85% to 90% in recent years). In effect, Section 170(p) partly changes the old rule that only itemizers get tax breaks for charitable giving, providing a small incentive for most taxpayers to donate.

The provision operates as a separate, below-the-line deduction allowed in addition to the standard deduction, rather than as an itemized or above-the-line deduction. The deduction is taken in computing taxable income, not in computing AGI, so it does not affect AGI-based thresholds elsewhere in the Tax Code. Unlike the temporary "above-the-line" charitable deduction in the CARES Act, which expired after 2021, the new Section 170(p) deduction is not scheduled to expire.

DEDUCTION LIMITS AND QUALIFYING CONTRIBUTIONS

The new deduction is subject to modest, fixed dollar caps by filing status. Married couples filing a joint return may deduct up to $2,000 of qualifying cash charitable contributions each year, while other filing statuses may deduct up to $1,000. These

caps apply on top of, rather than reducing, the taxpayer's entitlement to the full standard deduction.

Example. A married couple claims the standard deduction in 2026 and donates $2,500 in cash to a qualified charity. Through the OBBBA's new charitable deduction for non-itemizers [under IRC Section 170(p)], these joint filers may deduct up to $2,000 for their charitable contribution while also taking the standard deduction.

The new deduction only applies to cash contributions (such as checks, credit cards, electronic transfers, and payroll-deducted cash contributions) made during the tax year to qualified public charities under Section 170(b)(1)(A) — churches, schools, hospitals, museums, and other 501(c)(3) organizations that get broad public support.

Donations of property, such as clothing or household goods, do not count for the non-itemizer deduction. Because the deduction is limited to cash contributions to Section 170(b)(1)(A) public charities, donations to donor-advised funds, supporting organizations, and private nonoperating foundations are not included.

Because the deduction is limited to cash contributions, keeping records is easier than for property donations. Still, taxpayers must keep records of their charitable contributions, such as receipts or written acknowledgments, as required by the existing rules under Section 170(f). Notably, donations of $250 or more still require a written acknowledgment at the time of the gift.

The provision does not permit any carryforward of excess gifts above the $1,000/$2,000 cap into later years for purposes of this special non-itemizer deduction. Because the deduction is capped and does not carry forward, there is no tax incentive to “bunch” contributions for non-itemizers under Section 170(p), unlike traditional itemized deduction planning.

Example. Assume Lakendra, a single taxpayer, has $60,000 of adjusted gross income in 2026 and does not itemize deductions. Instead, she claims the standard deduction. During the year, Lakendra makes $1,200 of cash contributions to qualified public charities, all of which are properly substantiated. Under pre-OBBBA law, Lakendra would receive no tax benefit for her charitable giving because she does not itemize. Under Section 170(p), however, Lakendra may deduct up to $1,000 of her cash contributions in addition to the standard deduction. As a result, Lakendra's taxable income is reduced by the full standard deduction plus an additional $1,000. The remaining $200 of contributions provides no current tax benefit and cannot be carried forward for purposes of Section 170(p). If Lakendra is in the 12% marginal bracket, the $1,000 deduction reduces her federal income tax by $120.

Feature	Itemized Deduction [§170(a)]	Non-Itemizer Deduction [§170(p)]	CARES Act Deduction [Expired]
Who can claim?	Only itemizers	Only standard deduction filers	Only standard deduction filers
Type of contributions	Cash + property	Cash only [to §170(b)(1)(A) orgs]	Cash only [to §170(b)(1)(A) orgs]
Dollar limit	%-of-AGI limits (e.g., 60%)	$1,000 single / $2,000 MFJ	$300 single / $600 MFJ
Carryforward allowed?	Yes	No	No
Permanent?	Yes	Yes	No (expired after 2021)

This provision is not adjusted for future inflation. Without a future change in the law, the real value of the deduction will go down over time. This is different from the standard deduction and most other OBBBA-created deductions, which are adjusted each year.

The title of IRC Section 170(p) is a "Special Rule for Taxpayers Who Do Not Elect To Itemize Deductions." If a taxpayer itemizes, none of their contributions may be claimed under Section 170(p), even if they are below the caps. If a taxpayer switches between itemizing and not itemizing across years, the rule applies year-by-year. The Section 170(p) deduction is determined without regard to the new 0.5% AGI floor imposed by the OBBBA on itemizers. Non-itemizers claiming Section 170(p) are thus insulated from that separate limitation, which applies only to those who elect to itemize.

Section 170(p) allows taxpayers to receive a limited tax benefit for charitable giving without sacrificing the simplicity of the standard deduction. However, the benefit is capped and does not permit carryovers. Because the deduction is capped and cash-only, practitioners should remind clients that non-cash donations — often a significant portion of charitable giving — remain deductible only for itemizers.

LOOKING AHEAD: THE SECTION 199A QBI DEDUCTION

The provisions explored throughout this chapter demonstrate Congress's ongoing expansion of non-itemized deductions, allowing more taxpayers to reduce taxable income without itemizing.

One additional non-itemized deduction — Section 199A's deduction for qualified business income — rounds out the OBBBA's changes to the non-itemized deduction landscape. Like the provisions discussed above, the Section 199A deduction is claimed outside the itemized deduction framework as a separate below-the-line deduction. It is available regardless of whether a taxpayer itemizes or takes the standard deduction.

Effective beginning in tax year 2026, the OBBBA makes several important changes to Section 199A. Below is a partial list of improvements to the QBI deduction:

● The OBBBA makes the QBI deduction permanent by removing its prior sunset after 2025;
● The new law increases the income thresholds and phase-in ranges for the W-2 wage/UBIA and SSTB limitations; and
● It adds a new inflation-adjusted minimum deduction of $400 for taxpayers with at least $1,000 of qualifying QBI from active businesses, making sure there is at least a small benefit even when the usual percentage calculation would give a smaller deduction or none at all.

Because of its complexity, detailed eligibility rules, and significant planning implications for sole proprietors, partnerships, and S corporations, the QBI deduction is best addressed separately. Accordingly, we will revisit Section 199A in a later chapter and examine it in greater detail.

REVIEW QUESTIONS

7. Which of the following HSA distributions would be subject to both ordinary income tax and the 20% additional penalty?
{A}. A distribution taken by a 45-year-old account holder to pay for gym membership fees.
{B}. A distribution taken by a 66-year-old account holder for non-medical expenses.
{C}. A distribution taken after the account holder becomes permanently disabled.
{D}. A distribution taken by a beneficiary following the account holder's death.

8. Olga has a qualified student loan used to pay graduate-school tuition. Her employer offers a Section 127 student-loan repayment assistance program and pays $2,000 of Olga's student-loan interest in 2026. That amount is excluded from her gross income under IRC Section 127. She also pays $1,000 out of pocket on loan interest. Which of the following best describes what Olga may deduct in 2026?
{A}. She may deduct the full $3,000 of interest paid, up to the $2,500 ceiling.
{B}. Olga may deduct only the $1,000 of interest she paid out of her own pocket.
{C}. She may deduct nothing because the employer-paid interest disqualifies her from the deduction entirely.
{D}. Olga may deduct the $2,000 of employer-paid interest, but not the $1,000 she paid out of pocket.

9. Wayne is single. He contributes $1,900 in cash to qualified public charities in 2026 but does not itemize. According to the OBBBA's charitable deduction under IRC Section 170(p), Wayne may deduct:
{A}. the full $1,900 in 2026
{B}. $1,000 in 2026, and $900 is carried forward to 2027
{C}. $1,000 in 2026, but $900 provides no tax benefit in the present or future
{D}. $0 because he does not itemize

Part E reveals the correct answers to all end-of-chapter review questions while providing feedback on both correct and incorrect responses.

Chapter 4. ITEMIZED DEDUCTIONS AFTER THE OBBBA

Learning objectives: By the end of this chapter, you will see that the OBBBA mostly keeps the TCJA's itemized deduction rules in place. You'll be able to identify which Schedule A deductions are still available, apply the rules and limits for each category, and spot when a taxpayer's situation triggers these rules.

Chapter Topics

- Deduction for medical expenses
  - » The two-threshold test
  - » Connection to the OBBBA
- Nonfederal tax payments
  - » What is a deductible tax?
  - » State and local income taxes
  - » State and local sales taxes
  - » Real estate taxes
  - » Personal property taxes
  - » Foreign income taxes
  - » New SALT deduction cap under the OBBBA
- Mortgage interest payments
  - » Itemizers with a second home
  - » Acquisition loans yield deductible interest
  - » Mortgage insurance premiums are deductible again
  - » Home equity loans yield nondeductible interest
  - » Mortgage points may count as deductible interest
- Charitable contributions
  - » Not all gifts qualify for a tax deduction
  - » Donating cash
  - » Donating personal property
  - » Donating investment property
  - » Overview of limits on deductibility
  - » OBBBA modifications
- The overall limitation on itemized deductions
  - » Relationship to other itemized deduction rules
  - » How the new formula works
- Casualty and theft losses
  - » Calculating the loss amount
  - » Smaller deduction under the standard framework
  - » Flexible timing
  - » Larger deduction under the QDL framework
- Other itemized deductions
  - » What remains disallowed in 2026
  - » What remains deductible in 2026
  - » Last word on last category

The OBBBA shifts much of the tax benefit structure outside of itemization — by adding new deductions on Schedule 1-A (for tips, overtime, car loan interest, and seniors), reviving a charitable deduction for non-itemizers, and maintaining a higher standard deduction. As a result, fewer taxpayers are expected to itemize, and Schedule A will play a reduced role in the preparation of Form 1040 for most individuals.

A smaller group, mostly higher-income families in high-tax states, will continue to itemize deductions. For them, the basic structure of Schedule A remains the same, but the OBBBA introduces key changes. Some deductions are now permanently disallowed, some rules have been expanded, and new limits have been added. These updates significantly affect how deductions are calculated.

This chapter reviews each type of deduction on Schedule A and explains how the OBBBA affects their use. Key changes effective for 2026 and later include:

- **State and local taxes (SALT)**. The deduction cap is quadrupled through 2029, allowing some taxpayers to deduct more. However, phaseout rules may reduce the benefit for certain individuals.
- **Home mortgage interest**. While the TCJA limits on post-2017 home loans still apply, qualifying taxpayers can once again deduct mortgage insurance premiums as "interest."
- **Charitable contributions**. Under a new rule, only donations exceeding 0.5% of AGI are deductible. This means people who give smaller amounts receive less tax benefit.
- **Casualty and theft losses**. With the TCJA limits now permanent, most losses are no longer deductible. However, taxpayers can now deduct losses from certain disasters officially declared by states.
- **Miscellaneous itemized deductions**. Deductions that previously had to exceed 2% of AGI are now permanently disallowed, but a small group of deductions exempt from the 2% limit remain.
- **Overall limitation**. A new cap for taxpayers in the 37% tax bracket reduces the total benefit from itemized deductions, making them less valuable for top earners than in the past.

Tax professionals must apply these rules carefully when preparing Schedule A for the relatively small percentage of taxpayers who continue to itemize. The sections that follow provide guidance on applying the relevant limitations and rules across each category of deduction.

SCHEDULE A (Form 1040)

Department of the Treasury
Internal Revenue Service

Itemized Deductions

Attach to Form 1040 or 1040-SR.
Go to *www.irs.gov/ScheduleA* for instructions and the latest information.
Caution: If you are claiming a net qualified disaster loss on Form 4684, see the instructions for line 16.

OMB No. 1545-0074

Attachment Sequence No. **07**

Name(s) shown on Form 1040 or 1040-SR | **Your social security number**

Medical and Dental Expenses		**Caution:** Do not include expenses reimbursed or paid by others.			
	1	Medical and dental expenses (see instructions)	1		
	2	Enter amount from Form 1040 or 1040-SR, line 11b (2)			
	3	Multiply line 2 by 7.5% (0.075)	3		
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-			4
Taxes You Paid	5	State and local taxes (SALT).			
	a	State and local income taxes or general sales taxes. You may include either income taxes or general sales taxes on line 5a, but not both. If you elect to include general sales taxes instead of income taxes, check this box ☐	5a		
	b	State and local real estate taxes (see instructions)	5b		
	c	State and local personal property taxes	5c		
	d	Add lines 5a through 5c	5d		
	e	Enter the smaller of line 5d or $40,000 ($20,000 if married filing separately). If Form 1040 or 1040-SR, line 11b is more than $500,000 ($250,000 if married filing separately), or if you completed Form 2555, Form 4563, or excluded income from Puerto Rico, see instructions	5e		
	6	Other taxes. List type and amount:	6		
	7	Add lines 5e and 6			7
Interest You Paid	8	Home mortgage interest and points. If you didn't use all of your home mortgage loan(s) to buy, build, or improve your home, see instructions and check this box ☐			
Caution: Your mortgage interest deduction may be limited. See instructions.	a	Home mortgage interest and points reported to you on Form 1098. See instructions if limited	8a		
	b	Home mortgage interest not reported to you on Form 1098. See instructions if limited. If paid to the person from whom you bought the home, see instructions and show that person's name, identifying no., and address	8b		
	c	Points not reported to you on Form 1098. See instructions for special rules	8c		
	d	Reserved for future use	8d		
	e	Add lines 8a through 8c	8e		
	9	Investment interest. Attach Form 4952 if required. See instructions	9		
	10	Add lines 8e and 9			10
Gifts to Charity	11	Gifts by cash or check. If you made any gift of $250 or more, see instructions	11		
Caution: If you made a gift and got a benefit for it, see instructions.	12	Other than by cash or check. If you made any gift of $250 or more, see instructions. You **must** attach Form 8283 if over $500	12		
	13	Carryover from prior year	13		
	14	Add lines 11 through 13			14
Casualty and Theft Losses	15	Casualty and theft loss(es) from a federally declared disaster (other than net qualified disaster losses). Attach Form 4684 and enter the amount from line 18 of that form. See instructions			15
Other Itemized Deductions	16	Other—from list in instructions. List type and amount:			16
Total Itemized Deductions	17	Add the amounts in the far right column for lines 4 through 16. Also, enter this amount on Form 1040 or 1040-SR, line 12e			17
	18	If you elect to itemize deductions even though they are less than your standard deduction, check this box ☐			

MEDICAL EXPENSES

Under IRC Section 213, taxpayers who itemize may deduct unreimbursed qualified medical expenses for themselves, their spouse, and their dependents. A special rule allows a divorced or separated parent to deduct medical costs paid for a child even if the other parent claims the child as a dependent.

Qualified expenses include payments for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the treatment of any structure or function of the body. Common examples include:

- Payments to doctors, dentists, surgeons, chiropractors, and other licensed medical practitioners;
- Mental health counseling;
- Vision and hearing care;
- Hospital care, nursing services, and inpatient treatment;
- Prescription drugs and insulin;
- Certain medical equipment (e.g., wheelchairs and hearing aids);
- Health insurance premiums (including Medicare premiums);
- Long-term care premiums (see IRS Publication 502 for current age-based limits);
- Transportation primarily for medical care (including mileage at the IRS medical rate);
- Certain home modifications for medical necessity (e.g., ramps and widened doorways).

Nondeductible expenses include over-the-counter drugs (unless prescribed), cosmetic surgery for personal appearance, general health items (vitamins, gym memberships), and funeral or burial expenses.

DEDUCTIBLE VS. NONDEDUCTIBLE MEDICAL EXPENSES	
Deductible	***Nondeductible***
Doctor visits	Cosmetic surgery (non-medical)
Prescription drugs	Gym memberships
Acupuncture	General wellness items
Laser eye surgery	Hair loss treatment
Fertility treatments	Vitamins (general health)

Taxpayers have to subtract any insurance reimbursements or employer benefits from their deductible medical expenses. If someone claims a deduction in one year and later gets reimbursed, that amount may need to be included as income under the tax benefit rule.

Only unreimbursed expenses qualify. Amounts paid with tax-advantaged funds — such as distributions from Health Savings Accounts (HSAs) or Flexible Spending Arrangements (FSAs) — are not deductible. This “no double benefit” rule frequently traps clients who use HSAs or FSAs and then try to claim the same expenses on Schedule A.

THE TWO-THRESHOLD TEST

Two main limits sharply reduce who benefits from the medical deduction: the standard deduction and the 7.5% AGI floor. First, total itemized deductions must be more than the standard deduction. For tax year 2026, these amounts are $32,200 for married filing jointly and $16,100 for single filers — high limits that greatly reduce the number of taxpayers who itemize.

Medical expenses retain their longstanding 7.5% floor with no additional limitation. Although Congress adjusted this floor repeatedly over the decades — ranging from 5% at enactment in 1942 to a high of 10% under the Affordable Care Act — the current 7.5% rate was made permanent by the Consolidated Appropriations Act of 2021 and left intact by the OBBBA.

Because of this floor, the deduction mostly helps people with very high medical costs relative to their income — often older adults, people with chronic illnesses, or those dealing with a major medical event. It is not meant to cover regular medical spending.

Example. Rachel, age 63 and single, has an AGI of $26,667; her AGI is low because Rachel receives substantial nontaxable income, such as Social Security benefits. She incurred $14,000 in qualified medical expenses. The 7.5% threshold for Rachel is $2,000, so she must subtract $2,000 from her medical bills; this leaves her with a $12,000 deduction for medical expenses (because $14,000 minus $2,000 equals $12,000). If Rachel's annual property tax bill is $5,000, she would be better off itemizing her deductions because $12,000 plus $5,000 is greater than the 2026 standard deduction for a single filer ($16,100).

SCHEDULE A (Form 1040) — Department of the Treasury, Internal Revenue Service

Itemized Deductions

Attach to Form 1040 or 1040-SR.

Go to *www.irs.gov/ScheduleA* for instructions and the latest information.

Caution: If you are claiming a net qualified disaster loss on Form 4684, see the instructions for line 16.

OMB No. 1545-0074

Attachment Sequence No. **07**

Name(s) shown on Form 1040 or 1040-SR: Rachel Reed

Your social security number: 987-65-4321

Medical and Dental Expenses

Caution: Do not include expenses reimbursed or paid by others.

1	Medical and dental expenses (see instructions)			1	$14,000
2	Enter amount from Form 1040 or 1040-SR, line 11	2	$26,667		
3	Multiply line 2 by 7.5% (0.075)			3	$2,000
4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-			4	$12,000

Medical expenses are deductible in the year paid, not necessarily in the year the services are provided. This timing rule creates planning opportunities through "bunching." Clients with controllable medical expenses (e.g., elective surgeries, dental work, new glasses or hearing aids) may benefit from bunching into one year to clear the 7.5% floor.

CONNECTION TO THE OBBBA

The OBBBA does not change IRC Section 213 itself, but it does affect the landscape in which the medical expense deduction operates. These changes are indirect but still important.

The new law permanently preserves the higher standard deduction from the TCJA and introduces new deductions on Schedule 1-A. These changes make itemizing less common, so fewer taxpayers will claim medical expenses on Schedule A, even when they have substantial costs.

The OBBBA temporarily raises the SALT cap (with a phaseout), which may cause some people — especially in high-tax states like California — to start itemizing again. For these taxpayers, the medical expense deduction could become important, even if their medical costs alone would not be enough to itemize.

Starting in 2026, the OBBBA limits the tax benefit of itemized deductions for people in the 37% tax bracket. For these taxpayers, each dollar of itemized deductions — including medical — is now worth 35 cents instead of 37 cents, because of the new 2/37 overall limit (described later).

Because of the recent changes to Health Savings Accounts (covered in the last chapter), more people may pay for routine or preventive care with pretax HSA funds. This means there will be fewer unreimbursed expenses left to deduct on Schedule A. Taxpayers with HSAs should use those funds first for qualified medical expenses before thinking about itemizing.

For tax professionals, the medical expense deduction is still a key part of Schedule A, but it now applies to fewer people. It mainly helps those with very high medical costs, such as people facing major illnesses or long-term care expenses.

NONFEDERAL TAX PAYMENTS

Taxes touch nearly every aspect of daily life. Income taxes are deducted from workers' paychecks and/or paid with a tax return; sales taxes are added to almost everything we buy; and there are special taxes we pay each year for our home and automobile.

The federal government lets taxpayers deduct certain tax payments on Schedule A to help lower their overall tax bill.

WHAT IS A DEDUCTIBLE TAX?

The US Constitution created a federal system of government in which power is shared between the federal government and other governments. Each layer of government (federal, state, county, and municipal) provides public goods and services for its residents. Of course, to pay for these public goods and services, governments need to raise revenue.

When the federal government levies a tax, the payment is not deductible on Schedule A. However, taxpayers who itemize their deductions can deduct certain nonfederal tax payments. According to IRC Section 164 [subsections (a) and (b)], the following nonbusiness taxes "shall be allowed as a deduction for the taxable year within which paid or accrued:"

● State, local, and foreign income taxes;
● State and local general sales taxes;
● State and local real estate taxes; and
● State and local personal property taxes.

Schedule A includes a section on "Taxes You Paid," which lists the taxes mentioned in Section 164. These taxes are generally deductible in the year they are paid, regardless of the year assessed.

STATE AND LOCAL INCOME TAXES
The California Constitution, Article 13, Section 26(a), gives the state the constitutional authority to levy an income tax. This state income tax is deductible on the federal income tax return.

The California Revenue and Taxation Code [R&TC Section 17041.5] prohibits local governments from imposing an income tax. Thus, your California-based clients with W-2 forms will have entries in box 15 (state ID number), box 16 (state wages), and box 17 (state income tax); but there will be no entries in box 18 (local wages), box 19 (local income tax), and box 20 (locality name).

If you serve clients outside California who paid local income taxes, those taxes could be deducted on Schedule A.

Contributions to state benefit funds. In addition to traditional income taxes, California imposes certain payroll-based contributions that raise deductibility questions. Notably, California State Disability Insurance, typically shown in box 14 of Form W-2 as "SDI" or "CASDI," is a state-regulated disability program for short-term income replacement. The IRS treats mandatory state disability insurance contributions (such as California SDI) as deductible state income taxes.

If the employer codes disability insurance premiums as "VPDI" or "VDI" on Form W-2, the employee is enrolled in a ***private*** and ***voluntary*** plan. Voluntary Plan Disability Insurance (VPDI) is not deductible on the federal return because it is not a "mandatory tax" imposed by a state or local government.

STATE AND LOCAL SALES TAXES
Some taxpayers in California will pay more sales tax than income tax, perhaps because they made an expensive purchase such as a motor vehicle, a boat, an airplane, or a major home renovation.

There are two methods to find the total amount of sales tax paid. Taxpayers can use either their actual expenses or the state sales tax tables.

Actual amount. With this method, your client would keep all their receipts and add up the total amount of sales tax they paid during the year. This method requires meticulous recordkeeping but could result in a higher deduction.

Estimated amount. Instead of keeping records, the taxpayer may use optional tables and worksheets provided in Schedule A instructions or a sales tax deduction calculator on the IRS website. The online calculator will give the taxpayer the same result as using the worksheet and tables in the Schedule A instructions.

Taxpayers may deduct either state and local income taxes or state and local general sales taxes, but not both.

REAL ESTATE TAXES

"Property taxes" and "real estate taxes" are used interchangeably in ordinary speech.

While "property taxes" is a broad term, the IRS specifically distinguishes between real property taxes and personal property taxes for deduction purposes. For federal tax purposes, the distinction is more precise: real estate taxes are imposed on immovable property, while personal property taxes are levied on movable property.

Deductible real estate taxes are generally state or local taxes levied on real property for the general public welfare. The charge must be uniform against all real property in the jurisdiction at a like rate.

What is deductible? "Property tax" bills list many different taxes, fees, and service charges — not just the real estate tax on the immovable property. Sifting out the real estate tax from the other taxes and fees on a property tax bill is the starting point for determining the correct deduction amount on a taxpayer's return.

In most cases, a real estate tax must be "ad valorem" to be deductible. An ad valorem tax is levied as a percentage of the property's assessed value. In the context of California real estate taxes, a prime example of an ad valorem tax is the 1% limit imposed by Prop 13 that is applied in each of California's 58 counties. In many communities, an additional assessment will be levied to pay for voter-approved bonds. These deductible ad valorem taxes typically fund school districts (K-12 and community colleges) as well as local water supplies.

What is not deductible? Ad valorem taxes are a percentage of the property's value, whereas special assessments are fixed charges applied per property, independent of the property's value. These fixed charges on a property tax bill for garbage pickup or for the local police and fire departments are nondeductible.

The local taxing authority may include "direct levies" on property tax bills to fund parks, libraries, and lighting. Fixed charges may also be assessed for servicing the area's water infrastructure (sewers and flood control). When charges on a property tax bill are not ad valorem, they are not deductible.

Many California counties list parcel taxes under "direct levies." These are not deductible.

Homeowner association (HOA) dues are nondeductible even though they are often confused with property taxes.

SAMPLE PROPERTY TAX BILL

PROPERTY OWNER
Bree Baer 123 Zzyzx Road San Angel, CA 90000

PROPERTY VALUATION	
	Value
Land	$115,000
Improvements	$242,000
Total	$357,000
Less exemptions	$7,000
Net assessed value	$350,000

DETAIL OF TAXES DUE

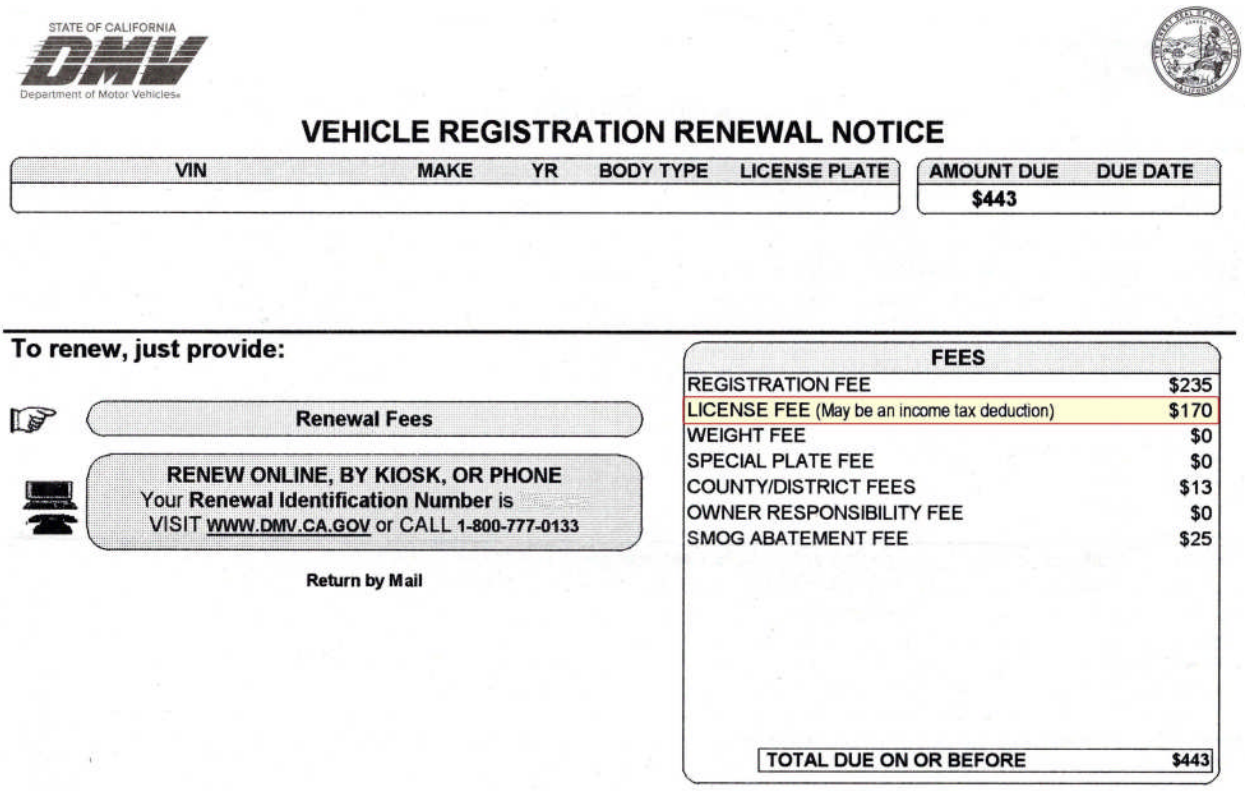
Agency	**Rate**	**Amount**
General Tax Levy	1.0000	$3,500
Other ad valorem taxes		
County Roads	0.0201	$70.35
Water District	0.0018	$6.30
School District	0.1010	$353.50
Community College District	0.0102	$35.70
Direct Levies		
Parks and lighting services		$9.36
Flood control district assessment		$64.39
Residential street lighting		$12.71
Trash collection and recycling		$86.51
School district parcel tax		$125
Total taxes due		**$4,263.82**

PERSONAL PROPERTY TAXES

In general, personal property is that which is movable and is not "real" property. Examples of personal property often taxed by state governments are vehicles, vessels, and aircraft.

The personal property tax deduction must apply only to personal property the taxpayer owns, be based on its value, and be charged annually.

Any fee paid to register a vehicle is deductible on Schedule A as a personal property tax if the fee is based on a percentage of the vehicle's value. Part of the California vehicle registration is a deductible tax. It is called the Vehicle License Fee (VLF). The VLF is a tax based on the vehicle's value. The other fees listed on the annual billing notice, such as the registration and county or district fees, are not deductible.



STATE OF CALIFORNIA
DMV
Department of Motor Vehicles

VEHICLE REGISTRATION RENEWAL NOTICE

VIN	MAKE	YR	BODY TYPE	LICENSE PLATE	AMOUNT DUE	DUE DATE
					$443	

To renew, just provide:

Renewal Fees

RENEW ONLINE, BY KIOSK, OR PHONE
Your **Renewal Identification Number** is
VISIT WWW.DMV.CA.GOV or CALL 1-800-777-0133

Return by Mail

FEES	
REGISTRATION FEE	$235
LICENSE FEE (May be an income tax deduction)	$170
WEIGHT FEE	$0
SPECIAL PLATE FEE	$0
COUNTY/DISTRICT FEES	$13
OWNER RESPONSIBILITY FEE	$0
SMOG ABATEMENT FEE	$25
TOTAL DUE ON OR BEFORE	$443

FOREIGN INCOME TAXES

The United States employs a global tax system and, under the residence principle, taxes the income that its residents earn abroad. This foreign income may be taxed in the foreign country under the source principle.

To offset this double taxation of income by two countries, the US grants individuals a foreign tax deduction that can be used to offset income taxes assessed by a foreign country on the income earned there. Foreign income taxes can be deducted from US income, including those levied by local governments below the national level — such as by a state in Mexico or a province in Canada.

Most taxpayers instead elect to claim the foreign tax credit on Form 1116, which generally provides a dollar-for-dollar offset of US tax liability rather than a deduction. Also, taxpayers cannot deduct foreign income taxes on income they exclude under IRC Section 911.

When a client instead chooses to claim a foreign tax deduction, add the foreign tax from all sources and enter the total on line 6 of Schedule A, which is for “other taxes” paid (just below state and local taxes). Your tax software may show a text field on line 6. Within the limited space, describe the entry concisely. For example, “Foreign income taxes from Form 1099-INT and Form 1099-DIV.” Enter the dollar amount in the adjacent numerical field.

Foreign personal or real property taxes are not deductible on Schedule A.

NEW SALT DEDUCTION CAP UNDER THE OBBBA

In 2017, the TCJA introduced an upper limit on the combined deduction for state and local taxes (SALT). That cap — formally codified in IRC Section 164(b)(6) — limited the combined deduction for state and local income taxes, general sales taxes, and real and personal property taxes to $10,000 per return or $5,000 for married filing separately (MFS). Once a taxpayer reaches the cap, additional state or local tax payments generally produce no federal tax benefit. This SALT cap applied from 2018 through 2025, before OBBBA's new structure took effect in 2025. For many California homeowners and high-income earners, the $10,000 ceiling was far below their actual tax burden, making the excess entirely nondeductible.

The TCJA cap was scheduled to expire at the end of 2025. Rather than allow it to lapse entirely — which would have restored the unlimited deduction that existed before 2018 — Congress chose a middle path. The OBBBA temporarily quadruples the SALT deduction cap. For tax years 2025 through 2029, the maximum deductible amount of SALT rises to $40,000 ($20,000 if married filing separately). In California, for example, a married couple with $18,000 of state income tax withholding and $9,000 of property taxes will once again be able to deduct the full $27,000, rather than being capped at $10,000.

The cap grows each year: $40,000 in 2025, $40,400 in 2026, and continuing upward by 1% annually through 2029. After 2029, the cap is scheduled to revert to the original TCJA level of $10,000 ($5,000 MFS) unless Congress acts again.

The expanded cap is reduced by 30% of the amount by which a taxpayer's MAGI exceeds an indexed threshold. For 2025, the threshold was $500,000 ($250,000 MFS); for 2026, it increases to $505,000 ($252,500 MFS), with an additional 1% annual increase through 2029. However, the deduction cap never drops below $10,000 ($5,000 MFS), regardless of the taxpayer's income. At approximately $606,333 ($303,167 MFS), the benefit is fully phased out back to the original $10,000 limit.

Example. In 2026, Irina and Harvey are married and file a joint return. They live in California and have $480,000 of MAGI. During the year, the couple pays $25,000 in California income tax and $14,000 in property taxes on their home, for a total SALT of $39,000. Because the 2026 SALT cap is $40,400 and their MAGI is below the $505,000 phaseout threshold, Irina and Harvey may deduct the full $39,000 on Schedule A. Now assume their MAGI increases to $540,000, with the same $39,000 of SALT paid. In 2026, the cap is reduced by 30% of the excess MAGI over $505,000. The couple's excess is $35,000 ($540,000 − $505,000), so the reduction is $10,500 (30% × $35,000). The adjusted SALT cap is $29,900 ($40,400 − $10,500). In that case, Irina and Harvey may deduct only $29,900 of their $39,000 SALT payments; the remaining $9,100 is nondeductible.

The OBBBA did not change the categories of taxes that qualify for the itemized deduction or that are subject to the SALT cap. The SALT cap remains an aggregate

limit on the combined total of qualifying taxes discussed earlier in this section (income or sales taxes, real estate taxes, and personal property taxes).

Not all taxes described in Section 164 are subject to the limitation. For example, foreign income taxes claimed as an itemized deduction are not included in the SALT cap. These amounts remain outside the SALT computation and continue to be deductible on Schedule A, line 6, without limitation by the new cap.

Example. In 2026, Brody and April paid $45,000 in nonfederal taxes. This amount consisted of payments toward California state income taxes, ad valorem property taxes (imposed by a California county), California's vehicle license fee, and foreign income taxes. Foreign income taxes are not included in the SALT amount. However, the following payments are subject to the SALT deduction cap:

- Ad valorem property taxes.
- California state income taxes.
- California's vehicle license fee.

The SALT limitation also does not apply to taxes directly attributable to an income-producing activity. Real estate taxes on a rental property reported on Schedule E, for example, are deductible in full as a business expense and do not count toward the cap. Similarly, pass-through entity taxes (PTET) paid at the entity level by a partnership or S corporation are treated as business deductions under IRC Section 162 and are likewise unaffected by the individual SALT cap.

Clients in high-tax states like California, who often have substantial property taxes and either high state income taxes or large one-time sales taxes, stand to benefit the most from the higher cap. For many upper-middle-income households in California, the increased limit can make itemizing significantly more attractive compared with taking the standard deduction. The relief is real — but it is temporary. The scheduled return to a $10,000 cap in 2030 means that the conversation about SALT planning is far from over.

MORTGAGE INTEREST PAYMENTS

A mortgage is a loan that a bank or lender gives a borrower to help finance the purchase of a house. A monthly mortgage payment has many parts: the loan principal, loan interest, taxes, homeowners' insurance, and potentially mortgage insurance. Schedule A generally allows a deduction only for the interest portion of a mortgage payment. Principal repayments and homeowners' insurance are not treated as mortgage interest. Property taxes are not mortgage interest, but they may be separately deductible on Schedule A in the SALT category (subject to the limitations discussed earlier).

With several limitations, a mortgage interest deduction is allowed under IRC Section 163(h). One such limitation is that the borrower must elect to itemize deductions. Also, a borrower cannot deduct payments made for someone else if the taxpayer is not legally liable to make the payments. Other deduction requirements are discussed below.

For taxpayers who itemize, claiming the home mortgage interest deduction is straightforward. The lender reports mortgage interest to the IRS and the taxpayer on Form 1098. Most itemizers can transfer the amount from Form 1098 (box 1) to Schedule A.

However, the amount a borrower can deduct on Schedule A could be more or less than the amounts from Form 1098 after considering all the allowances and limitations associated with deductible interest.

ITEMIZERS WITH A SECOND HOME

To be deductible, mortgage interest must be paid on debt secured by a "qualified home." A borrower may claim qualified residence interest for at most two homes at a time: a main home and one second home (often a vacation property).

A qualified home can be any livable dwelling with a kitchen, bathroom, and sleeping accommodations. Thus, a house, condominium, mobile home, manufactured home, recreational vehicle (RV), or boat with eating, sleeping, and sanitary facilities might qualify as a first or second home. A qualified residence may be located outside the United States, provided it otherwise meets the definition of a qualified home and secures the debt.

Second home not rented out. If a taxpayer has a second home that they do not hold out for rent or resale to others at any time during the year, they can treat it as a qualified home. The taxpayer does not have to use the property during the year.

Second home rented out. If a taxpayer has a second home they rent out for part of the year, they must also use it as a home during the year for it to be a qualified home. The taxpayer must use this home for more than 14 days, or for more than 10% of the days during the year that the property is rented at a fair rental value, whichever is longer. If the taxpayer lives in it long enough, it is treated as a "vacation" property, and the taxpayer can deduct the mortgage interest.

If the taxpayer uses the home they rent out for fewer days than the required number of days, it is considered a rental property, not a second home. In this case, the taxpayer cannot deduct mortgage interest on Schedule A, but they can report it on Schedule E for the rental.

Example. Annette lived in her primary home for 11 months. Annette lived in her vacation home for the other 30 days of the year, but she rented it out for 330 days at fair market rent. Although Annette lived in her vacation home for more than 14 days, she did not meet the 10% threshold. That is, Annette did not use the vacation home for more than 10% of the days during the year that the property was rented at a fair rental value (10% of 330 days equals 33 days). She may deduct mortgage interest on her main home, but may not deduct mortgage interest on the second property on Schedule A; instead, it is deductible on Schedule E as a rental expense.

ACQUISITION LOANS YIELD DEDUCTIBLE INTEREST

Beyond the number of homes, another set of limitations restricts how much debt can generate deductible interest.

Before 2018, homeowners could deduct interest on up to $1,000,000 of home acquisition debt ($500,000 if married filing separately). Beginning in 2018, federal law reduced this cap to $750,000 ($375,000 MFS) for new acquisition debt. This lower limit was scheduled to sunset after December 31, 2025. Absent the OBBBA, the $750,000 limit would have expired after 2025, and the $1,000,000 limit would have returned for all taxpayers.

The OBBBA permanently extended the TCJA limit. For tax years beginning after December 31, 2025, the $750,000 cap applies to new acquisition debt, and the $1,000,000 cap remains grandfathered for qualifying debt incurred before December 16, 2017. A refinanced loan retains grandfathered status up to the outstanding balance of the original loan at the time of refinancing — not the original loan amount. If a borrower refinances a $900,000 grandfathered loan when the balance has been paid down to $820,000, the new loan is grandfathered only up to $820,000.

Most new homeowners can deduct the interest paid on up to $750,000 in mortgage debt. Interest is deductible on up to $750,000 of mortgage principal when the homeowner is

single, a joint filer, or head of household. Married taxpayers who file separately can deduct interest on home loans up to $375,000.

The $750,000 (or $375,000) limit applies to combined acquisition debt across all qualified residences. If a borrower has both a main home and a second home, the $750,000 cap applies to the combined acquisition debt on both properties, not to each property separately.

The $750,000 limit is not indexed for inflation. As home prices and inflation rise, the tax benefit will cover a smaller share of the average home loan over time.

According to Zillow, as of February 2026, the average US home value is approximately $360,591. It follows then that a large share of American homeowners will not owe more than $750,000 on their residence and won't be impacted by the post-TCJA limit. However, $360,591 is nothing more than a down payment on a home in many parts of California. According to the California Association of Realtors, California's median home price will rise to $905,000 in 2026. As a result, new homebuyers in California are likely to be affected by the $750,000 limitation on mortgage interest (and very likely to be affected when the new home is in the Bay Area or one of the coastal counties stretching from Santa Cruz to San Diego).

When total acquisition debt exceeds the applicable cap, interest must be allocated proportionally between deductible and nondeductible portions.

Example. After making a down payment of $240,000 on a new home in San Jose, Marissa and Charles borrowed $960,000 to complete the purchase of the $1,200,000 home. This loan, taken out in December 2025, was used solely to acquire their residence. The mortgage deduction will be limited since this loan exceeds the $750,000 limit for home acquisition debt. Let's say the loan has a fixed interest rate of 6.75%, and the total interest paid in 2026 was $64,430 (to be shown on Form 1098). Since $750,000 is 78.125% of $960,000, then 78.125% of $64,430 is $50,336. Marissa and Charles can only deduct $50,336, the interest on the first $750,000 of home acquisition debt. As a result of the permanent $750,000 cap now in Section 163(h)(3), Marissa and Charles lose a deduction for the interest allocable to the excess $210,000 of debt, resulting in over $14,000 of nondeductible interest in 2026.

MORTGAGE ORIGINATES	LOAN AMOUNT	TAX BENEFIT (2026 AND LATER)
On or before December 15, 2017	Up to $1,000,000	Interest is fully deductible (grandfathered)
After December 15, 2017	Up to $750,000	Interest is fully deductible (subject to limitations)
	Over $750,000	Only interest on the first $750,000 is deductible

MORTGAGE INSURANCE PREMIUMS ARE DEDUCTIBLE AGAIN

Beginning in 2026, the OBBBA permanently restores the deduction for mortgage insurance (MI) premiums paid on acquisition debt, treating them as qualified mortgage interest on Schedule A. Mortgage insurance premiums are deductible only when associated with acquisition debt, not home equity loans used for nonqualifying purposes.

The OBBBA covers both private mortgage insurance (PMI) on conventional loans and government-backed equivalents. Qualified mortgage insurance under the OBBBA includes insurance provided by the Department of Veterans Affairs, the Federal Housing Administration, or the Rural Housing Service, as well as PMI.

The mortgage insurance contract must have been issued after 2006 to qualify. Homeowners paying MI premiums will be allowed to include it in their itemized deductions alongside mortgage interest. This provision had lapsed after December 31, 2021.

The deduction begins to phase out once AGI exceeds $100,000 ($50,000 for married individuals filing separately), with the phaseout equal to 10% of the allowable deduction for each $1,000 that AGI exceeds the threshold [IRC Section 163(h)(3)(E)(ii)]. For an unmarried individual or joint-filing couple, the deduction for MI premiums is completely phased out at AGI of $110,000 or higher. For example, at AGI of $105,000, 50% of the MI premium is disallowed.

HOME EQUITY LOANS YIELD NONDEDUCTIBLE INTEREST

A home equity loan or home equity line of credit (HELOC) allows homeowners to borrow money using their home's equity as collateral. These loans can be used for various purposes, such as covering unexpected medical expenses, paying for a child's college education, weddings, home improvements, or consolidating debt. Before the TCJA, homeowners could deduct interest on home equity debt of up to $100,000, regardless of how the funds were used.

The TCJA imposed new restrictions on interest claimed for home equity loans and HELOCs. Interest on home equity loans or lines of credit is only deductible if the debt is used to "buy, build, or substantially improve" the home that secures the loan. In other words, the deduction applies exclusively to expenses related to the house. Therefore, if a borrower used a home equity loan or line of credit for non-property-related costs, the interest is no longer deductible. If a HELOC is used partly for improvements and partly for personal expenses, the interest must be allocated accordingly. Only the improvement-related portion is deductible.

The OBBBA permanently excludes interest on home equity indebtedness from the definition of qualified residence interest. For current law purposes, "home acquisition debt" is money borrowed to buy, build, or improve the home that secures the loan. In contrast, "home equity debt" is money borrowed (using one's home as collateral) for any other purpose. However, a loan's label does not control its tax treatment. For example,

a HELOC used to improve the home is treated as acquisition debt. The deductibility of interest depends on the use of proceeds (the "tracing rule"), not the label of the loan.

Example 1. In January 2026, Alicia and Jaime made a $136,800 down payment on a house worth $706,800. They take out a $570,000 mortgage to complete the home purchase. In July 2026, the joint filers take out a $20,000 home equity loan to pay for their daughter's quinceañera. The interest paid on the first loan is deductible. However, since Alicia and Jaime used the home equity loan to pay for personal expenses, the interest on that second loan is not deductible.

The $750,000 combined cap applies to both the original acquisition mortgage and any home equity debt used for improvements.

Example 2. In February 2026, Dana took out a $600,000 mortgage to purchase a $750,000 "fixer-upper" home in a nice neighborhood, which she will use as her main home. In May 2026, Dana took out a $115,000 home equity loan to make repairs, renovations, and additions to the property built in 1928. The main home secures both loans, and the total debt does not exceed the cost of the house. Because the combined balance of the original mortgage and the improvement-related home equity loan does not exceed both the cost of the home and the $750,000 acquisition-debt cap, all of Dana's interest qualifies as deductible home acquisition interest.

The home equity interest rules apply regardless of when the loan originated; there is no grandfathered deduction for interest on home equity debt used for nonqualifying personal expenses.

MORTGAGE POINTS MAY COUNT AS DEDUCTIBLE INTEREST

It's not just the interest part of the monthly payment that may qualify for the mortgage interest deduction. The Tax Code treats mortgage insurance premiums (Form 1098, box 5) as deductible interest, and itemizers might be able to include the "points" they pay (Form 1098, box 6) in their deductible mortgage interest.

Points are less common in today's rate environment, but these rules remain important for practitioners to know.

RECIPIENT'S/LENDER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.		*Caution: The amount shown may not be fully deductible by you. Limits based on the loan amount and the cost and value of the secured property may apply. Also, you may only deduct interest to the extent it was incurred by you, actually paid by you, and not reimbursed by another person.	OMB No. 1545-1380 Form 1098 (Rev. April 2025) For calendar year _____	Mortgage Interest Statement
		1 Mortgage interest received from payer(s)/borrower(s)* $		Copy B For Payer/ Borrower The information in boxes 1 through 9 and 11 is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if the IRS determines that an underpayment of tax results because you overstated a deduction for this mortgage interest or for these points, reported in boxes 1 and 6; or because you didn't report the refund of interest (box 4); or because you claimed a nondeductible item.
RECIPIENT'S/LENDER'S TIN	PAYER'S/BORROWER'S TIN	2 Outstanding mortgage principal $	3 Mortgage origination date	
		4 Refund of overpaid interest $	5 Mortgage insurance premiums $	
PAYER'S/BORROWER'S name		6 Points paid on purchase of principal residence $		
Street address (including apt. no.)		7 ☐ If address of property securing mortgage is the same as PAYER'S/BORROWER'S address, the box is checked, or the address or description is entered in box 8.		
City or town, state or province, country, and ZIP or foreign postal code		8 Address or description of property securing mortgage		
9 Number of properties securing the mortgage	10 Other			
Account number (see instructions)				11 Mortgage acquisition date

To determine whether points are deductible, one must examine how the money is used. A service fee labeled "points" is not deductible. Points charged for specific services, such as preparation costs for a mortgage note, appraisal fees, or notary fees, are not prepaid interest and cannot be deducted.

If the points are prepaid interest, they are deductible even if the lender refers to them as "loan origination fees" or if the points are deducted from the principal rather than being paid directly by the borrower. Tax professionals should ensure that points reported on Form 1098 (box 6) have satisfied the deduction requirements listed below.

- The taxpayer's home must secure the loan.
- The points must be paid on a loan to buy, build, or improve one's principal residence.
- The points must be calculated as a percentage of the loan principal.
- Paying points must be considered an established business practice in the taxpayer's area, and the amount paid as points must not exceed the usual range charged in the area.
- Taxpayers must use the cash method of accounting (which is the most commonly used method among individuals).
- The HUD-1 settlement or loan statement must identify the amount of the points paid (by the buyer or seller) in exchange for a lower interest rate.
- The points are not paid to reduce appraisal fees, inspection fees, title fees, attorney fees, and/or property taxes.
- The funds a taxpayer comes up with at or before closing (such as a down payment) must be at least as much as the points charged.

If the points are paid on a loan secured by a second home or a loan used only to refinance existing debt, the points are generally amortized over the life of the loan rather than deducted in full in the year paid.

SUMMARY OF MORTGAGE INTEREST RULES		
	Pre-2018 Law	***Current Law (Post-OBBBA)***
Mortgage debt for acquisition of residence	Interest deductible for loans up to $1,000,000	Interest deductible for loans up to $750,000
Home equity debt to improve 1st / 2nd residence	Interest deductible for loans up to $100,000	Included in $750,000 acquisition debt limit
Home equity debt NOT for home improvements	Interest deductible for loans up to $100,000	No deduction
Mortgage insurance premiums	Deductible as interest (subject to AGI phaseout)	Deductible as interest (subject to AGI phaseout)
Mortgage points (when considered prepaid interest)	Deductible as interest (if all conditions are met)	Deductible as interest (if all conditions are met)

CHARITABLE CONTRIBUTIONS

Effective for tax years after December 31, 2025, individuals who claim the standard deduction (i.e., they do not itemize) can also deduct charitable contributions up to $1,000 for individuals and $2,000 for married couples filing jointly. This deduction applies only to cash contributions (including electronic payments) to qualified public operating charities; it does not apply to gifts to donor-advised funds, supporting organizations, and private nonoperating foundations. The substantiation rules described below apply to the new non-itemizer deduction.

For the roughly 10% of taxpayers who still itemize, the tax advantages of a charitable contribution depend on a few factors. To claim a charitable contribution deduction on Schedule A, the donor must generally satisfy the following conditions:

- The recipient must be a qualified organization (not an individual or nonqualified entity).
- The contribution must be in the form of cash or property, not time or services.
- The donor must obtain and maintain appropriate documentation for the gift.
- AGI percentage thresholds may limit the contribution.
- The donor may not claim a non-itemizer deduction while also itemizing.

NOT ALL GIFTS QUALIFY FOR A TAX DEDUCTION

For a charitable contribution to be deductible, the recipient must be a qualified organization under tax law. The organization must be recognized by the IRS as tax-exempt under the Internal Revenue Code. Most types of organizations described in

IRC Section 501(c)(3) are eligible to receive tax-deductible contributions. The IRS has a search tool on its website that allows you to check the status of a recipient organization: https://apps.irs.gov/app/eos/.

Eligible entities include organizations operated exclusively for religious, charitable, scientific, literary, or educational purposes; the prevention of cruelty to animals or children; or the development of amateur sports.

Contributions to entities not qualifying as charities under the tax law are ineligible for the itemized deduction. Donations that are not tax-deductible include:

- Person-to-person donations;
- Contributions to for-profit schools and hospitals;
- Gifts made to political parties, political campaigns, or political action committees;
- Contributions to labor unions, chambers of commerce, or business associations.

Tax preparers frequently find themselves presenting bad news to clients seeking charitable deductions for bingo games, raffle tickets, or lottery-based drawings used by organizations to raise money. Such contributions are not deductible.

Another misconception relates to community drives aimed at helping an individual or family. GoFundMe accounts that allow people to raise funds for life events (such as celebrations and graduations) or challenging circumstances (such as accidents and illnesses) are not tax-deductible because they collect money for individuals.

Sometimes, taxpayers give to a "qualified organization," but ***what they give*** does not qualify for a federal tax deduction. For example, the value of a taxpayer's time or services, such as the income they forgo by working as an unpaid volunteer, is not

deductible. Nor can volunteers deduct the value of the time and labor of people they employ for certain services (such as hiring a babysitter) while they are doing their charity work.

Blood donations to blood banks are nondeductible. The IRS treats them as a donation of time or services rather than property, as donors incur no cost basis and can generally regenerate blood.

DONATING CASH

Cash contributions include payments made by check, credit card, or electronic transfer (e.g., Venmo and PayPal).

A taxpayer may not deduct a cash donation unless they have a tangible record of the gift, regardless of the amount. Taxpayers cannot write off those few dollars they dropped in the church collection plate or the Salvation Army bucket without documents to back up their claim.

If a taxpayer makes a cash donation of less than $250, a canceled check or a receipt from the charity showing its name, the amount, and the date of the contribution is sufficient. However, donations of $250 or more require written documentation from the charitable organization. Charitable organizations often provide donors with a written letter acknowledging the gift (also known as a "contemporaneous written acknowledgment" or CWA). Donors should keep these acknowledgment letters with their tax records.

The Latin phrase "quid pro quo" roughly translates to "this for that," "something for something," or "you scratch my back, I'll scratch yours." It describes a reciprocal arrangement, in which one party expects to receive a benefit or favor in return for what they provide. Generally, a quid pro quo contribution is not deductible because it was not made through "detached and disinterested generosity" — a phrase coined by the Supreme Court in a 1960 case dealing with taxable and nontaxable "gifts."

Suppose a donor contributes more than $75 and receives goods or services from the charity. In that case, the charity must give the donor a written disclosure statement that includes a good faith estimate of the value of the goods or services the donor received. The donor's deduction amount should be reduced by the value of the benefits received from the charity.

Example. Becky attends a nonprofit charity's fundraising gala. She pays $200 for a ticket that would normally retail for $80. The charity provides her with a written disclosure statement noting that the fair market value of the ticket is $80. Under current substantiation and quid pro quo rules, Becky's allowable charitable deduction for this payment is $120, as the deductible amount is the excess of her payment over the fair market value of the benefit received.

DONATING PERSONAL PROPERTY

Value of donated property less than $250. A noncash (property) contribution of less than $250 requires a detailed record of the donated items; this record should include the charity's name, the date of the donation, and the deduction value of all the donated items, which the donor will enter on Schedule A. The taxpayer should also do the following:

- Make a list of the things they are giving away.
- Briefly describe each item, noting its condition and value.
- Consider taking a picture or video of their donated property in addition to the written record.

The taxpayer should obtain a written receipt from the charity upon delivery of the items. However, a receipt isn't required if it's impractical to get one, such as where property is left at the charity's unattended drop site. In that case, for each item of donated property, the taxpayer must keep reliable records, as described above.

Value of donated property between $250 and $500. In addition to the detailed record described above, donations between $250 and $500 require a CWA from the charity stating whether the organization provided the taxpayer with any goods or services as a result of their contribution. If a taxpayer received anything in exchange for their donation, the CWA must include a description and good faith estimate of the value of any goods or services.

Value of donated property between $501 and $5,000. Taxpayers must use Form 8283, *Noncash Charitable Contributions*, to report noncash contributions of more than $500 in aggregate noncash contributions for the year.

If a taxpayer gives property valued at more than $500, they must complete Section A of Form 8283 and attach it to their Form 1040. Form 8283 will ask for details about each item that the taxpayer donated. The form will ask the taxpayer to identify the recipient and provide information about the item's value, including its cost or adjusted basis.

Value of donated property over $5,000. The $5,000 threshold in this section applies to the aggregate value of similar items (e.g., clothing), not each item. If a taxpayer contributed an item (or a group of similar items) for which they are claiming a deduction of more than $5,000, they must complete Section B of Form 8283 (unless an exception applies). In addition, the receiving charity must complete and sign Part IV of Section B.

When a taxpayer deducts a donation of artwork, jewelry, or another item worth more than $5,000, independent verification of its value is required by Section 170(f) and Treasury Regulation 1.170A-13. The taxpayer must obtain a formal appraisal for property valued at more than $5,000. Not only that, they will have to ensure the appraiser is a member of a recognized professional group or meets minimum education and experience requirements. The appraiser must sign and date Part III of Section B (Form 8283).

The qualified appraisal isn't typically submitted to the IRS. Instead, Form 8283 (containing the appraisal summary) is attached to the donor's tax return. However, if the donated property is art worth $20,000 or more (and any other property worth more than $500,000), the full-length qualified appraisal must be attached to the donor's tax return.

Publicly traded securities generally do not require an appraisal, as their fair market value is readily verifiable. Written appraisals are also not required for:
● Intellectual property;
● Non-publicly traded stock valued at $10,000 or less;
● Inventory or property held primarily for sale to customers in the ordinary course of the donor's trade or business; and
● A qualified vehicle (including a car, boat, or airplane) if the deduction for the vehicle is limited to the gross proceeds from its sale and the donor obtained a CWA.

DONATING INVESTMENT PROPERTY
A taxpayer's donation of investment property can qualify for a charitable deduction. The precise amount of the deduction will depend on how the property would have been taxed at the time of the donation.

Ordinary income property. If a property is sold within one year of its purchase, the gain is characterized as short-term and taxed at the same marginal rate as the taxpayer's other ordinary income. Short-term capital gains do not benefit from any special tax rate — they are taxed at the same rate as the taxpayer's ordinary income. Ordinary tax rates range from 10% to 37%.

The deduction for donating ordinary income property, in general, is limited to the lesser of the fair market value of the property when it was donated or the donor's cost basis in the property [IRC Section 170(b)(1)(C)(iii)]. In most cases, a donor of ordinary income property can deduct the amount they originally paid for a stock or other security, but they can't deduct any subsequent appreciation.

Capital gain property. If the taxpayer holds property for more than one year before selling, any gain from the sale is characterized as long-term capital gain and is taxed at a favorable long-term rate. The long-term capital gains tax rates are 0%, 15%, and 20% for most taxpayers.

If taxpayers donate capital gain property that they have owned for more than a year, they can deduct its current fair market value [IRC Section 170(b)(1)(B)(i)]. The taxpayer does not have to reduce their deduction amount to the property's cost basis. Donating appreciated capital gain property can be more tax-efficient than selling the asset and donating the proceeds, because the donor avoids recognizing capital gain while still receiving a deduction equal to fair market value.

CHARITABLE CONTRIBUTION SUBSTANTIATION REQUIREMENTS	
Contribution Type & Amount	**What the Donor Must Keep or Obtain**
Cash gifts under $250	• Bank record (canceled check, credit card statement) or • Receipt showing charity name, date, and amount (receipt recommended but not required if impractical)
Cash gifts of $250 or more	• Contemporaneous Written Acknowledgment (CWA) from the charity
Quid pro quo gifts over $75	• CWA from the charity and • Written disclosure from charity stating: – Amount paid – Value of goods/services received
Noncash property under $250	• Detailed record including: – Charity name – Date – Description & condition of items – Fair market value
Noncash property $250–$500	• Detailed record • CWA
Noncash property $501–$5,000	• Detailed record (including estimated fair market value) • CWA • Form 8283, Section A attached to return (for total noncash contributions over $500)
Noncash property over $5,000	• Qualified appraisal (unless exception applies) • Form 8283, Section B signed by appraiser and charity
Artwork ≥ $20,000	• Full qualified appraisal attached to return • Form 8283, Section B (Parts III and IV completed)
Any donated property > $500,000	• Full qualified appraisal attached to return • Form 8283, Section B (Parts III and IV completed)

OVERVIEW OF LIMITS ON DEDUCTIBILITY

AGI ceiling for charitable deductions. Under pre-TCJA law, deductions for contributions to typical charities, colleges, and religious groups could not exceed 50% of the donor's AGI.

Under the TCJA, philanthropic taxpayers can deduct up to 60% of AGI for cash contributions to public charities. When the contribution exceeds 60% of the donor's AGI, the excess can be carried forward for up to 5 years.

Non-50% limit organizations. Certain groups have never been eligible for the higher AGI limit (formerly 50% and currently 60%) on cash and ordinary income property contributions. IRS guidance still uses pre-TCJA terminology and refers to these groups as "non-50% limit organizations." Generally, non-50% limit organizations are fraternal organizations, veterans organizations, and nonprofit cemeteries. An example of a non-50% limit organization is the American Legion. Donations to these non-50% limit organizations have a lower ceiling of 30% of AGI for cash and ordinary income property contributions.

Deductible contributions of capital gain property to public charities, colleges, and religious organizations generally cannot exceed 30% of adjusted gross income. Deductible contributions of capital gain property to non-50% limit organizations have an even lower ceiling of 20% of AGI.

Excess contribution carryovers. Charitable contributions above these 60%, 30%, or 20% limits can be carried over to the following tax year. Excess contributions can be carried over for up to 5 years.

OBBBA MODIFICATIONS

Beginning in 2026, the OBBBA significantly changes how charitable deductions operate. The law has reshaped the incentive structure for charitable giving, adding a new floor for itemizers and a new deduction for non-itemizers, while making the existing 60% ceiling permanent.

Pre-2026	Under the TCJA, the main story was a higher ceiling (60% of AGI) for cash gifts and the temporary suspension of Pease.
Post-2025	Under the OBBBA, the story shifts to a permanent 60% cash cap, a new floor (0.5% of AGI), and a 2/37 haircut for very high-income taxpayers.

The temporary provision from the TCJA allowing the deduction of cash contributions up to 60% of AGI is made permanent under the OBBBA. However, the new law does not change the AGI ceilings for capital gain property applied to public charities. For capital gain property, the AGI cap is still 30% for public charities and 20% for non-50% limit organizations.

New charitable AGI floor. Under the OBBBA, the otherwise allowable charitable deduction for itemizers is reduced by 0.5% of AGI; donors may only deduct charitable

contributions that exceed this floor. For example, an itemizer with $100,000 of AGI who donates $400 receives no deduction, because the contribution does not exceed the $500 floor. On the other hand, a couple with an AGI of $100,000 who donate $600 may claim a $100 deduction on Schedule A. The 0.5% floor effectively eliminates the tax benefit of small donations for itemizers. Given the 0.5% floor, bunching gifts is now more important than ever for itemizers.

For those ages 70½ and older, a qualified charitable distribution (QCD) is a direct transfer from an IRA to a public charity that is excluded from gross income and satisfies RMD requirements. Importantly, QCDs are not subject to the 0.5% floor or the 60% ceiling because they are excluded from income rather than deducted from income. This makes QCDs an even more attractive strategy in 2026 than they were before.

The 0.5% of AGI floor applies to all itemizers, regardless of contribution type. However, an ordering rule exists when donors are subject to both the floor and ceiling on their annual contributions. The applicable AGI percentage limits (such as the 60% ceiling for cash contributions) are applied first. The resulting allowable deduction is then reduced by 0.5% of AGI.

Amounts disallowed by the 0.5%-of-AGI floor generally cannot be carried forward. However, according to IRC Section 170(d)(1)(C), if a taxpayer already has excess contributions that exceed both the floor and the charitable ceilings, the disallowed amount may increase their total charitable carryforward. In other words, amounts disallowed by the 0.5% floor can only be carried forward (up to 5 years) if the taxpayer has other contributions that are carried forward due to exceeding the 60% or 30% or 20% ceilings.

Example. In 2026, Waylon's adjusted gross income will be $100,000. Using part of the tax-free proceeds from the sale of his principal residence, he contributes $65,000 in cash to the American Cancer Society. In 2026, Waylon's write-off for this charitable contribution would undergo two reductions:

- His deduction is first limited to 60% of AGI ($60,000); then
- It is reduced by 0.5% of his AGI ($500).

Waylon's $65,000 donation results in a Schedule A deduction of $59,500 in 2026. The "excess" amount cut off by the 60% limit ($5,000) is carried forward for up to 5 years. Because the 60%-limit carryforward exists, the $500 floor amount can "ride along" with the existing AGI-cap carryover, giving Waylon a total carryforward of $5,500.

It should be noted that if Waylon's contribution had been $60,000 or less — keeping him at or under the 60% ceiling with no cap carryforward — the $500 would have been permanently lost. There is no standalone carryforward for amounts lost solely to the floor.

Feature / limitation	2025 (TCJA)	2026+ (OBBBA)
Maximum cash to public charities (itemizers)	60% of AGI (temporary)	60% of AGI (permanent)
Capital-gain-property AGI cap (public charities)	30% of AGI	30% of AGI (unchanged)
Capital-gain-property cap (non-50% limit orgs)	20% of AGI	20% of AGI (unchanged)
Charitable AGI floor (itemizers)	None	0.5% of AGI (only amounts above floor are deductible)
Non-itemizer cash deduction	None	$1,000 (single), $2,000 (joint) on Form 1040
Overall Pease-style limitation	Suspended	Replaced by 2/37 overall limitation for 37%-bracket taxpayers

THE OVERALL LIMITATION ON ITEMIZED DEDUCTIONS

Before 2018, high-income taxpayers were subject to the so-called "Pease limitation," which generally required a reduction of itemized deductions by 3% of the amount by which AGI exceeded applicable thresholds (up to a maximum reduction of 80% of itemized deductions). The TCJA suspended the Pease limitation entirely for tax years 2018 through 2025. As that suspension approached expiration, Congress faced a policy choice: allow Pease to return, extend its suspension, or replace it with a new structure.

Effective January 1, 2026, the OBBBA lets the old Pease formula expire and imposes a new limitation on taxpayers whose income (computed without regard to itemized deductions) exceeds the threshold for the 37% bracket.

The new rule under amended IRC Section 68 does not affect the calculation of adjusted gross income, the availability of specific deductions, or eligibility for itemizing; it only limits the ultimate tax benefit. The limitation applies only to taxpayers who itemize; those claiming the standard deduction are unaffected. For most taxpayers, the limitation has no effect; its impact is concentrated on high-income individuals who both itemize and have income in the 37% bracket.

RELATIONSHIP TO OTHER ITEMIZED DEDUCTION RULES

The rule under Section 68 is not a new deduction floor or a cap on a particular expense category; it is an overall haircut applied after other itemized deduction limits have been applied. For example:

- The percentage-of-AGI limitations on charitable contributions must be applied first.
- The 7.5%-of-AGI floor for medical expenses is applied before the overall limitation.
- The SALT cap and mortgage interest limitations are likewise determined independently.

Because the rule applies only after other deduction-specific limits, it functions as a final "back-end" constraint rather than a substitute for those separate rules. The overall limitation is imposed on the aggregate amount of itemized deductions. Its practical effect is to convert part of the 37% bracket benefit on itemized deductions into a 35% benefit for affected taxpayers.

HOW THE NEW FORMULA WORKS

Step 1. First, compute the taxpayer's itemized deductions after applying all specific limits (such as the SALT cap, charitable contribution percentage limits, and the medical expense floor).

Step 2. The second step is to find the taxpayer's "modified taxable income." For itemizers, regular taxable income is generally AGI reduced by itemized deductions and other below-the-line deductions. For purposes of the Section 68 limitation, the taxpayer must add back the itemized deductions to recompute taxable income as if no itemized deductions were allowed. This produces the modified taxable income figure.

Step 3. The overall limitation applies only to the extent a taxpayer's modified taxable income exceeds the threshold for the 37% bracket. So, the third step in the formula is to subtract the 37% bracket threshold from modified taxable income to determine the excess. The following table summarizes these thresholds for tax year 2026:

Filing Status	2026 Threshold for 37% Bracket
Single	$640,601
Married Filing Jointly	$768,701
Head of Household	$640,601
Married Filing Separately	$384,351

Step 4. The reduction in allowable itemized deductions equals (2/37) × the lesser of (itemized deductions or the excess).

Example. A married couple filing jointly has $60,000 of itemized deductions (generated by mortgage interest, charitable contributions, and SALT). Their taxable income after subtracting full itemized deductions (but before the limitation) would be $900,000. The couple's modified taxable income (computed without regard to itemized deductions) is $960,000. The 37% bracket threshold for 2026 is $768,701. Here is how we apply the formula:

- Modified taxable income = $960,000.
- Excess over threshold = $960,000 − $768,701 = $191,299.
- Lesser of itemized deductions ($60,000) or excess ($191,299) = $60,000.
- Reduction = (2/37) × $60,000 is about $3,243.
- Allowable itemized deductions = $60,000 − $3,243 = $56,757.
- Final taxable income = $960,000 − $56,757 = $903,243.

CASUALTY AND THEFT LOSSES

A casualty loss arises from the damage, destruction, or loss of property caused by a sudden, unexpected, or unusual event — such as a fire, storm, flood, or theft. From the enactment of the modern income tax through 2017, individuals could deduct such losses.

The TCJA dramatically narrowed this deduction. Under the TCJA, taxpayers could only deduct personal casualty losses if the loss resulted from a federally declared disaster. The TCJA's restriction to federally declared disasters was a temporary measure scheduled to expire after 2025.

For tax years beginning after December 31, 2025, the OBBBA confirms that personal casualty and theft losses remain deductible only if they arise from a federally declared disaster. For federally declared disasters, the loss must occur:
- In the disaster area; and
- During the incident period specified by FEMA.

The new law also expands the scope of "eligible disasters" to include certain state-declared disasters [IRC Section 165(h)(5)]. The addition of the state-declared disaster category is new and applies to tax years beginning after December 31, 2025. Specifically, a state-declared disaster is defined as a natural catastrophe — such as a fire, storm, flood, earthquake, hurricane, or tornado — that the governor determines to be severe enough to warrant special tax treatment. This expansion is meaningful for taxpayers in states that frequently declare emergencies that do not rise to the level of federal disaster declarations.

Not all state emergencies qualify. The governor must issue a declaration, and the event must be designated as qualifying for special tax treatment. The Secretary of the Treasury must concur with the governor on eligibility under IRC Section 165(h)(5), as amended by the OBBBA.

CALCULATING THE LOSS AMOUNT

The following steps are used to determine the amount of the casualty loss for personal-use property on Form 4684, *Casualties and Thefts*.

Step 1. Determine the adjusted tax basis in the property immediately before the casualty. The adjusted basis generally equals the property's original cost plus capital improvements, reduced by any prior casualty losses claimed or other basis adjustments.

Step 2. Determine the decrease in the property's fair market value (FMV) immediately after the casualty occurred; this is the difference between the FMV immediately before and immediately after the casualty. An appraisal might be needed to document this for tax purposes.

Step 3. Take the smaller of the basis or the FMV decline.

Step 4. Finally, the amount of a casualty loss is further reduced by any insurance claim proceeds or other reimbursements received for the property. A taxpayer cannot claim a casualty loss for amounts that could have been reimbursed through insurance but were not claimed. Taxpayers with insurance or reimbursement proceeds exceeding their damaged property's adjusted basis may experience a casualty gain (potentially taxable unless deferred via replacement under Section 1033).

First 10 lines on Form 4684

Form **4684**

Department of the Treasury
Internal Revenue Service

Casualties and Thefts

Attach to your tax return.
Use a separate Form 4684 for each casualty or theft.
Go to *www.irs.gov/Form4684* for instructions and the latest information.

OMB No. 1545-0177

Attachment Sequence No. **26**

Name(s) shown on tax return | **Identifying number**

SECTION A—Personal Use Property (Use this section to report casualties and thefts of property **not** used in a trade or business or for income-producing purposes. For tax years beginning after 2017, if you are an individual, casualty or theft losses of personal-use property are deductible only if the loss is attributable to a federally declared disaster. You must use a separate Form 4684 (through line 12) for each casualty or theft event involving personal-use property. **If reporting a qualified disaster loss, see the instructions for special rules that apply before completing this section.**)

If the casualty or theft loss is attributable to a federally declared disaster, check here ☐ and enter the DR- _____ or EM-_____ declaration number assigned by FEMA. (See instructions.)

1 Description of properties (show type, location (city, state, and ZIP code), and date acquired for each property). Use a separate line for each property lost or damaged from the same casualty or theft. If you checked the box and entered the FEMA disaster declaration number above, enter the ZIP code for the property most affected on the line for Property **A**.

	Type of Property	City and State	ZIP Code	Date Acquired
Property **A**				
Property **B**				
Property **C**				
Property **D**				

		Properties			
		A	**B**	**C**	**D**
2 Cost or other basis of each property	2				
3 Insurance or other reimbursement (whether or not you filed a claim) (see instructions) **Note:** If line 2 is **more** than line 3, skip line 4.	3				
4 Gain from casualty or theft. If line 3 is **more** than line 2, enter the difference here and skip lines 5 through 9 for that column. See instructions if line 3 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year	4				
5 Fair market value **before** casualty or theft	5				
6 Fair market value **after** casualty or theft	6				
7 Subtract line 6 from line 5	7				
8 Enter the **smaller** of line 2 or line 7	8				
9 Subtract line 3 from line 8. If zero or less, enter -0-	9				
10 Casualty or theft loss. Add the amounts on line 9 in columns A through D	10				

SMALLER DEDUCTION UNDER THE STANDARD FRAMEWORK

The OBBBA made permanent the $100-per-casualty floor (per event, not per item) and the 10% of AGI limitation on aggregate net losses [IRC Section 165(h)]. Only the amount remaining after these two reductions is carried to Schedule A as an itemized deduction.

If a taxpayer suffers two separate casualty events in the same year (e.g., a storm in February and a fire in October), the $100 reduction applies twice, and the 10% AGI floor applies to the aggregate.

Example. In 2026, a married couple filing jointly with AGI of $150,000 suffers a qualifying storm loss in a state-declared disaster area. Their unreimbursed loss (after insurance) on their personal residence is $25,000 (lesser of basis or FMV decline). The table below illustrates the required computational sequence.

Step	Calculation	Deductible loss
Unreimbursed loss	Lesser of basis or FMV decline	$25,000
Subtract $100 floor	Per casualty	$24,900
Subtract 10% AGI	$15,000 (AGI $150,000)	$9,900

Taxpayers must itemize deductions on Schedule A to claim a personal casualty or theft loss; the deduction is generally not available to those who take the standard deduction. Given that the OBBBA has further increased the standard deduction amounts for 2026, relatively fewer taxpayers will choose to itemize, which further narrows the group of individuals who actually realize any benefit from the casualty-loss regime.

For high-income taxpayers, allowable casualty losses (after applying all specific limitations) are included in total itemized deductions and may be subject to the overall limitation on itemized deductions. Thus, even after surviving the statutory floors, the tax benefit of the casualty-loss deduction may be further reduced for high-income taxpayers.

The disaster-declaration requirement applies only to losses on ***personal-use property***. Losses on ***business-use property*** follow different rules: they are fully deductible, with no $100 reduction, no 10%-of-AGI rule, and no disaster declaration requirement. This distinction means that a self-employed taxpayer whose business equipment is destroyed by fire — even one not tied to any government declaration — may still claim a business casualty loss deduction under IRC Section 165(c)(1).

Example. Gilbert, a sole proprietor, had business equipment destroyed by a fire in 2026. The fire is not part of any federally or state-declared disaster. The unreimbursed loss is $40,000. Gilbert files Schedule C annually; he has never filed Schedule A. Gilbert may claim a $40,000 business casualty loss on Schedule C with no $100 floor or 10% AGI limitation.

FLEXIBLE TIMING

Casualty losses must generally be deducted in the tax year in which the loss event occurred. However, taxpayers have some flexibility when a casualty loss takes place in a federally declared disaster area. With an eligible disaster loss, the taxpayer may deduct the loss for the year it occurred, or they may choose to amend their previous year's return and deduct the loss in that prior tax year [IRC Section 165(i)]. This election applies only to federally declared disasters.

If taxpayers decide to amend their previous year's return, they can get a tax refund much earlier than if they wait to claim their loss on their current-year return (to be filed

next year). A quick tax refund should give the taxpayer additional funds to rebuild after the casualty. To do this, the taxpayer must file an amended tax return for the preceding year. The taxpayer would calculate the loss and the change in taxes precisely as if the loss occurred in that earlier year.

The deadline for taking the deduction in the earlier tax year falls on either the filing deadline for the current tax year (usually April 15) or the extended deadline for the previous tax year (usually October 15).

LARGER DEDUCTION UNDER THE QDL FRAMEWORK

In addition to the standard casualty-loss framework, Congress has periodically enacted special relief provisions for specific disasters. A separate and more favorable set of rules applies to losses designated by Congress as "Qualified Disaster Losses" (QDLs). QDLs are occasional and temporary relief for major events.

Taxpayers with QDLs can claim a more generous deduction than under the standard rules: they can deduct qualified disaster losses even if they also claim the standard deduction, their per-event limitation is generally $500 instead of $100, and they are not limited to deducting losses that exceed 10% of their AGI.

The Federal Disaster Tax Relief Act (FDTRA) of 2023 allowed individual taxpayers affected by federally declared disasters to deduct personal casualty losses without having to itemize deductions and without the typical $100 per casualty loss and 10% of adjusted gross income limitations. Instead, the deduction could be reduced by $500 per casualty loss. The FDTRA disaster relief benefits expired after December 12, 2024.

There is no QDL legislation in effect at this time. Therefore, only itemizers may deduct a disaster loss under the $100 rule and the 10%-of-AGI threshold.

OTHER ITEMIZED DEDUCTIONS

Before 2018, the lower portion of Schedule A displayed two fields for expenses not covered by the major itemized deduction categories:

- "Job Expenses and Certain Miscellaneous Deductions" subject to the 2%-of-AGI floor; and
- "Other Itemized Deductions" not subject to the 2%-of-AGI limit.

The TCJA suspended all miscellaneous itemized deductions subject to the 2% floor for tax years 2018 through 2025. As a result, the Schedule A forms from 2018 to 2025 removed the field for "Job Expenses and Certain Miscellaneous Deductions," but retained the field for "Other Itemized Deductions," not subject to the 2% rule.

The OBBBA permanently eliminates miscellaneous itemized deductions subject to the 2%-of-AGI floor for tax years beginning after 2025. The new law preserves the list of allowable "Other Itemized Deductions" exempt from the 2% limitation.

WHAT REMAINS DISALLOWED IN 2026

Because the OBBBA makes the TCJA suspension permanent, the following remain nondeductible:

- Job-search expenses;
- Home office expenses for employees;
- Hobby expenses (up to hobby income);
- Union dues and professional society memberships;
- Appraisal fees (except those related to casualty losses);
- Tax preparation fees paid to a preparer or for tax software;
- Investment advisory and management fees;
- Safe deposit box fees (when used for investment purposes);
- Legal fees related to the production of income (some legal fees remain deductible elsewhere); and
- Unreimbursed employee business expenses (other than eligible educator expenses).

Example. In 2026, a W-2 employee incurs $3,000 in investment advisory fees, $500 in tax preparation fees for their individual return, and $1,200 in union dues. Under the OBBBA, these expenses are nondeductible.

Planning considerations for disallowed expenses. Tax preparation fees paid in connection with business returns or estate/trust returns may still be deductible in those contexts (not as miscellaneous itemized deductions on an individual return).

Employees with significant unreimbursed business expenses should explore whether they qualify as independent contractors or can negotiate reimbursements under an accountable plan (which are tax-free to the employee and deductible by the employer).

WHAT REMAINS DEDUCTIBLE IN 2026

"Other Itemized Deductions" that are NOT subject to the 2% limitation can still be claimed on the 2026 version of Schedule A — specifically, on line 16, which covers the following items:

- Gambling losses (subject to a new limitation);
- Impairment-related work expenses [Section 67(d)];
- Estate tax attributable to IRD [Section 691(c)];
- Claim-of-right repayments [Section 1341]; and
- Casualty or theft losses on income-producing property.

Itemized deduction for educator expenses. As we saw in Chapter 2, educators get the $350 above-the-line deduction on Schedule 1, ***and*** the ability to deduct any excess on Schedule A. Qualifying elementary and secondary school teachers, instructors, counselors, principals, or aides can now claim unreimbursed classroom expenses as an itemized deduction when their out-of-pocket expenses exceed $350 (the cap for the above-the-line deduction). Athletic supplies are added in 2026 under the OBBBA, and the pool of eligible educators is broadened to include sports administrators and coaches.

OBBBA changes to gambling loss deductibility. Previously, taxpayers who itemized their deductions could deduct 100% of their gambling losses, up to the amount of their gambling winnings, essentially allowing break-even or losing gamblers to avoid paying taxes on gambling income. However, the OBBBA amended IRC Section 165(d)(1). The deductible amount now equals 90% of documented gambling losses. The 90% cap applies to losses, not to winnings. For tax years beginning after December 31, 2025, itemizers may deduct the ***lesser*** of gambling winnings or 90% of gambling losses.

Example. Ximena is an itemizer who visits her local Indian casino almost every Friday night. At the end of the year, she reviews her gambling diary and determines that she won $12,000 and lost $10,000. Ximena must enter the full amount of winnings on Schedule 1 ($12,000) and then deduct the allowable amount of gambling losses on Schedule A. IRC Section 165(d)(1) limits the deduction to the lesser of 90% of losses ($10,000 × 90% = $9,000) or the gains ($12,000). In this scenario, the deduction equals $9,000.

The 90% limitation also applies to professional gamblers reporting on Schedule C. Professional poker players and others who treat gambling as a trade or business often operate on thin profit margins. The 90% cap can lead to a taxable gain even in a break-even or losing year, potentially causing them to owe taxes on income they didn't actually earn. So if a professional gambler wins $250,000 and loses $250,000, only $225,000 (90% of $250,000) is deductible on Schedule C — leaving them with "phantom income" of $25,000.

Another change affecting gamblers is that the OBBBA raised the reporting threshold for gambling winnings on Form W-2G. Before 2026, there were multiple thresholds depending on the game ($600 general; $1,200 for slots and bingo; $1,500 for keno). There is now a unified threshold of $2,000 for most gambling winnings.

FORM W-2G		
Gambling Category	**2025 Threshold**	**2026 Threshold**
Slots & Bingo	$1,200 or more	$2,000 or more
Keno	$1,500 net winnings	$2,000 net winnings
Other wagers (horse racing, sports betting, etc.)	$600+ and ≥300× wager	$2,000+ and ≥300× wager
Poker tournaments	Net winnings > $5,000	Net winnings > $5,000 (unchanged)
General minimum threshold	No unified minimum; category-specific rules	New inflation-indexed $2,000 minimum applies to most categories

Impairment-related work expenses. Certain taxpayers with disabilities may deduct impairment-related work expenses necessary to enable them to be employed. These expenses, defined under IRC Section 67(d), remain deductible because they were never subject to the 2% floor. They include attendant care services and equipment required for a disabled individual to work.

Estate tax on income in respect of a decedent (IRD). IRD-related deductions appear regularly in estate and trust administration. When a taxpayer receives income in respect of a decedent — such as distributions from a decedent's IRA or deferred compensation plan — that income may have been subject to federal estate tax at the decedent's death. To mitigate double taxation, the recipient may claim an itemized deduction for the portion of estate tax attributable to that income [IRC Section 691(c)].

Repayments of income under the claim of right doctrine. Claim-of-right repayments occasionally arise in wage disputes, clawbacks, and overpayments. In limited circumstances, a taxpayer who included income in a prior year under a "claim of right" and later repays that amount (more than $3,000) may be entitled to a current-year tax benefit. Depending on the facts, this deduction may be claimed as an itemized deduction or addressed through a credit mechanism under IRC Section 1341.

Casualty and theft losses of income-producing property. Losses on income-producing property remain deductible under IRC Section 165 without regard to the 2% floor or the personal-use disaster limitations that restrict casualty losses on personal property. Income-producing property (the kind that goes on Schedule A) is a specific category that sits between personal property and true business property. It includes things like:

- Investment property (stocks, bonds, gold, collectibles);
- Vacant land held for appreciation; and
- Other property held for the production of income but not rising to a trade or business.

Example: A taxpayer owns a vacant lot held for long-term appreciation. A wildfire destroys the trees and damages the land. The lot is income-producing property (held for investment). It is not a trade or business. The casualty loss is therefore a Schedule A itemized deduction. In this case, the taxpayer deducts only the economic loss — the lesser of basis or FMV decline — not the costs of restoring or repairing the property.

Deduction category	Pre-TCJA Through 2017	TCJA 2018–2025	OBBBA 2026 and after
2%-floor deductions (Sch. A — Job Expenses)	Allowed Subject to 2% AGI floor	Suspended TCJA temporary ban	Eliminated Permanently
Non-2% deductions (Sch. A — Other)	Allowed No floor applied	Allowed Continued as before	Preserved No floor, no sunset
Gambling losses (to extent of winnings)	100% of losses capped at winnings	100% of losses + broader expense def.	90% of losses capped at winnings
Educator expenses (classroom costs)	Above-the-line Up to $250 cap	Above-the-line Up to $300 cap	Dual-track Above-the-line + Sch. A Itemizers only

LAST WORD ON LAST CATEGORY

This last bucket of write-offs on Schedule A is included in total itemized deductions and may be subject to the new overall limitation on itemized deductions under IRC Section 68. High-income taxpayers may therefore see these deductions reduced.

Although the category of "Other Itemized Deductions" is narrow, these write-offs remain important for taxpayers with specialized circumstances. Tax professionals should continue to screen for these deduction opportunities, especially for clients with educator expenses, gambling activity, or impairment-related work expenses.

REVIEW QUESTIONS

10. Which of the following statements correctly reflects the timing rule for deductible medical expenses?
{A}. Medical expenses are deductible in the year paid.
{B}. Medical expenses are deductible when reimbursed.
{C}. Medical expenses are deductible in the year the services are provided, regardless of when paid.
{D}. Because of a change implemented by the OBBBA, medical expenses are no longer deductible.

11. Warren paid $2,921 in state income taxes (as shown in box 17 of Form W-2). Box 14 of his Form W-2 shows an entry of $1,200 for California State Disability Insurance (SDI). Based on these numbers, how much can Warren (a single filer) deduct on Schedule A of Form 1040 for state and local income taxes?
{A}. $4,121; state income taxes ($2,921) plus SDI ($1,200).
{B}. Just $2,921 because the IRS does not consider SDI to be a deductible tax.
{C}. $0; the OBBBA has repealed the itemized deduction for state and local income taxes.
{D}. Just $1,200 because the IRS does not consider box 17 of Form W-2 to be a deductible tax.

12. A California client presents a property tax bill containing several line items. Which of the following items is deductible as a real estate tax on Schedule A?
{A}. A direct levy for local park maintenance and lighting.
{B}. A flat "parcel tax" used to fund the local library system.
{C}. A fixed charge for services such as garbage pickup or sewer maintenance.
{D}. The 1% ad valorem tax applied under Proposition 13 based on the property's assessed value.

13. In 2026, Eliana donates a sofa, dining table, and lamps to a qualified charity. She values the items at $420 in the aggregate. The items are picked up from her porch, and Eliana keeps a detailed written list describing each item, its condition, and estimated value. She also takes photos. Which of the following is the most accurate statement regarding substantiation?
{A}. She must complete Section B of Form 8283 because the donation exceeds $250.
{B}. She needs a contemporaneous written acknowledgment (CWA) from the charity because the donation exceeds $250.
{C}. She must get a formal appraisal of the donated property and attach it to her return.
{D}. She is not required to obtain a CWA because the donation's value is under $500.

14. The OBBBA's new overall limitation on itemized deductions is effective January 1, 2026. This limitation is triggered when a taxpayer's "modified taxable income" (computed without regard to itemized deductions) exceeds which specific benchmark?
{A}. The SALT cap.
{B}. The Pease limitation.
{C}. The threshold for the 37% tax bracket.
{D}. A flat amount of $384,350 for all filing statuses.

15. Carol is a commission-based outside salesperson who works for a small company. Her employer does not provide an accountable plan. In 2026, Carol incurred $4,200 in unreimbursed business travel expenses and $600 in tax preparation fees for her personal return. Carol's AGI is $90,000. How much of these expenses may the W-2 employee deduct as itemized deductions on her 2026 Schedule A?
{A}. $4,800, since both categories are now fully deductible.
{B}. $3,000, after applying the 2%-of-AGI floor to the aggregate expenses.
{C}. $600, because tax preparation fees are the only category that survived the OBBBA.
{D}. $0; these expenses are not deductible under current law.

Part E reveals the correct answers to all end-of-chapter review questions while providing feedback on both correct and incorrect responses.

Chapter 5. QUALIFIED BUSINESS INCOME DEDUCTION

Learning objective: Upon the completion of this chapter, course participants will gain a better understanding of the requirements, definitions, thresholds, and phase-outs related to the QBI deduction for pass-through businesses.

Chapter Topics

- OBBBA extends and improves the QBI deduction
- Section 199A terms and definitions
    - » Below-the-line deduction
    - » Qualified business income
    - » Qualified business loss
    - » Qualified trade or business
    - » Specified service trade or business (SSTB)
- Calculating the deduction for most claimants
    - » Income range where deduction rate = 20%
    - » Qualified business income versus taxable income
- New for 2026: OBBBA minimum QBI deduction
- Deduction limits exclusively for high-incomers
    - » The OBBBA expands the phase-out ranges
    - » The reduction ratio
    - » The applicable percentage
    - » The wage/property limit
- Calculating the deduction for high incomers
    - » SSTBs between the thresholds
    - » Non-SSTBs between the thresholds
    - » SSTBs which surpass §199A's income ceiling
    - » Non-SSTBs which surpass §199A's income ceiling
- Where to report the deduction
    - » Form 8995
    - » Form 8995-A

The overwhelming majority of businesses in the US are "pass-through" entities. A pass-through entity is a business structure that passes any income straight to its owners, shareholders, or investors. Pass-through taxation means that the business pays no federal taxes at the entity level. Instead, individual owners pay their share of federal taxes on their personal tax returns using Form 1040. Examples of pass-through businesses include sole proprietorships, partnerships, and S corporations. Limited liability companies (LLCs) are pass-through entities by default, but their owners can choose to be taxed as a C corporation.

The qualified business income (QBI) deduction, outlined in IRC Section 199A, allows most pass-through business owners to deduct a portion of their business income when computing taxable income. The IRS refers to this as the "Section 199A deduction" or "qualified business income deduction," which we abbreviate as the "QBI deduction."

At a basic level, Section 199A allows owners of sole proprietorships, partnerships, S corporations, and most LLCs to claim a 20% deduction on business income. However, the deduction amount will depend on the nature of the business activity and the owner's total income. It relies on complex rules that treat different types and sizes of businesses differently. The deduction may depend on how much the pass-through entity pays its employees and how much property it owns. Although well-intentioned, Section 199A has arguably become the most complicated provision for individuals in the Tax Code. As we will see below, claiming the QBI deduction requires navigating a tangle of limitations, thresholds, and phase-outs.

OBBBA EXTENDS AND IMPROVES THE QBI DEDUCTION

The QBI deduction was originally scheduled to expire after December 31, 2025. The OBBBA permanently extends Section 199A, maintaining the 20% deduction rate while making the following enhancements effective for tax years beginning after December 31, 2025:

● The OBBBA introduces a new minimum deduction (adjusted for inflation after 2026) for taxpayers with at least $1,000 of active QBI from materially participated businesses. In this context, "material participation" means the owner is actively involved in the business, rather than being a passive investor. This new provision ensures that small Schedule C and Schedule E filers receive at least a modest benefit even when their 20% calculation yields a negligible deduction.

● The OBBBA expands the phase-out ranges but does not alter the underlying threshold amounts, which continue to be inflation-adjusted annually. As of 2026, the phase-out range for single filers increases from $50,000 to $75,000 above the indexed threshold, and from $100,000 to $150,000 for joint filers.

These improvements, discussed later, provide long-term certainty and expand access to the QBI deduction for millions of American businesses.

SECTION 199A TERMS AND DEFINITIONS

BELOW-THE-LINE DEDUCTION

The QBI deduction is not an above-the-line deduction that adjusts gross income; it is taken after after AGI is computed but before taxable income is finalized. As such, the benefit is a "below-the-line" deduction (on line 13a of Form 1040) that affects taxable income. Noncorporate business owners can claim the deduction regardless of whether they itemize or claim the standard deduction.

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	

QBI reduces ***income tax*** but does not affect the 15.3% ***self-employment tax*** — a common source of confusion for sole proprietors. Self-employment taxes for Social

Security and Medicare are still calculated on net business income before the Section 199A deduction. For example, a taxpayer earning $100,000 and deducting $20,000 under Section 199A still pays self-employment taxes on $100,000.

QUALIFIED BUSINESS INCOME

Almost every tax deduction is linked to one's expenses in a government-approved category (e.g., paying student loan interest or making contributions to a traditional IRA). The deduction under Section 199A is unusual because it is based on incoming revenue rather than outgoing expenditures. However, not all types of "incoming revenue" qualify for the QBI deduction.

"Qualified business income" is generally defined in Section 199A(c) as the net amount of ordinary income generated (in the United States) from a noncorporate taxpayer's business during the year. Section 199A subsequently excludes several sources of income from QBI. Income that does ***not*** generate a QBI deduction includes the prospective claimant's wages, salaries, guaranteed payments, capital gains, dividends, income from businesses outside the US, and interest income not properly allocable to a trade or business.

The QBI deduction is a valuable tax benefit for sole proprietors (Schedule C), real estate investors (Schedule E), farmers (Schedule F), and individuals with business income from a partnership or S corporation who receive Schedule K-1.

For sole proprietors, the starting point for the QBI calculation is the net profit reported on line 31 of Schedule C. However, that amount will be reduced by the following Schedule 1 deductions:

- The deductible part of self-employment tax;
- Contributions to a retirement savings plan that is based on the taxpayer's self-employment earnings; and
- The self-employed health insurance deduction.

Example. A single-member LLC taxed as a sole proprietorship reports $184,000 of net profit on Schedule C for 2026. On Schedule 1, the owner claims a $13,000 deduction for one-half of self-employment tax, a $9,000 deduction for contributing to a SEP IRA, and a $12,000 deduction for self-employed health insurance. The owner materially participates in the business and has no other QBI. After making the necessary adjustments, the owner's QBI for purposes of the Section 199A deduction is $150,000.

Calculating QBI can be tricky for pass-throughs that mix income for work in the business with income for ownership of the business. Section 199A regulations prohibit treating salaries or wages paid to S corporation owners as QBI. Wages paid to shareholders lower QBI because S corporations deduct them as business expenses, reducing both net income and QBI.

Example. Jennine owns 33% of an S corporation that pays her a reasonable salary of $60,000 plus $40,000 in non-dividend distributions from corporate earnings. Jennine's

QBI from the S corporation is limited to $40,000 in distributions; the $60,000 in salary or wages do not count.

Regarding partnerships, guaranteed payments should also be excluded from qualified business income. Guaranteed payments to partners or LLC members are payments meant to compensate a partner or member for services rendered (or for the use of their capital). The payments are considered guaranteed because they are first-priority distributions and are paid even if the partnership incurs a net loss. Essentially, they are the equivalent of a salary for partners or LLC members. Many partners mistakenly assume guaranteed payments qualify for QBI — they do not.

Capital gains, dividends, and interest income are not eligible for QBI treatment. Investors cannot shift their investment income into a partnership or LLC to convert it into QBI.

Example. Laquita is a partner in a partnership. In 2026, she receives the following amounts from the partnership: $70,000 of ordinary business income, $30,000 of guaranteed payments for services, and $5,000 of interest income. Laquita's initial QBI is the $70,000 of ordinary business income. The guaranteed payments and interest income would not generate a Section 199A deduction.

Two types of investment income could count towards QBI. First, QBI might include income from a publicly traded partnership (PTP). PTPs are publicly traded companies managed by partners and financed by investors. The PTP would report qualified business income to eligible partners on Schedule K-1 (Form 1065) in box 20 with the code AD.

Second, the rules permit income from real estate investment trusts (REITs) to qualify for the Section 199A deduction. REITs allow individuals to invest in real estate without owning a physical parcel. Some REITs invest directly in properties, earning rental income and management fees. Others invest in real estate debt (i.e., mortgages and mortgage-backed securities). REITs qualify for the Section 199A deduction to the extent that their distributions are ordinary income and not attributable to long-term capital gains or qualified dividends.

Example. Rex and Savanna are married and earn $220,000 per year. This income includes Rex's $90,000 in salaries (earned while employed as a pharmacist) and $130,000 from Savanna's clothing store (a sole proprietorship reported on her Schedule C). Also, the couple has a $150,000 taxable investment portfolio that produced $3,000 in qualified dividends and $2,000 in ordinary REIT income. Rex and Savanna's total income is $225,000, of which $132,000 (including Savanna's business income and the ordinary REIT income) is qualified business income. In 2026, the couple claims above-the-line and itemized deductions, bringing their taxable income down to $173,000. As such, they will receive a $26,400 QBI deduction ($132,000 × 20%).

Income Type	QBI?	Notes
Schedule C net profit	Yes	Reduced by ½ SE tax, retirement (e.g., SEP IRA), self-employed health insurance
Partnership ordinary income	Yes	Excludes guaranteed payments
S corp distributions	Yes	Wages excluded
Capital gains	No	Always excluded
Dividends	No	Always excluded
REIT ordinary dividends	Yes	If not capital gain or qualified dividend
PTP income	Yes	If reported as QBI on K-1

QUALIFIED BUSINESS LOSS

QBI can be positive or negative. When QBI is negative, there is a qualified business loss amount.

Let's say a sole proprietorship, partnership, S corporation, or LLC generates a loss in Year 1. There would be no 20% deduction in Year 1 since there's no income. What happens to that loss in Year 2 if there is a profit (in the form of QBI) in the following year?

Section 199A(c)(2) describes the treatment of losses generated in connection with a taxpayer's qualified businesses. Under the stated rule, if the net QBI is negative, the loss is carried forward to the next tax year and included in the calculation of qualified business income for that year.

Example. Anton is one of the owners of a qualified pass-through entity. In 2025, the entity allocated a $50,000 loss to Anton. Because he materially participated in the business, he used the $50,000 loss to offset his wife's $60,000 of wages. In 2026, the pass-through entity allocates $100,000 of income to Anton. While he would generally start the process of determining his Section 199A deduction by taking 20% of $100,000, Section 199A(c)(2) provides that in finding Anton's QBI deduction for 2026, the $100,000 of income must be reduced by the $50,000 loss from 2025. Thus, while Anton will still include the full $100,000 in his 2026 taxable income, his QBI deduction will be limited to $10,000 (20% × $50,000) rather than $20,000 (20% × $100,000).

QUALIFIED TRADE OR BUSINESS

QBI includes income from a sole proprietorship, a partnership, an S corporation, an LLC, as well as agricultural and horticultural cooperatives. In addition, a real estate rental activity can generate QBI if certain conditions are met.

IRC Section 162. Several provisions in the Tax Code elicit different interpretations of what constitutes a trade or business. The highest standard is that of a Section 162 trade or business.

When Section 199A(d) requires that QBI be earned in a "trade or business," it means a Section 162 trade or business. The QBI regulations define a Section 199A business as "a trade or business under Section 162 (trade or business expenses) other than the trade or business of performing services as an employee."

Over the years, what rises to the level of a Section 162 business has been largely determined by the courts, which have generally held that the taxpayer must be involved in the activity with continuity and regularity. In the words of the Supreme Court: "We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit" (Commissioner v. Groetzinger, 1987).

Rental real estate activities. IRS guidance clarifies that not all real estate income is eligible for the QBI deduction. Before claiming the deduction, landlords and real estate investors must demonstrate that they are operating a Section 162 business that involves spending a substantial amount of time overseeing and managing the rental property.

The IRS has issued a safe harbor rule for real estate investors. According to Notice 2019-7, a rental real estate enterprise will be treated as a Section 199A "trade or business" if the following requirements are satisfied during the tax year:

- Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise;
- The taxpayer retains contemporaneous records, including time reports, logs, or similar documents; and
- The property owners, or someone they hire, spend at least 250 hours a year on the business.

The IRS says the 250-hour requirement may include services performed by owners, employees, and independent contractors. The 250 hours could be spent on maintenance, repairs, rent collection, payment of expenses, tenant services, and efforts to rent the property. However, hours spent in the owner's capacity as an investor — such as arranging loans, procuring a new property, reviewing financial statements, as

well as traveling to and from the real estate — will not be considered hours of service for the enterprise.

Substantial case law holds that rental real estate activities generally rise to the level of a Section 162 business activity, except in triple net lease arrangements. In a triple-net lease, a tenant is responsible for paying rent, property taxes, as well as repairs and maintenance. Property leased under a triple net lease or used by the taxpayer as a residence for any part of the year would not be eligible under the proposed safe harbor.

SPECIFIED SERVICE TRADE OR BUSINESS (SSTB)

From a macro viewpoint, an economy may be divided into three different sectors:
- The extractive sector, which includes agriculture and mining;
- The goods-producing sector, which contains manufacturing; and
- The service sector.

For Section 199A deduction purposes, the QBI of an entity must be earned in a qualified trade or business. An eligible business inherently includes unincorporated enterprises in the agriculture and manufacturing sectors. Thus, a self-employed farmer (in the agriculture sector) and a dressmaker (in the manufacturing sector) would be prime candidates for the QBI deduction.

Not everyone working in the service sector would be linked to "a qualified trade or business." According to IRC Section 199A(d)(1), the term "qualified trade or business" means any trade or business other than "a specified service trade or business." As such, Section 199A(d) presents two mutually exclusive types of pass-through businesses:
- A "qualified trade or business," and
- A "specified service trade or business" (SSTB).

The SSTB category encompasses "specified" service businesses, not any or all service businesses. An SSTB is any trade or business involving the performance of services in the fields of:
- Accounting;
- Actuarial science;
- Brokerage services;
- Consulting;
- Financial services;
- Health;
- Law;
- Athletics;
- Performing arts; and
- Any trade or business where the "principal asset" is the "reputation or skill" of one or more of its employees or owners.

The IRS clarifies that the "principal asset" test applies only to celebrities who earn income from endorsements, appearance fees, or licensing. On its website, the IRS

writes: “The principal asset of a trade or business is the reputation or skill of its employees or owners if the trade or business consists of the receipt of income from endorsing products or services, the use of an individual’s image, likeness, voice or other symbols associated with the individual’s identity, or appearance at events or on radio, television and other media outlets.” For instance, income Ariana Grande earns endorsing Swarovski Jewelry would generate no Section 199A deduction because the “principal asset” of these activities is her “reputation and skill.”

The availability of the QBI deduction is not guaranteed to accountants, consultants, dentists, doctors, investment advisers, lawyers, stockbrokers, performing artists, athletes, and celebrities. On the other hand, service-oriented businesses that are not considered SSTBs include architects, engineers, real estate agents/brokers, and insurance agents/brokers.

Non-SSTB. A “qualified trade or business” is defined by Section 199A(d)(1) as any business that is not an SSTB. This chapter will refer to a qualified trade or business as a “non-SSTB.” We find this label appropriate because a “qualified trade or business” and an SSTB can both “qualify” for the Section 199A deduction, so the Section 199A term doesn’t help distinguish one kind of business from the other.

CALCULATING THE DEDUCTION FOR MOST CLAIMANTS

Different sets of rules apply to the QBI deduction depending on the pass-through owner’s taxable income level and the type of business activity. Each individual’s QBI computation depends on the specific facts of their business, marital status, and other income sources.

INCOME RANGE WHERE DEDUCTION RATE = 20%

Business owners can deduct 20% of the income they receive from their pass-through businesses if the taxable income (determined without the QBI deduction) they report on their personal returns does not exceed certain thresholds. Section 199A(b)(3)(A) provides that if taxable income for the year (not QBI) is less than the “threshold amount” for the year, then the business owner can claim the deduction regardless of the type of business. For taxpayers below the threshold, whether their business is an SSTB or a non-SSTB does not matter.

The threshold amount is a specific dollar amount of taxable income (computed without the QBI deduction). Per Revenue Procedure 2025-32, the Section 199A threshold amounts for 2026 are:

- $403,500 for married taxpayers filing jointly (joint filers);
- $201,775 for married filing separately; and
- $201,750 for unmarried filers (singles and head-of-household filers).

QUALIFIED BUSINESS INCOME VERSUS TAXABLE INCOME

IRC Section 199A is called “Qualified business income,” so the deduction described in this Tax Code section is referred to by the IRS and others in the tax professional

community as the “Qualified business income” deduction or QBI deduction. There are good reasons for labeling the write-off in this way. Yet, under the technical definitions in Section 199A, the 20% deduction may be based on *taxable income* when that amount is less than *qualified business income*.

For most pass-through business owners
the Section 199A deduction is 20%
of QBI or taxable income (not including net capital gains)
whichever is less

Suppose a pass-through business owner qualifies for the QBI deduction. The deduction will be based on qualified business income, not the taxpayer’s wages or investment income. The tax break will apply to the lesser of the taxpayer’s combined qualified business income amount or their taxable income minus any net capital gains. Taxable income is determined without factoring in the QBI deduction.

If a taxpayer has net capital gains, those gains may reduce the QBI deduction. The QBI deduction is the lesser of:
- 20% of qualified business income; or
- 20% of taxable income, not including net capital gains.

Example. Terrell and Cynthia are joint filers who operate a pet food business that generated $100,000 in QBI in 2026. They also realized $5,000 in net capital gains. After accounting for other deductions (not including the QBI deduction), their taxable income is $66,000. The couple is eligible to claim a Section 199A deduction based on the lower of the following two amounts:
- 20% of $100,000 (QBI), totaling $20,000; or
- 20% of taxable income after subtracting net capital gains, calculated as 20% of ($66,000 minus $5,000), which equals $12,200.

Therefore, Terrell and Cynthia are permitted to claim a $12,200 deduction.

NEW FOR 2026: OBBBA MINIMUM QBI DEDUCTION

Beginning in 2026, the OBBBA introduces a minimum QBI deduction for certain taxpayers [under Section 199A(i)]. If a taxpayer has at least $1,000 in qualified business income and actively participates in the business, they qualify for a minimum deduction of $400, even if the 20% calculation would result in a smaller amount. The minimum deduction is $400 — it applies only when the standard 20% calculation would yield less than $400.

The $400 minimum deduction requires material participation within the meaning of IRC Section 469(h). Passive investors (e.g., limited partners who do not meet material participation tests) do not qualify for the minimum.

Both the income floor ($1,000) and deduction amount ($400) will be adjusted annually for inflation starting in 2027.

This provision ensures that small business owners receive at least some benefit from Section 199A, even when the standard calculation would otherwise yield a negligible deduction. It provides a safety net for modest QBI amounts and simplifies compliance for very small businesses.

Example. Janessa operates a small sole proprietorship that generates $1,200 of QBI. Under the standard 20% calculation, her QBI deduction would be $240. However, because she meets the minimum income requirement and materially participates in the business, Janessa is entitled to the $400 minimum deduction.

DEDUCTION LIMITS EXCLUSIVELY FOR HIGH-INCOMERS

THE OBBBA EXPANDS THE PHASE-OUT RANGES

As mentioned above, the Section 199A income thresholds for 2026 are $403,500 for joint filers, $201,775 for married filing separately, and $201,750 for unmarried filers. These are the starting points for phasing out the QBI deduction. Pass-through business owners with taxable income below these thresholds can claim a full QBI deduction (assuming all other requirements are met). A given threshold is the point where the "simple" QBI deduction ends and the "complex" rules begin.

Threshold vs phase-out range. The phase-out range is the income band above the threshold and below the "ceiling." In this zone, the limitations gradually kick in over a set dollar width. In the context of Section 199A, crossing the lower threshold does not eliminate the deduction; it simply changes the computational regime.

If a pass-through business owner is below the first threshold, the QBI deduction generally works at full strength. If their income falls within the phase-out range, the deduction is reduced. When income exceeds the upper end of the phase-out range (the "ceiling"), SSTB owners lose the deduction entirely, while non-SSTB owners might still get a deduction — subject to a restrictive set of rules discussed below.

Before the OBBBA, the phase-out range was $50,000 for unmarried filers and $100,000 for joint filers. The OBBBA expands these phase-out ranges to $75,000 for unmarried filers (from $50,000) and to $150,000 for joint filers (from $100,000).

Filing Status	Threshold	Phase-Out Range	Ceiling
Single/Unmarried	$201,750	+ $75,000	= $276,750
Married Filing Jointly	$403,500	+ $150,000	= $553,500
Married Filing Separately	$201,775	+ $75,000	= $276,775

The OBBBA expanded the phase-out range but does not change how the limitation formulas operate. Because the phase-out range is expanded, SSTB owners now have

a wider income window in which they can claim a partial QBI deduction before it is fully eliminated.

THE REDUCTION RATIO

Unmarried filers with a taxable income between $201,750 and $276,750 (or joint filers with taxable income between $403,500 and $553,500) will see their Section 199A deductions phased out [Rev. Proc. 2025-32]. The method of phasing out the QBI deduction depends on the Section 199A business category. SSTBs calculate the phase-out in one way, while non-SSTBs compute the reduction in another way.

Those with taxable income (determined without the QBI deduction) in the phase-out range may have to reduce their QBI by a "reduction ratio" equal to the proportion of taxable income encroaching into the phase-out zone.

The reduction ratio for:	***Can be found with this formula:***
Unmarried filers	(Taxable income – $201,750) ÷ $75,000
Joint filers	(Taxable income – $403,500) ÷ 150,000

THE APPLICABLE PERCENTAGE

Taxpayers owning an SSTB with taxable income (determined without the QBI deduction) in the phase-out range must use another formula term beyond the reduction ratio. These taxpayers will have to reduce their tentative deduction numbers by an "applicable percentage." SSTB owners in the phase-out range can find the applicable percentage with the following simple formula:

100% – Reduction Ratio = Applicable Percentage

Example 1. A married couple files jointly and reports a taxable income of $418,500. When we plug this dollar amount into the reduction ratio formula, we find that these SSTB owners have crossed into the phase-out range by 10% [($418,500 − $403,500) ÷ $150,000]. Since the reduction ratio is 10%, the couple's applicable percentage is 90% (100% − 10% = 90%).

Example 2. A single person reports a taxable income of $261,750. When we plug this dollar amount into the reduction ratio formula, we find that this SSTB owner has traversed the phase-out range by 80% [($261,750 − $201,750) ÷ $75,000]. Since the reduction ratio is 80%, the person's applicable percentage is 20% (100% − 80% = 20%).

How is the applicable percentage used? When SSTB business owners have taxable income that falls in the QBI phase-out range, the applicable percentage will be multiplied against their tentative deduction and other business attributes discussed in the next section.

THE WAGE/PROPERTY LIMIT

Section 199A separates SSTBs from non-SSTBs, and it also puts owners of pass-through entities into one of three income categories:

- Those below the taxable income threshold;
- Those above the taxable income threshold and within the phase-out range; and
- Those above the phase-out range.

The limits discussed in this section do not apply to unmarried filers whose taxable income (determined without regard to the QBI deduction) is less than $201,750 (or $403,500 for joint filers). However, if taxable income exceeds this lower threshold, IRC Section 199A(b)(2) activates limitations relating to employee wages and depreciable assets owned by the business. Specifically, the tentative deductible amount for a pass-through business is limited to the lesser of:

- 20% of the taxpayer's QBI; or
- The greater of (a) 50% of W-2 wages paid by the business, or (b) 25% of W-2 wages paid by the business plus 2.5% of the unadjusted basis immediately after acquisition (UBIA) of property used in the business.

Once the taxable income of a pass-through business surpasses the lower threshold, the standard 20% QBI deduction begins to decrease, and the Section 199A write-off becomes more reliant on the amount of wages paid and depreciable property used in the business.

W-2 wages paid by the business. The taxpayer's pro rata share of the total W-2 wages paid by the business (including wages paid to the taxpayer) could be a factor in determining the QBI deduction. For Section 199A purposes, W-2 wages are defined as total wages paid during the calendar year that are subject to withholding, elective deferrals, and deferred compensation. W-2 wages for Section 199A purposes are determined under regulatory methods and do not necessarily equal any single box on Form W-2.

Revenue Procedure 2019-11 offers guidance on finding the amount of W-2 wages for the QBI deduction. The revenue procedure provides taxpayers with three methods to calculate W-2 wages for purposes of Section 199A. The first method is simpler, while the second and third methods are more complex but may yield higher W-2 wage totals (along with larger deductions). The three different calculation options are briefly described below:

- The simple method involves taking, without modification, the lesser of the amount reported in box 1 or box 5 of the Form W-2 filed by the business owner.
- The modified box 1 method involves making modifications to the total entries in box 1 of all W-2s filed by subtracting amounts that are not wages for federal income tax withholding purposes (such as supplemental unemployment compensation benefits) and adding the total amounts of various elective deferrals that are reported in box 12.
- Under the tracking wages method, the taxpayer tracks wages subject to federal income tax withholding and elective deferrals reported in box 12 with codes D, E, F, G, and S.

Unadjusted basis immediately after acquisition (UBIA). Publication 535 defines UBIA as "the basis of the qualified property on the placed-in-service date." To count as "qualified property," the property must be tangible, subject to depreciation, and used to produce qualified business income.

Because UBIA uses the property's value "immediately after acquisition," depreciation, bonus depreciation, and Section 179 expensing have no impact on this number. However, the property used to calculate UBIA must still be within its depreciation period, which is 10 years from the date it was first put into use by the business. Property that has surpassed this period is not included in the calculation.

Example. Alba conducts business as a sole proprietor, making widgets. She bought a widget-making machine for $100,000. It now has a remaining basis of $50,000. Alba will continue to depreciate the property on her 2026 return. Assume that Alba's sole proprietorship rises to the level of a Section 199A and Section 162 business and that she is subject to the wage and property limit. When calculating the UBIA of depreciable property, Alba will use the original $100,000 basis rather than the remaining basis of $50,000.

The regulations under Section 199A require business property to be held at the close of the tax year to count towards the limitations test. Property sold during the year would not be included as qualified business property. Therefore, a calendar year taxpayer who finalizes the sale of business-related real estate on December 31 could not use any basis associated with the property as part of its UBIA calculation for that tax year.

Businesses cannot simply acquire property briefly at the end of the year to "beef up" the UBIA amount. Property that is acquired within 60 days of year-end and disposed of within 120 days without being used in the business for at least 45 days is not counted towards UBIA [Treasury Regulation 1.199A-2(c)(1)(iv)].

Substantial UBIA may be needed to avoid a reduction of the 20% QBI deduction. For example, if a business has no wages, 2.5% of UBIA would need to be eight times the amount of QBI to take advantage of the full 20% QBI deduction (because .20 × QBI = .025 × 8 × QBI).

CALCULATING THE DEDUCTION FOR HIGH INCOMERS

SSTBs BETWEEN THE THRESHOLDS

The QBI deduction remains partially available to specified service businesses until the unmarried filer's overall taxable income reaches $276,750 (or $553,500 if the taxpayer files jointly). The deduction disappears entirely when an unmarried filer's income exceeds $276,750 (or $553,500 for joint filers).

Extended example. Adam and Helen are married. Adam earns $300,000 of QBI from a specified service business; his share of W-2 wages paid by the pass-through entity is $40,000; and his share of the unadjusted basis of qualified property held by the

business is $0. Helen earns wages from her job, so Adam and Helen's taxable income is $456,000 (which exceeds the lower threshold for joint filers). Since QBI is less than the couple's taxable income, Adam's business deduction will hinge on QBI.

The income phase-out for an SSTB is based on several key numbers on a personal tax return, not just the amount of business income. For instance, Adam's business income is $300,000, which is below the $403,500 threshold. However, Adam and Helen's combined taxable income is $456,000, which is enough to partially phase out the QBI deduction for Adam's specified service business income.

● Step 1. What would Adam's deduction have been if his taxable income were less than $403,500? Section 199A limits don't apply below the threshold — so Adam would take a deduction of 20% of QBI. If the QBI is $300,000, 20% equals $60,000. This number will be used in the Step 4 calculations.

● Step 2. Here, Adam will determine how much his taxable income exceeds his threshold.

Taxable income	$456,000
Threshold	$403,500
Excess taxable income	$52,500

Next, we use these numbers to find the reduction ratio.

Excess taxable income	$52,500
Total phase-out range	$150,000
Reduction ratio	35%

● Step 3. Section 199A(d)(3)(B) then requires Adam to compute his "applicable percentage," which is 100% minus the percentage found in Step 2.

Starting Percentage	100%
Reduction ratio	35%
Applicable percentage	65%

● Step 4. In computing the Section 199A write-off of a specified service business, the taxpayer will use the applicable percentage to prorate his deduction, allocable W-2 wages, and eligible property.

In Adam's case, he is only entitled to use 65% (the applicable percentage) of his business attributes towards the QBI deduction. In other words, his tentative QBI deduction of $60,000 in Step 1 gets reduced to $39,000 ($60,000 × 65%); his initial wage payments of $40,000 are now $26,000 ($40,000 × 65%), while his unadjusted basis of the business property remains at $0.

In a best-case scenario, Adam's QBI deduction would have been $60,000 (20% of QBI). His deduction decreased to $39,000 after applying the applicable percentage. We now plug the numbers from the paragraph above into the wage and property formula to see whether Adam's deduction amount will be further reduced. Adam's $39,000 QBI deduction might be further reduced if any of the numbers below are less than $39,000. If so, Adam's deduction will equal the higher number of (a) or (b):
(a) 50% of allowable W-2 wages ($26,000), which equals $13,000; or
(b) 25% of the allowable W-2 wages ($26,000), or $6,500, plus 2.5% of $0 in business property, for a total of $6,500.

Thus, Adam's deduction is now lowered to the $13,000 in (a). Adam might have qualified for a $39,000 deduction if the wage-and-property formula had not been applied.

● Step 5. The "excess amount" is the extra deduction allowed to a pass-through business owner in the absence of the wage and property limit. For Adam, the excess amount is the modified QBI deduction minus the wage limit, or $39,000 minus $13,000, which equals $26,000. This excess amount of $26,000 will be used in the next step.

● Step 6. Here, we must reduce the excess amount by the reduction ratio from Step 2.

Adam is given a range of $150,000 of taxable income — from $403,500 to $553,500 — before his $26,000 extra deduction is eliminated. So, it makes sense that the $26,000 excess amount should be reduced to the same extent that Adam burns through the $150,000 phase-out range.

Adam started with an excess amount of $26,000 — that is, a $39,000 deduction when a $13,000 wage and property limit would have otherwise applied. Now that Adam has gone through 35% of the phase-out range, he should lose 35% of the $26,000 extra deduction, or $9,100.

As a final step, we reduce Adam's tentative QBI deduction of $39,000 by the appropriate amount.

20% of QBI deduction (computed with applicable percentage)	$39,000
35% of the $26,000 excess amount	$9,100
Final QBI deduction	$29,900

Therefore, after applying all Section 199A reductions and limitations, Adam is entitled to a QBI deduction of only $29,900 for his SSTB activity.

Below is a worksheet that summarizes the key steps for calculating the QBI deduction on Form 8995-A.

Worksheet for Adam and Helen's SSTB activity		
Line	*Action*	*Entry*
1	Enter the tentative 20% QBI deduction for this activity, and multiply by the applicable percentage	$60,000 × 65% = $39,000
2	Enter W-2 wages paid by the taxpayer that are allocable to this business, and multiply by the applicable percentage	$40,000 × 65% = $26,000
3	Multiply Line 2 by 0.5	$13,000
4	Multiply Line 2 by 0.25	$6,500
5	Enter the UBIA of qualified property AND multiply by the applicable percentage	$0
6	Multiply Line 5 by 2.5% (0.025)	$0
7	Add Line 4 and Line 6	$6,500
8	Enter the greater of Line 3 or Line 7. This number will be the potential wage and property limitation	$13,000
9	Subtract Line 8 from Line 1. Enter zero if negative. This is the potentially disallowed tentative deductible amount due to the limitation	$26,000
10	Multiply Line 9 by the applicable percentage	$26,000 × 65% = $16,900
11	Add Line 8 to Line 10. This is the deduction for the business after applying the wage/property limit and the applicable percentage	$29,900

NON-SSTBs BETWEEN THE THRESHOLDS

As mentioned earlier, the maximum QBI deduction rate of 20% could be available to unmarried filers with taxable income below $201,750 (or $403,500 for joint filers). However, when taxable income exceeds this threshold, the Section 199A formula activates limitations relating to the wages paid to employees and depreciable assets owned by the pass-through business.

When taxable income exceeds the lower threshold, business owners must start factoring in the wage and property limit, but not all at once. The limitation will be "phased in" over the next $75,000 of taxable income (or $150,000 for joint filers).

Extended example. Flynn and Elisa are married and file jointly. Flynn earns $300,000 from a non-SSTB. His share of the W-2 wages paid by the qualified business (an S corporation) is $40,000. Flynn's share of the unadjusted basis of qualified property held by the S corporation is $0. Elisa earns wages from her job, which lift the couple's taxable income to $456,000. This taxable income amount exceeds the $403,500 threshold for joint filers, so the married couple will need to reduce their QBI deduction.

● Step 1. What would Flynn's deduction have been if his taxable income were less than $403,500? Flynn's QBI of $300,000 would have resulted in a $60,000 write-off ($300,000 × 20%) in the best-case scenario.

● Step 2. Now that we know Flynn's maximum deduction would have been $60,000, let's find his deduction amount per the wage and property formula. Here, Flynn's $60,000 deduction could be decreased — but not increased — to (a) or (b), whichever number is higher:
(a) 50% of W-2 wages ($40,000), which equals $20,000; or
(b) 25% of W-2 wages ($40,000), which equals $10,000, plus 2.5% of $0 in business property, for a total of $10,000.

So, when applying the wage and property limit, Flynn is restricted to a deduction of $20,000 — the higher number in (a).

● Step 3. In this step, we get the "excess amount" described in Section 199A(b)(3)(B)(iii). The excess amount equals the full QBI deduction amount from Step 1 minus the wage and property limits from Step 2. In this case, $60,000 (from Step 1) minus $20,000 (from Step 2) equals $40,000.

● Step 4. Once taxable income exceeds the threshold, unmarried filers start to lose the benefit of that excess amount (found in Step 3), bit by bit, over the next $75,000 of taxable income (or $150,000 for joint filers). But by how much? Section 199A(b)(3)(B)(ii) gives us a reduction ratio for this part of the calculation.

Since Flynn is a joint filer, he is given a range of $150,000 of taxable income — from $403,500 to $553,500 — before his $40,000 excess amount is eliminated. Flynn should reduce the $40,000 excess amount based on how far he is into that $150,000 range.

How much of the business owner's taxable income exceeds their threshold?

Taxable income	$456,000
The threshold for joint filers	$403,500
Excess taxable income	$52,500

In this case, Flynn has traversed $52,500 through a $150,000 phase-out range. Next, we divide these two dollar amounts to get the reduction ratio.

Excess taxable income	$52,500
Total phase-out range	$150,000
Reduction ratio	35%

● Step 5. Flynn started with an "excess amount" of $40,000 (as determined in Step 3). Now that Flynn has run through 35% of the phase-out range, he should lose 35% of that $40,000 excess, or $14,000.

As a final step, we reduce Flynn's tentative QBI deduction of $60,000 from Step 1 by the appropriate amount.

20% of QBI deduction	$60,000
35% of $40,000 excess amount	$14,000
Final QBI deduction	$46,000

After applying Section 199A limitations on business owners with taxable income in the phase-out range, we find that Flynn is entitled to a QBI deduction of only $46,000 for his non-SSTB activity.

Worksheet for Flynn and Elisa's non-SSTB activity		
Line	*Action*	*Entry*
1	Enter the tentative 20% QBI deduction for this activity without regard to Section 199A limits	$60,000
2	Enter W-2 wages paid by the taxpayer that are allocable to this business activity	$40,000
3	Multiply Line 2 by 0.5	$20,000
4	Multiply Line 2 by 0.25	$10,000
5	Enter the UBIA of qualified property	0
6	Multiply Line 5 by 2.5% (0.025)	0
7	Add Line 4 and Line 6	$10,000
8	Enter the greater of Line 3 or Line 7. This dollar amount is the potential wage and property limitation	$20,000
9	Subtract Line 8 from Line 1. Enter zero if negative. This is the potentially disallowed tentative deductible amount due to the limitation	$40,000
10	Multiply Line 9 by the reduction ratio	$40,000 × .35 = $14,000
11	Subtract Line 10 from Line 1. This dollar amount is the deduction for this activity after applying the wage/property limit and the reduction ratio	$46,000

Had Flynn and Elisa's taxable income exceeded $553,500, their $40,000 excess amount would have been reduced 100%, bringing their QBI deduction down to the $20,000 wage and property limit. In other words, non-SSTB owners who pay wages and own depreciable property could still see a QBI deduction even after surpassing the Section 199A income ceiling.

SSTBs WHICH SURPASS §199A'S INCOME CEILING

Calculating the QBI deduction is relatively straightforward for unmarried filers with taxable income below the $201,750 threshold (or $403,500 for joint filers). Basically, the deduction equals 20% of QBI or taxable income, whichever is lower.

When claimants fall in the phase-out range for the QBI deduction, the computation rules get lengthy and complex. To further complicate matters, the deduction formulas change depending on the claimant's filing status and type of business (SSTB or non-SSTB).

When claimants exceed the income ceilings for the QBI deduction, the computation rules become simpler.

For specified service businesses — such as accounting firms, law firms, and doctors' offices — the deduction is reduced to zero when the thresholds and phase-out ranges are exceeded. The highest income level has no applicable percentages or wage and property limits.

Suppose taxable income is more than $276,750 for unmarried filers (or $553,500 for joint filers). At this income level, the reduction ratio becomes 100% (the applicable percentage becomes 0%), and the QBI deduction is reduced to zero for an SSTB.

Example. Saul is an attorney who owns an SSTB. He is married to Rena, a VP at a pharmaceutical company. In 2026, Saul has QBI of $300,000 from his specified service business, while Rena earns a salary of $320,000. After entering other sources of income and deductions, Saul and Rena's taxable income is $560,000. Since the couple's taxable income exceeds the upper threshold for joint filers ($553,500), Saul and Rena will receive no QBI deduction.

NON-SSTBs WHICH SURPASS §199A'S INCOME CEILING

High-income taxpayers in SSTBs cannot claim a QBI deduction after exceeding the $276,750 or $553,500 thresholds. However, other taxpayers with QBI from a non-SSTB could still qualify for the Section 199A deduction, depending on how the wage and property formula plays out.

The terms "phase-out" and "income ceiling" don't apply in the usual way with non-SSTBs. Yes, there's a phase-out of the QBI deduction for unmarried filers with taxable income between $201,750 and $276,750 (or $403,500 and $553,500 for joint filers). While moving across the phase-out stretch, the deduction is slowly chipped away by the reduction ratio. When the "income ceiling" is reached, non-SSTBs are not automatically prohibited from claiming the QBI deduction. What happens instead is that their deduction becomes entirely subject to the wage and property limit.

After surpassing the income ceiling, many non-SSTBs will see their QBI deduction go down to zero. However, the owner of a non-SSTB business with taxable income over the Section 199A income ceiling might still qualify for a deduction if they do at least one of the following:

● Employ a substantial number of people relative to the size of the business since this would boost the QBI deduction under the W-2 wages limit; or

● Make significant investments in business property since this would raise the deduction under the UBIA component.

Extended example. Wesley is a single tax filer. He owns a 12-unit apartment building. During the year, he devoted more than 250 hours to his rental real estate business (which is not a specified service business). In 2026, Wesley earned $314,000 in net income from his qualified business (as reported on Schedule E). The rental enterprise

paid $50,000 in wages to a property manager. The original depreciable basis of the apartment building was $1 million.

After accounting for deductions (other than the QBI deduction), Wesley ends up with a taxable income of $290,000, which exceeds the phase-out level of $276,750 for single filers. In this case, Wesley will need to apply the wage and property limit to determine the amount of his deduction.

Wesley's deduction would be computed as follows:
(a) 50% of W-2 wages ($50,000), which equals $25,000; or
(b) 25% of W-2 wages ($50,000), or $12,500, plus 2.5% of $1,000,000 in business property, or $25,000, for a total of $37,500.

After applying the wage and property limit, Wesley is entitled to the higher deduction amount in (b): $37,500. Wesley's QBI deduction for 2026 is therefore $37,500.

Given that Wesley's income exceeded the phase-out level of $276,750, he must fully apply the wage and property limits, resulting in a final deduction of $37,500. There is no need to use the reduction ratio or applicable percentage for non-SSTB owners in this income range.

Taxable income (before QBI deduction)	SSTB (e.g., law, health, consulting)	Non-SSTB (e.g., retail, farming, most rentals)
Below threshold: ● $201,750 single ● $403,500 joint	Full 20% of lesser of QBI or (taxable income minus net capital gain)	Full 20% of lesser of QBI or (taxable income minus net capital gain)
Within phase-out range: $201,750–$276,750 single $403,500–$553,500 joint	Partial: Applicable % × tentative 20% QBI, then subject to wage/property limit phased in	Partial: 20% QBI reduced by wage/property limit phased in via reduction ratio
Above upper limit (phase-out ends)	$0 deduction	Limited to wage/property limit (greater of 50% W-2 wages or 25% W-2 + 2.5% UBIA)

SSTBs and non-SSTBs below the first income threshold generally qualify for a full QBI deduction (20% of QBI or taxable income)	
Pass-through businesses (SSTBs and non-SSTBs) in the phase-out range may get a partial QBI deduction depending on W-2 wages paid and/or the UBIA of qualified business property	
SSTBs over the phase-out range get no QBI deduction	**non-SSTBs over the phase-out range might get a QBI deduction depending entirely on W-2 wages paid and/or the UBIA of qualified business property**

WHERE TO REPORT THE DEDUCTION

FORM 8995

Most pass-through business owners who claim the QBI deduction need only complete Form 8995, a relatively simple one-page document. Form 8995 is for business owners whose taxable income before the QBI deduction doesn't reach the first threshold for their filing status ($201,750 for unmarried filers and $403,500 for joint filers). The form consists of one section (with 17 lines) that guides us through a straightforward computation of the QBI deduction. Form 8995 is required for QBI-eligible taxpayers who:

- Have qualified business income, qualified REIT dividends, or qualified PTP income;
- Have taxable income that does not exceed the lower threshold amount; and
- Are ***not*** patrons of agricultural and horticultural cooperatives.

An agricultural or horticultural cooperative is a type of business entity in which farmers and growers come together to pool their resources and expertise to achieve common goals, such as improving market access, strengthening bargaining power, and securing supplies.

FORM 8995-A

A smaller group of pass-through business owners must complete Form 8995-A. This form is for more complex scenarios, such as business owners with taxable income in the phase-out range, or patrons of a specified cooperative. In addition to the information required for Form 8995, those who use the longer form must complete four sections and supplementary schedules to help them determine their deduction.

Example. Ruben is a construction business owner who files his Form 1040 (and Schedule C) as a single taxpayer. His total taxable income before the qualified business income deduction for 2026 is $150,000. Since Ruben's income is below the $201,750 threshold, he would calculate his pass-through deduction using Form 8995. However, if Ruben's total taxable income before the QBI deduction is $210,000, he would need to use Form 8995-A.

REVIEW QUESTIONS

16. Gwen owns four rental properties. She could be eligible for the QBI deduction on that rental income if her real estate activity rises to the level of a Section 162 business. Separate books and records are maintained for each rental real estate enterprise, and Gwen retains contemporaneous records. Which of the following rental scenarios is specifically **EXCLUDED** from the Section 199A safe harbor?

{A}. A single-family rental home where Gwen records 260 hours of service annually.
{B}. A multi-unit residential property with 300 hours of employee service per year.
{C}. A property leased under a triple net lease where the tenant is responsible for taxes, insurance, and maintenance.
{D}. A residential property with a hired property manager who spends 275 hours per year on tenant services.

17. Ted is a single taxpayer with taxable income of $180,000 and $100,000 of QBI from his non-SSTB pass-through business. The business pays W-2 wages and has tangible business property, subject to depreciation. Which of the following best describes the application of the wage/property limitation to Ted's QBI deduction?
{A}. The wage/property limitation **fully applies** because Ted's taxable income is above the threshold.
{B}. The wage/property limitation **does not apply** because Ted's taxable income is below the threshold.
{C}. The wage/property limitation **partially applies** because Ted is within the phase-out range.
{D}. The wage/property limitation **applies only if** wages and property exceed $1 million.

18. Nerisa is a single pediatrician (SSTB) with $100,000 of QBI. Nerisa's 2026 taxable income is $231,750, placing her $30,000 into the $75,000 phase-out range. Nerisa's reduction ratio is 40%, and her applicable percentage is 60%. She pays wages to her office staff and owns depreciable medical equipment with UBIA. Which statement best describes how Nerisa's Section 199A QBI deduction is determined?
{A}. Her deduction is calculated by applying the **applicable percentage (60%)** directly to Nerisa's QBI, W-2 wages, and UBIA of qualified property.
{B}. Her deduction is calculated by applying the **reduction ratio (40%)** directly to Nerisa's QBI, W-2 wages, and UBIA of qualified property.
{C}. Her deduction is limited to **20% of her QBI**, as the wage and property limitations apply only to non-SSTB entities.
{D}. Because she is an SSTB owner above the $201,750 threshold, her deduction is **$0** regardless of wages paid or property owned.

19. Rashaad and Pamela file jointly in 2026. Rashaad's non-SSTB business pays $60,000 in W-2 wages. His share of UBIA is $0. The couple's taxable income is $410,000. If their taxable income had been less than $403,500, Rashaad's QBI of $350,000 would have resulted in a $70,000 write-off ($350,000 × 20%). What is Rashaad's QBI deduction after applying the wage and property formula?
{A}. The wage and property limits don't apply to a non-SSTB, so Rashaad's final deduction amount will remain $70,000.
{B}. 50% of W-2 wages ($60,000) equals $30,000. This is Rashaad's tentative deduction before applying the reduction ratio and excess amount.
{C}. 25% of W-2 wages ($60,000) equals $15,000, plus 2.5% of $0 in business property, for a total of $15,000. This is Rashaad's final deduction amount.
{D}. Rashaad's taxable income exceeded the threshold, so his deduction will be $0.

Part E reveals the correct answers to all end-of-chapter review questions while providing feedback on both correct and incorrect responses.

Chapter 6. OTHER BUSINESS PROVISIONS UNDER OBBBA

Learning objectives: After finishing this chapter, readers will be able to recognize, use, and assess the main OBBBA small-business rules for 2026 and later — including improved cost recovery rules, bigger investment incentives, updated employer credits for childcare and paid leave, changed loss limits, and simpler 1099 reporting thresholds.

Chapter Topics

- Depreciation and expensing provisions
  - » Bonus depreciation & qualified production property
  - » Section 179 expensing
- Capital gains and investment incentives
  - » Qualified Small Business Stock (QSBS)
  - » Qualified Opportunity Zone (QOZ) program
- Business credits for employers
  - » Section 45F credit for employer-provided childcare
  - » Employer credit for paid family and medical leave
- Noncorporate business loss limitation
  - » Regular business loss
  - » Net Operating Loss (NOL)
  - » Excess Business Loss (EBL)
- Changes to 1099 reporting requirements
  - » Forms 1099-NEC and 1099-MISC — threshold increased
  - » Form 1099-K — threshold reverted

Small businesses drive the US economy, and the OBBBA provides specific tax relief to help them invest, hire, and grow. Unlike the previous chapter on the QBI deduction — which covers one complex rule — this chapter covers a group of rules that affect different parts of business taxes. The discussion here does not include rules for large companies or international tax topics.

DEPRECIATION AND EXPENSING PROVISIONS

BONUS DEPRECIATION & QUALIFIED PRODUCTION PROPERTY

The OBBBA improves cost recovery for small businesses by bringing back 100% first-year bonus depreciation under Section 168(k) and adding a new option for 100% expensing of qualified production property (QPP) under Section 168(n).

100% bonus depreciation. The OBBBA permanently restores 100% bonus depreciation for most qualified property acquired and placed in service after January 19, 2025. This reverses the phasedown scheduled under prior law.

Qualified property usually includes most physical personal property that can be depreciated over 20 years or less, like equipment, machinery, computers, and some improvements to nonresidential buildings (for example, qualified improvement property).

Bonus depreciation, unlike Section 179 expensing, does not have an annual dollar limit or taxable income limit. It applies to both new and used property (subject to acquisition and original-use rules).

Qualified production property (QPP) expensing. Besides restoring bonus depreciation, the OBBBA adds a new option under Section 168(n). Taxpayers can now immediately expense 100% of certain new nonresidential real estate used directly in a "qualified production activity." This usually means making, producing, or refining physical products that undergo significant change.

The food and beverage industry is specifically excluded — even though restaurants transform ingredients into meals, if the food is sold in the same retail establishment, the facility doesn't qualify.

To qualify for Section 168(n), construction must begin in the window after January 19, 2025, and before January 1, 2029, and the property must be placed in service after July 4, 2025, and before January 1, 2031. The property must also:
- Have its original use generally commence with the taxpayer; and
- Be properly designated in an election on the timely filed return.

Only the part of the building used directly for the qualified production activity (QPA) qualifies. Property used for offices, administration, lodging, parking, sales, research, software development, or engineering does not qualify. Storage of finished products is also excluded, but storing raw materials and manufacturing inputs used in the QPA may count as an essential activity.

IRS Notice 2026-16 (issued February 20, 2026) provides interim guidance on definitions, basis allocation, and depreciation recapture. It also covers special rules for related-party leases, dual-use infrastructure, and the allocation of basis between qualifying and nonqualifying property. There is a de minimis rule: if 95% or more of the physical space of a property satisfies the integral part requirement, the taxpayer may elect to treat the entire property as qualifying.

Example. Pacific Custom Cabinetry, a family-owned cabinet shop, begins constructing a new facility in 2026. The nonresidential building will be used for cutting, assembling, finishing, and packaging cabinets. About 80% of the building houses the production floor and 20% administrative space. Under Section 168(n), if the production portion costs $1 million, Pacific Custom Cabinetry may deduct the entire $1 million in the year placed in service, instead of depreciating it over 39 years.

Feature	§168(k) Bonus Depreciation	§168(n) QPP Expensing
Policy goal	Broad investment stimulus	Domestic production expansion
Duration	Permanent (this reverses the TCJA phasedown)	Temporary (construction must begin by 12/31/2028; placed in service by 12/31/2030)
Property Type	Tangible personal property (≤20-yr recovery) + certain improvements	Portions of nonresidential real property (buildings/structures)
Key Limitation	Class life ≤ 20 years	Must be used in production activity
Excludes	Buildings (39-yr/27.5-yr property)	Offices, admin, sales, research, lodging within the facility
New vs. Used	New and used (with related-party limits)	Generally new construction
Election required	No (unless opting out)	Yes

SECTION 179 EXPENSING

The OBBBA raised Section 179 limits for property placed in service in tax years starting after December 31, 2024.

Eligible property. Section 179 is not a general write-off for all business assets. It applies to most tangible personal property bought for use in an active business, such as:

- Machinery;
- Equipment;
- Office furniture;
- Certain vehicles;
- Off-the-shelf software; and
- Computer hardware and peripherals.

Section 179 may also cover other types of property. It can apply to certain improvements to nonresidential buildings, like roofs, heating and cooling systems, security systems, and fire protection or alarm systems. Both new and used property usually qualify if bought from an unrelated party or used more than 50% in the business.

Buildings, land, and property used outside the US usually do not qualify. Property bought from related parties or obtained in some tax-free deals may also be disallowed.

2026 limits. The Section 179 deduction has two main limits. First, it cannot exceed the taxpayer's total taxable income from active businesses. This limit is based on income from all active businesses, not just the one that bought the property. Any amount not allowed because of this limit can be carried forward to future years.

Section 179 is also subject to an annual dollar cap, which is indexed for inflation. For 2026, the maximum Section 179 deduction is $2,560,000, and the deduction begins to phase out when qualifying property placed in service exceeds $4,090,000; it is fully phased out at $6,650,000.

Example. In 2026, Main Street Bakery purchases $500,000 of equipment. Because this is below the $2.56 million limit, the bakery may elect to expense the full $500,000 under Section 179, subject to its taxable income. If the bakery's taxable income is $400,000, it may deduct $400,000 in 2026 and carry forward the remaining $100,000.

There is a special limit for SUVs and some other passenger vehicles with a gross vehicle weight rating (GVWR) between 6,001 and 14,000 pounds that are used more than 50% for business. The maximum Section 179 deduction for these vehicles is $32,000 in 2026.

Example. In 2026, Manuel pays $70,000 for a new Chevy Tahoe with a GVWR of 7,600 pounds that he uses 100% for his real estate business. Because the Tahoe is a heavy SUV (GVWR between 6,001 and 14,000 pounds), it is subject to the $32,000 heavy SUV cap under Section 179. Manuel first claims a Section 179 deduction of $32,000, leaving a remaining basis of $38,000. He then claims 100% bonus depreciation on the $38,000 remaining basis. In total, Manuel deducts the full $70,000 purchase price in year one — assuming he has sufficient business taxable income to absorb the Section 179 portion. Had his business use been less than 100%, his deductions would be reduced proportionally.

Vehicle Category (GVWR)	Regular Depreciation or Section 179	Bonus Depreciation (2026)
Vehicles with GVWR up to 6,000 pounds (light passenger automobiles)	Regular depreciation: Up to $12,300 (Year 1)*	PLUS up to $8,000 = $20,300 combined (Year 1)
Vehicles with GVWR 6,001 to 14,000 pounds (such as heavy SUVs)	Section 179: Up to $32,000 in 2026	PLUS 100% of the vehicle's remaining basis (immediate expensing)
Vehicles with GVWR over 14,000 pounds (true commercial vehicles)	Section 179: Up to the general dollar limit ($2,560,000 for 2026)	OR 100% of the vehicle's basis (immediate expensing)
* Source: IRS Rev. Proc. 2026-15, Table 2		

Recapture trap. If business use of an asset drops to 50% or less before the end of its recovery period, the taxpayer must pay back the benefit as regular income. This can lead to unexpected tax bills if business use declines, such as after a sale, due to increased personal use, or because of less business activity. Clients should keep detailed records of how assets are used.

Example. A contractor expensed a $60,000 skid-steer loader under Section 179 in 2026. Had the loader been depreciated under MACRS, total depreciation through 2028

would have been $30,000. When business use drops to 40% in 2028, the taxpayer must recapture the excess $30,000 ($60,000 deduction under Section 179 minus $30,000 MACRS) as ordinary income.

Coordination with bonus depreciation. Section 179 is applied first, followed by bonus depreciation, and then regular MACRS depreciation. Many taxpayers use both Section 179 and bonus depreciation to maximize their benefits. Section 179 helps reduce taxable income, while bonus depreciation can be used for any remaining amount. Section 179 is also helpful if business owners want to avoid a net operating loss and/or save deductions for future years.

Example. A new business purchases $100,000 worth of equipment in 2026. At the end of the year, this business has $30,000 of taxable income. The owner can explore two paths for cost recovery to determine which yields the greatest tax savings. One possibility is to write off $30,000 of the equipment cost under Section 179, with the remaining $70,000 carried forward to 2027. Alternatively, the business owner can forgo Section 179 entirely and deduct the full $100,000 through 100% bonus depreciation under Section 168(k), creating a $70,000 net operating loss that can be carried forward to 2027. The optimal choice depends on the owner's overall tax situation, projected future income, NOL utilization, and state tax conformity with federal bonus depreciation.

Feature	Section 179	100% Bonus Depreciation [§168(k)]	Qualified Production Property [§168(n)]
Maximum Deduction	$2,560,000 (2026)	No dollar limit	No dollar limit (elective)
Phase-out	Yes (phases out above $4,090,000)	No	No
Taxable income limit?	Yes	No	No
Carryforward	Yes, for disallowed amount	Not applicable	Not applicable
Losses	Cannot create a Net Operating Loss (NOL)	Can create or increase an NOL	Can create or increase an NOL
New vs. Used	Both	Both	New construction or qualifying purchase of nonresidential property

CAPITAL GAINS AND INVESTMENT INCENTIVES

QUALIFIED SMALL BUSINESS STOCK (QSBS)

To encourage investment in small businesses, IRC Section 1202 gives relief to investors who put their money at risk in these businesses. Specifically, it lets them exclude capital gains from the sale of "qualified small business stock" (QSBS). The

excluded gain is omitted from gross income and is not subject to regular income tax or the 3.8% net investment income tax (NIIT).

QSBS does not apply to all small businesses. It must be original stock in a domestic C corporation (not S corporations or LLCs) bought after August 10, 1993, directly from the company for money, property, or services. At least 80% of assets must be used in an active qualified business. Excluded industries include most service fields (health, law, consulting, financial services), hospitality, and farming [IRC Section 1202(e)(3)].

Before the OBBBA, a full 100% exclusion was available for stock issued after September 27, 2010, but only if the taxpayer held the stock for more than five years. The excludable gain was capped at the greater of $10 million or 10 times the taxpayer's adjusted basis in the stock. To qualify, the issuing corporation's aggregate gross assets could not exceed $50 million at or immediately after issuance.

OBBBA enhancements. The OBBBA greatly expands the tax benefits under IRC Section 1202 for QSBS. These changes apply to QSBS issued after July 4, 2025, and aim to make capital more accessible, shorten the holding period needed, and increase the amount of gain that can be excluded. The new law improves QSBS benefits in three main ways:

● Tiered holding period. The five-year holding period is no longer mandatory. The OBBBA introduces a tiered structure — 50% exclusion for stock held for at least 3 years, 75% for at least 4 years, and 100% for at least 5 years. The gain not excluded under the three- and four-year holding periods is taxed at 28%, a special rate that is higher than the standard 15% or 20% long-term capital gain rates that apply to most other capital assets. Non-excluded gain is also subject to the NIIT.

● Higher gain exclusion cap. The OBBBA raises the per-issuer limit from $10 million to $15 million, with the limit adjusted for inflation after 2026. The alternative limit of 10 times the stock basis remains unchanged.

● Higher gross asset threshold. For stock issued after July 4, 2025, the aggregate gross asset threshold increases from $50 million to $75 million, with annual inflation adjustments for tax years beginning after 2026. This expands QSBS eligibility to a broader range of growing companies.

Holding Period (Post-7/4/25 QSBS)	Capital gain exclusion rate	Tax rate on gain not excluded
< 3 years	0%	Standard capital gains tax
≥ 3 years	50%	28% (+ 3.8% NIIT)
≥ 4 years	75%	28% (+ 3.8% NIIT)
≥ 5 years	100%	0%

All three enhancements apply only to stock issued after July 4, 2025. Stock issued before that date continues to follow the original rules, including the five-year holding period and the $10 million exclusion cap, with no inflation adjustments.

Example. A taxpayer acquires QSBS in a qualifying C corporation on January 1, 2026, investing $500,000. She sells the stock four years later for $3 million, recognizing a $2.5 million gain. Under the OBBBA's 75% exclusion, $1,875,000 is excluded, and the remaining $625,000 is taxed at 28% (approximately $175,000 in federal tax). The $625,000 unexcluded gain may also be subject to the 3.8% NIIT depending on the taxpayer's income. Had she waited one more year (five-year holding), the entire $2.5 million gain — capped at the $15 million limit — would have been excluded, resulting in zero federal tax on the gain.

IRC Section 1045 rollover. If a taxpayer sells QSBS before meeting the required holding period, Section 1045 allows a taxpayer who has held QSBS for more than six months to defer gain by reinvesting the proceeds in replacement QSBS within the statutory rollover period (generally 60 days). The holding period of the original stock is carried over to the newly acquired stock, which is essential for meeting the 3-, 4-, or 5-year thresholds under the new tiered system.

QUALIFIED OPPORTUNITY ZONE (QOZ) PROGRAM

The TCJA's Opportunity Zone program is an economic development tool created in 2017 to stimulate investment in designated low-income and distressed communities throughout the United States. Economically distressed areas, typically identified by specific census tracts with high poverty or low median incomes, are designated as Qualified Opportunity Zones (QOZs).

Taxpayers with eligible capital gains from the sale of a prior investment may invest those gains within 180 days in a Qualified Opportunity Fund (QOF) and achieve potential tax benefits. A QOF is an investment vehicle that is organized to invest in QOZ property. QOFs can invest in various types of projects within QOZs, including real estate developments. Although many QOFs have focused on real estate development, the structure also supports investment in operating businesses.

Unlike some earlier economic development programs that used tax credits, the QOZ program primarily offers deferral and possible elimination of capital gains tax as its main incentive, rather than a direct tax credit for the amount invested.

Pre-OBBBA rules. Gains invested in a QOF by December 31, 2026, could be deferred until the earlier of the QOF disposition or December 31, 2026. A 10% basis increase applied after five years and an additional 5% after seven years (15% total). If the QOF interest was held for at least 10 years, the gain on the QOF investment itself (post-investment appreciation) was permanently excluded.

Because the deferral period ends on December 31, 2026, these basis step-ups are no longer achievable for investments made after 2021.

OBBBA enhancements. Without the OBBBA, investments in QOZs after December 31, 2026, would have been ineligible for QOZ tax benefits. The OBBBA replaces the original sunset with a permanent, rolling framework.

● Deferral extension. For capital gains reinvested into QOFs on or after January 1, 2027, the OBBBA changes the deferral period. Deferred gain is recognized on the earlier of the QOF investment's sale or exchange, or five years after the investment date.

● Step-up in basis. A 10% basis increase applies after 5 years (of the deferred gain amount). The prior additional 5% at 7 years is eliminated. The 10-year hold still allows exclusion of all post-acquisition appreciation (basis steps up to FMV on sale). However, if the investment is held for more than 30 years, the stepped-up basis is frozen at the fair market value on the 30th anniversary, and any appreciation after that is taxable [IRC Section 1400Z-2(c)]. In other words, the 10-to-30-year window is the maximum period during which appreciation can be fully excluded.

Example. In 2027, Vijay sells stock for a $200,000 gain and invests it in a QOF within 180 days. Vijay's deferred gain will be recognized at the earlier of the sale of his QOF investment and 2032 (five years later). In 2032, Vijay recognizes $180,000 of his original deferred gain (reduced by the 10% step-up). If he continues holding the investment for at least 10 years and sells it in 2038, any post-acquisition appreciation is excluded from income.

● Rural zones get enhanced benefits. The OBBBA establishes Qualified Rural Opportunity Funds (QROFs) for investments in rural QOZs. A rural area is generally defined as any area other than a city or town with a population greater than 50,000 or any urbanized area contiguous and adjacent to such a city or town [IRS Notice 2025-50]. QROFs get a 30% basis step-up (instead of 10%) after 5 years.

● Rolling designation of zones. Every 10 years, state governors will propose new qualified opportunity zones, and the Treasury Secretary will certify them, with the effective date of those new QOZ designations being July 1, 2026 (and every 10 years thereafter).

● Eligibility criteria narrowing. The definition of "low-income" has been tightened to include only those census tracts where the median family income does not exceed 70% of the state median (down from 80% under the 2017 legislation). Also, a provision that allowed governors to designate census tracts contiguous to low-income communities as OZs was eliminated. These changes will reduce the number of eligible census tracts.

● Operational requirements. To qualify, a QOF must hold at least 90% of its assets in qualified opportunity zone property, and underlying businesses must satisfy active trade or business requirements, including substantial improvement or original use tests.

QOFs must now report detailed information, including business classification, residential units, employee counts, and the QOZ census tracts in which the fund invests. Failure to file a complete and correct return results in costly penalties.

Planning considerations. Practitioners should advise interested investors that 2026 is the last year of the original QOZ program. A taxpayer who realizes a gain in October 2026 has a 180-day window that ends in 2027. If they invest in November 2026, they fall under the old rules (with deferral ending on December 31, 2026). If they wait until early 2027 to move the funds, they qualify for the OBBBA 5-year deferral.

Feature	Investments by 12/31/2026	Investments on or after 1/1/2027
Program Duration	Sunset for new investments after 12/31/2026	Permanent; zones redesignated every 10 years
Gain Deferral	Until earlier of sale or 12/31/2026	Until earlier of sale or 5 years after investment
Basis Step-Up (Deferred Gain)	10% at 5 yrs; 15% at 7 yrs	10% after 5 yrs; 30% for QROFs in rural zones
Post-Investment Appreciation	100% excluded if held ≥10 yrs	100% excluded if held ≥10 yrs; frozen at FMV on 30th anniversary
Zone Designation	One-time (2018)	Governors propose every 10 yrs (first 7/1/2026)
Reporting	Limited	Mandatory; penalties up to $50,000

BUSINESS CREDITS FOR EMPLOYERS

SECTION 45F CREDIT FOR EMPLOYER-PROVIDED CHILDCARE

The Section 45F credit for employer-provided childcare is a longstanding incentive designed to encourage employers — particularly small and mid-sized businesses — to invest in childcare solutions that support employee retention and workforce participation.

Pre-OBBBA rules (through 2025). Under prior law, Section 45F allowed a credit equal to 25% of qualified childcare facility expenditures plus 10% of qualified childcare resource and referral expenditures, subject to an annual maximum credit of $150,000.

Qualified expenditures included amounts paid or incurred to acquire, construct, rehabilitate, or expand property used as part of a qualified childcare facility. To qualify, the facility generally had to meet all applicable state and local licensing requirements. While direct contracts with third-party facilities were permitted, arrangements through intermediary agencies were not explicitly covered.

Historically, Section 45F was underutilized because of the $150,000 cap and restrictive rules favoring direct facility ownership.

OBBBA enhancements (2026 and later). The OBBBA greatly expands Section 45F to make the credit more accessible and better suited to modern childcare needs. For tax years starting after December 31, 2025, these rules apply:

● Qualified expenditures expansion. Under prior law, employers could contract directly with a licensed childcare facility to provide employee childcare services. The OBBBA adds a new pathway: employers may now contract with an intermediate entity that, in turn, contracts with one or more qualified childcare facilities. Qualified expenditures now more broadly include operating costs, payments to licensed providers, and contracts with third-party intermediaries that arrange care with licensed facilities.

● Higher credit rate. The credit rate increases from 25% to 40% of qualified childcare expenditures. The 10% credit rate for resource and referral services remains unchanged.

● Higher credit cap. The annual maximum credit rises from $150,000 to $500,000, indexed for inflation in years after 2026.

● Small business bonus. Small businesses receive an enhanced 50% credit rate and a $600,000 annual cap, also inflation-adjusted. An "eligible small business" for the childcare credit meets the gross receipts test under IRC Section 448(c), meaning its average annual gross receipts for the preceding five taxable years do not exceed $32 million (the 2026 inflation-adjusted amount).

● Pooling permitted. Small businesses may now pool resources and jointly contract with licensed providers or co-own a childcare facility, with each participant claiming a proportionate share of the credit.

Feature	Pre-OBBBA (through 2025)	OBBBA (2026 and later)
Credit rate (facility expenditures)	25%	40% (general) or 50% (small business)
Credit rate (resource & referral)	10%	10% (unchanged)
Annual cap	$150,000	$500,000 (general) or $600,000 (small business)
Is annual cap adjusted for inflation?	No	Yes
Qualified expenditures (third-party contracting)	Limited to direct contracts with a qualified facility	Expanded to include contracts with intermediate entities

Example. In 2026, an employer incurs $200,000 of qualified childcare expenditures. If the employer is not an eligible small business, the credit is $80,000, equal to 40% of qualified expenditures, subject to the $500,000 annual cap. If the employer qualifies as

an eligible small business, the credit would be $100,000, computed as 50% of the same expenditures, subject to the $600,000 cap.

Any credit claimed for qualifying childcare expenditures is recaptured if the qualified childcare facility ceases to operate as a qualified childcare facility, or for certain ownership transfers within the first 10 years. Employers that construct or acquire a childcare facility should be aware that the credit is subject to recapture if the facility ceases to qualify within 10 years, a risk that should be weighed when evaluating facility ownership versus third-party contracting.

How Section 45F interacts with other Tax Code sections. The Section 45F credit is claimed on Form 8882, *Credit for Employer-Provided Childcare Facilities and Services*. The computed credit from Form 8882 is then carried to Form 3800, *General Business Credit*, which aggregates all general business credits and applies the overall limitation before the net allowable credit flows to the taxpayer's main return. Unused amounts are nonrefundable but may be carried back one year and carried forward 20 years [IRC Section 39(a)(1)].

● Section 280C. While employers can deduct childcare expenses as a business cost, the Section 45F credit often provides a larger immediate tax benefit. When both benefits are claimed on the same tax return, employers must reduce any otherwise allowable deduction for childcare expenditures by the amount of the credit claimed. This prevents double-dipping.

● Section 129. While employers claim the 45F credit, employees can simultaneously use a Dependent Care FSA to pay their share of costs with pretax dollars, creating layered tax benefits for both employer and employees. We will cover Dependent Care FSAs in a later chapter.

EMPLOYER CREDIT FOR PAID FAMILY AND MEDICAL LEAVE

The United States does not mandate paid family and medical leave (PFML) for most private-sector workers, though several states have enacted their own programs. The TCJA created a tax credit — the Section 45S credit — to encourage private-sector employers to provide PFML voluntarily.

Section 45S and the FMLA framework. The Section 45S credit complements the Family and Medical Leave Act (FMLA) of 1993. The FMLA requires certain employers to provide eligible employees with job-protected, unpaid leave for specified family and medical reasons. The Section 45S credit provides a tax incentive to employers who go further and actually pay employees during qualifying FMLA-type leave.

The Section 45S credit applies when an eligible employee takes paid leave for one of the reasons recognized under the FMLA:
● The employee's own serious health condition.
● To care for a spouse, child, or parent with a serious health condition.
● Pregnancy, the birth of a child, or bonding with a newborn.

● Placement of a child for adoption or foster care.
● A qualifying "exigency" related to a family member's overseas military deployment, such as attending ceremonies or spending time with them during their short-term leave.

Pre-OBBBA rules (through 2025). Under prior law, the following requirements and rules governed the Section 45S credit:
● Written policy required. The employer must have a written policy that provides for PFML. It must provide at least 2 weeks of annual paid leave and specify the wage-replacement rate. The written policy must be in place before the leave is taken.
● Qualifying employee. The credit was available only to employees who were not highly compensated [as defined under IRC Section 414(q)] and who had been employed for at least 1 year.
● Minimum leave and wage replacement. Employers must have provided at least 2 weeks (and up to 12 weeks) of paid leave annually and compensated employees at a minimum of 50% of their regular wages.
● Credit rate. The credit ranged from 12.5% to 25% of wages paid during qualifying leave, based on the wage replacement rate.
● State law interaction. Any leave mandated by state or local law could not be counted toward determining the dollar amount of qualifying employer payments. This effectively prevented employers in states with mandatory PFML programs (e.g., California) from claiming the federal credit in addition to what state law required.

OBBBA enhancements (2026 and later). Before the OBBBA, Section 45S was a temporary credit that had been extended but was set to expire on December 31, 2025. The OBBBA removed the previous sunset date; Section 45S is now a permanent part of the Internal Revenue Code. Also, several eligibility and computation rules were revised, effective for tax years beginning after December 31, 2025.

● New insurance premium calculation method. Employers may elect to compute the credit based on insurance premiums paid for qualifying family and medical leave coverage rather than on wages paid to employees during leave. Premiums must relate to qualified PFML insurance, not general disability coverage. The same credit percentages (12.5% to 25%) apply to the premium amount. An employer may not use both the wages-paid method and the premium method in the same tax year. The premium method's most valuable feature is its ability to claim a credit in years when no employees actually take leave. Future IRS guidance (as of early 2026) is expected on premium method details, aggregation, and policy requirements.

● Reduced tenure requirement. The OBBBA permits employers to elect to reduce the minimum tenure requirement from one year to six months. This allows employers to claim the credit for qualifying leave taken by employees who have worked for the employer for at least six months.

● Revised state law interaction. Mandated leave is still excluded from the amount of wages on which the credit is computed; premiums paid into state-run PFML funds through payroll taxes are not creditable. Under the OBBBA, employers can get a credit

for ***voluntary*** top-up or extra leave, but not for what's ***required*** by law.

● Part-time employees. The credit is now explicitly available for part-time employees who customarily work 20 or more hours per week, with leave requirements prorated accordingly.

● Qualifying employee compensation limit. Paid leave provided to employees with 2025 compensation above $96,000 are not eligible for the 2026 credit (prorated for part-time employees). The precise rule is that prior-year compensation must not exceed 60% of the inflation-adjusted amount under IRC Section 414(q)(1)(B).

The credit equals the applicable percentage of qualifying wages paid or qualifying insurance premiums for up to 12 weeks of leave per employee. The applicable percentage starts at 12.5% when the employer pays 50% of regular wages and increases by 0.25 percentage points for each additional 1% of wage replacement, up to a maximum credit rate of 25% when wage replacement equals 100%.

Wage Replacement Rate	Credit Percentage
50%	12.5%
60%	15%
70%	17.5%
80%	20%
90%	22.5%
100%	25%

Example. A full-time employee earns $24.96 per hour, or $998.40 per 40-hour week. Over two weeks, normal earnings total $1,996.80. Under the employer's written policy, the employee receives 70% of regular wages during two weeks of qualifying family and medical leave, or $1,397.76. The applicable credit percentage at 70% replacement is 17.5%. The employer's Section 45S credit for this leave is $244.61 ($1,397.76 × 17.5%).

Section 45S is part of the general business credit and is nonrefundable. Unused credits generally may be carried back one year and forward 20 years. Wages used to determine the Section 45S credit cannot be used to calculate any other business credit, and wages used to determine any other business credit cannot be used again for the employer credit for PFML.

The amount of the credit must reduce the employer's deduction for wages (or insurance premiums) claimed. Employers cannot deduct 100% of the wages and take the credit. They must also reduce their wage deduction — or the insurance premium deduction, if the premium method is elected — by the amount of the credit under IRC Section 280C.

NONCORPORATE BUSINESS LOSS LIMITATION

REGULAR BUSINESS LOSS

A regular business loss occurs when a taxpayer's allowable deductions from their trade or business exceed their gross income from that activity in a given tax year. For example, if a sole proprietor has $80,000 in business expenses and $50,000 in business income, the regular business loss is $30,000.

Business owners can generally use this loss to offset other types of income on their tax return (like wages, interest, or capital gains). A regular business loss is subject to the "at-risk" and "passive activity" limitations before it can offset other income.

NET OPERATING LOSS (NOL)

A loss from business activities within a year can offset other income in that same year. But what happens if the business losses exceed all other income reported on the tax return?

While a business loss can reduce taxable income to zero, it does not by itself generate a tax refund. A net operating loss is the "leftover" loss that occurs when total allowable deductions (including business losses) are more than total gross income. That leftover loss is a pending deduction that must be delayed, or carried forward, to the next tax year. Under current law, NOLs generally carry forward indefinitely. In carryforward years, NOLs can offset up to 80% of taxable income.

Example. Hayley, a single taxpayer, launches an unincorporated business in 2026. The business incurs a $100,000 loss, largely due to bonus depreciation. Hayley has no other positive income to offset on her tax return. With no other positive income, the $100,000 loss produces a net operating loss of $100,000 on the current-year return. There is nothing to offset, and a tax refund cannot be generated solely from a current-year business loss with no income. The entire $100,000 loss is carried forward as an NOL.

EXCESS BUSINESS LOSS (EBL)

An excess business loss is a special limitation imposed on noncorporate taxpayers. The limitation applies when a taxpayer's net business loss for the year exceeds an inflation-adjusted threshold.

Only losses up to the threshold can be deducted in the current year. Taxpayers cannot deduct any amount over this threshold to offset nonbusiness income (like a salary or investment income) in the current year. Losses above the threshold are disallowed for the current year and are instead converted into an NOL carryforward for the next year.

Consider a taxpayer who has $1 million of nonbusiness income — perhaps from investment gains, a large salary, or a spouse's earnings — and a $900,000 business loss from a pass-through entity. Without Section 461(l), that taxpayer could wipe out nearly all of the $1 million with the business loss, paying little or no current-year tax.

Section 461(l) steps in and says: you can only use part of that business loss against your other income in the current tax year. The remaining amount is carried forward as an NOL, subject to the 80% limitation in future years.

Section 461(l) was originally intended to limit noncorporate "excess business losses" for tax years 2018 through 2025. Subsequent legislation (including the American Rescue Plan Act of 2021 and the Inflation Reduction Act of 2022) extended the provision through 2028.

The OBBBA made Section 461(l) permanent. It also reset the statutory base amounts used for inflation adjustments. As a result, the 2026 thresholds — computed by applying inflation to the new base — are $512,000 for married taxpayers filing jointly and $256,000 for all other filers [Revenue Procedure 2025-32], significantly lower than the 2025 amounts of $626,000 and $313,000.

Example. In 2026, an unmarried taxpayer recognizes a $296,000 loss from an unincorporated single-member LLC, and a $296,000 nonbusiness long-term capital gain from the sale of investment real estate. The taxpayer has no other income or deductions. Without Section 461(l), the loss would completely offset the gain, so there would be no taxable income. However, Section 461(l) only allows $256,000 of the loss to offset the gain. The limitation leaves $40,000 of the capital gain unshielded, so the taxpayer has $40,000 in taxable income for 2026. The disallowed amount of $40,000 is carried forward as an NOL to 2027. This example shows the taxpayer must pay current-year tax on the $40,000 portion of their capital gain, even though their total losses could have covered it if Section 461(l) did not apply.

Use Form 461 to compute and report any excess business loss; attach it to your client's Form 1040 (or other applicable return).

CHANGES TO 1099 REPORTING REQUIREMENTS

The OBBBA updated a few 1099 information reporting thresholds to reduce paperwork for small businesses while maintaining IRS oversight of larger transactions.

FORMS 1099-NEC AND 1099-MISC — THRESHOLD INCREASED

Under prior law, payers generally had to issue information returns for nonemployee compensation (Form 1099-NEC) or miscellaneous payments such as rents, royalties, or prizes (Form 1099-MISC) once aggregate payments to a recipient reached or exceeded $600 in a calendar year — a threshold unchanged since the 1950s.

The OBBBA increases this reporting threshold. Starting with payments made in 2026, businesses must file Forms 1099-NEC and 1099-MISC only when total payments to a recipient exceed $2,000 for the year (up from the longstanding $600 threshold). The higher threshold reduces the number of information returns that must be filed. However, it does not affect the taxability of the underlying income, which remains fully reportable by the recipient.

Example. A small business pays an independent contractor $1,800 in 2026. Under prior law, a Form 1099-NEC would have been required because payments exceeded $600. Under the OBBBA, no Form 1099-NEC is required because the total payments do not exceed the new $2,000 threshold. However, the contractor must still report the $1,800 as taxable income.

Beginning in 2027, the new 1099-MISC and 1099-NEC threshold is scheduled to be indexed for inflation, which should help prevent the reporting floor from becoming outdated again. Also, backup withholding under IRC Section 3406 now applies only when payments to a payee exceed $2,000.

FORM 1099-K — THRESHOLD REVERTED

Background. There was a time when businesses accepted only cash or checks for their goods or services. Nowadays, most businesses accept credit card payments, many accept debit card payments, and a few accept cash app payments.

When a customer (the first party) pays a business (the second party) using a card or app, a third party facilitates, processes, or settles the electronic payment behind the scenes. The IRS refers to this third party as a "third-party settlement organization" (TPSO). Below is a partial list of well-known TPSOs:

- Payment apps such as PayPal, Venmo, Cash App, Square, and Stripe.
- Online marketplaces such as eBay, Etsy, and Amazon (for third-party sellers).
- Gig service platforms such as Uber and Lyft.

Form 1099-K was introduced in 2008, with its reporting requirements taking effect in 2011. The 1099-K form specifically reports payments and transactions from online platforms, apps, or payment card processors. Officially, this tax form is called *Payment Card and Third Party Network Transactions*.

The original reporting threshold was set at $20,000 or more in gross payments and more than 200 transactions within a calendar year. This threshold was intended to capture significant e-commerce activity while excluding smaller, casual sellers from the reporting requirement.

ARPA and IRS transitional relief (2021–2025). Over the years, the threshold for reporting on Form 1099-K remained unchanged until Congress, in the American Rescue Plan Act (ARPA) of 2021, significantly lowered it. Starting in 2022, the threshold was reduced to $600 for total payments, with no minimum transaction count requirement.

Instead of immediately implementing the new Form 1099-K rules, the IRS delayed the ARPA change. Recognizing the challenges and concerns raised by this drastic reduction in the reporting threshold, the IRS announced transitional relief measures. Accordingly, the IRS designated 2022 through 2025 as transition years, allowing taxpayers and TPSOs sufficient time to adjust to the new requirements.

OBBBA changes. The OBBBA reverses the widely criticized 1099-K expansion from ARPA. It repealed the $600 Form 1099-K threshold enacted by ARPA and restored the prior threshold of $20,000 in aggregate payments and more than 200 transactions per year, applied retroactively. This change replaces the previously planned phase-in of lower thresholds ($5,000 for 2024, $2,500 for 2025, and $600 for 2026) announced by the IRS.

Unlike the 1099-NEC and 1099-MISC thresholds, the 1099-K threshold is not indexed for inflation.

FORM	PRIOR LAW	ARPA path (2021–2025)	OBBBA (2026+)
1099-MISC	$600	No change	$2,000 in 2026 indexed after 2026
1099-NEC	$600	No change	$2,000 in 2026 indexed after 2026
1099-K	$20,000 + 200 trxns	Phased down toward $600	$20,000 + 200 trxns Retroactive, no index

This change stops the large number of 1099-K forms that would have been required under the ARPA $600 rule. It gives relief to gig workers, small sellers, and businesses that use digital payments.

Helping clients with 1099-K income. Taxpayers who receive Form 1099-K must report the income on their tax returns, taking into account the gross transactions reported and deducting any relevant business expenses to determine their net taxable income. The amount reported on the 1099-K should be reported on the appropriate tax form for each type of business. For instance, Form 1099-K income is reported by:

- Sole proprietors on Schedule C (Form 1040);
- Landlords on Schedule E (Form 1040);
- S corporations on Form 1120-S; and
- Partnerships on Form 1065.

A Form 1099-K does not automatically mean all amounts reported are taxable. Taxpayers must determine whether the payments were business receipts or nontaxable transfers, such as personal reimbursements or gifts. Reportable income on 1099-Ks only includes business transactions and should exclude personal transfers such as gifts or reimbursements. Therefore, someone who receives rent money from their roommate through Venmo should not receive a 1099-K for these nonbusiness transactions.

Proper recordkeeping is still important, especially if the same account is used for both personal and business activity. Taxpayers can and should separate personal and business transactions within apps like PayPal to avoid incorrect reporting.

REVIEW QUESTIONS

20. Under the OBBBA, which of the following is a key difference between 100% bonus depreciation [Section 168(k)] and the new QPP expensing [Section 168(n)]?
{A}. Bonus depreciation is only for new property, while QPP expensing allows for used property.
{B}. Bonus depreciation applies to most tangible personal property, while QPP expensing is specifically for certain nonresidential real estate.
{C}. QPP expensing is a permanent provision, while 100% bonus depreciation is scheduled to expire in 2029.
{D}. Bonus depreciation requires construction to begin before 2029, while QPP expensing has no such start-date requirement.

21. An investor places $100,000 of eligible gain into a Qualified Rural Opportunity Fund (QROF) in 2027. After holding the investment for five years, what is the amount of the original deferred gain that must be recognized, assuming the QOF interest has not been sold?
{A}. $100,000; no basis step-up is available for investments made after 2021.
{B}. $90,000; reflecting a 10% basis step-up.
{C}. $70,000; reflecting a 30% basis step-up.
{D}. $0; the gain is permanently excluded because it was invested in a rural zone.

22. Mason, who is single, launches an unincorporated business in 2026. By the end of the year, the business had racked up a net loss of $290,000. Mason also has $290,000 of nonbusiness investment income in 2026. The Section 461(l) threshold for single noncorporate taxpayers is currently $256,000. What can Mason do with the excess business loss of $34,000?
{A}. He can use it to claim a $34,000 tax refund in 2026.
{B}. He can carry back the 2026 excess business loss to 2025.
{C}. Nothing; the excess business loss of $34,000 is lost money that will never convey any tax benefits to Mason.
{D}. $256,000 of the loss is allowed to offset positive income in 2026; the remaining $34,000 is an excess business loss carried forward as an NOL to 2027.

Part E reveals the correct answers to all end-of-chapter review questions while providing feedback on both correct and incorrect responses.

Chapter 7. THE CHILD TAX CREDIT & ITS ALTERNATIVES

Learning objective: Upon completing this chapter, course participants will understand the rules for claiming the nonrefundable child tax credit, the refundable additional child tax credit, and the credit for other dependents, as amended by the OBBBA.

Chapter Topics

- Tax deductions versus tax credits
  - » Tax deductions
  - » Tax credits
- The child tax credit (CTC)
  - » The classic version of the CTC
  - » The current version of the CTC
  - » OBBBA modifications to CTC
- CTC eligibility requirements
  - » SSN requirement is now for the child and parent
  - » Age test
  - » Citizenship test
  - » Relationship test
  - » Residence test
  - » Support test
  - » Income test
- The additional child tax credit (ACTC)
  - » The earnings requirement
  - » Refund formula
- The credit for other dependents (ODC)
  - » Age and citizenship tests
  - » Taxpayer identification number requirement
  - » Relationship and residence tests
  - » Support test
  - » Income test

TAX DEDUCTIONS VERSUS TAX CREDITS

TAX DEDUCTIONS

It is in the taxpayer's best interest to take advantage of every available tax deduction and credit. Deductions and credits reduce the taxes owed to the IRS — albeit in different ways and to varying degrees. The main difference is that deductions are subtracted from income, while tax credits directly reduce the tax owed.

An income tax deduction is an expense or amount of money that lowers AGI (in the case of above-the-line deductions) or taxable income (in the case of below-the-line deductions). Tax deductions are worth different amounts to different taxpayers because their value depends on a taxpayer's marginal tax rate. For example, high-income taxpayers in the 35% bracket receive a tax benefit of 35 cents for every dollar they

deduct. In comparison, middle-income taxpayers in the 12% bracket get a benefit worth only 12 cents on the dollar. In other words, a $10,000 deduction reduces taxes by $1,200 for people in the 12% bracket, whereas the same deduction saves $3,500 for those in the 35% bracket.

TAX CREDITS

After arriving at AGI and subtracting below-the-line deductions, the resulting taxable income is used to find the ordinary income tax amount owed. The gross tax due may include the ordinary income tax, the alternative minimum tax, the NIIT, the kiddie tax, and the capital gains tax. Tax credits are applied after this gross tax liability is determined. Tax credits reduce that liability dollar-for-dollar, regardless of the individual's tax bracket.

While tax deductions reduce taxable income, tax credits directly reduce the tax owed. Generally, credits can be more valuable because they offset the actual tax liability, dollar for dollar. In other words, a $1,000 credit saves taxpayers $1,000 in taxes. The government is, in essence, saying to the taxpayer: "We are giving you credit for having already paid $1,000 in tax."

FEDERAL INCOME TAX FORMULA FOR INDIVIDUALS		
1.	Starting point	Income "from whatever source derived"
2.	Minus (–)	Exclusions
3.	Equals (=)	Gross Income
4.	Minus (–)	Above-the-line deductions (on Schedule 1)
5.	Equals (=)	Adjusted Gross Income (AGI)
6.	Minus (–)	Below-the-line deductions (QBI, itemized or standard deduction)
7.	Equals (=)	Taxable Income
8.	Times (×)	Individual tax rate (10% to 37%)
9.	Equals (=)	Income Tax Due
10.	Plus (+)	Other taxes on Form 1040, top of page 2
11.	Equals (=)	Gross tax due
12.	Minus (–)	Credits and prepayments (withholdings and/or estimated taxes)
13.	Equals (=)	Net tax payable or refund due

Nonrefundable credits. Tax credits can be refundable or nonrefundable. Many tax credits are nonrefundable, meaning that the actual credit a taxpayer receives cannot exceed their income tax liability. Nonrefundable tax credits can reduce tax liability to zero but can't exceed the amount of tax owed — in short, taxpayers cannot use them to generate a refund.

Example. Lashanda qualifies for a $2,000 nonrefundable credit, but she only owes $1,000 in federal income tax. Lashanda can use $1,000 of the credit to bring her tax bill down to zero, but the remaining $1,000 is lost. She will not get a tax refund.

Nonrefundable credits are less helpful to lower-income filers than other taxpayers. Because lower-income households generally owe less in income taxes than those with

higher incomes, they are less likely to benefit from nonrefundable tax credits. With most nonrefundable tax credits, any excess amount expires in the year it was used, so it is not carried forward to the next tax year.

Refundable credits. Tax credits can be more valuable when they are refundable. As this label implies, refundable tax credits are entirely or partially refundable even when the taxpayer owes no income tax. A refundable credit can be viewed as a government payment — the taxpayer will still receive a refund even if they owe nothing.

So, if the value of a refundable tax credit exceeds a person's tax liability, the excess is paid to the filer as a refund. For example, a taxpayer who owes $1,000 and can claim a $3,000 refundable tax credit will have their liability wiped out and receive the excess $2,000 as a refund.

	Nonrefundable Credit	Refundable Credit
Claimant's gross tax liability	$1,000	$1,000
(–) Applicable tax credits	$3,000	$3,000
(=) Net tax due (or refund)	$0	$2,000 refund
	Nonrefundable credits reduce tax liability to zero but do not produce a refund.	Refundable credits can result in a cash refund to the claimant.

Withholding for federal income taxes and estimated tax payments may also be considered refundable credits, as these are prepayments toward a person's tax liability. Refundable tax credits, like prepayments, are applied toward a person's tax obligations, and any overpayments are refunded.

Exactly how much are tax credits worth? That depends on the particular credit. Because the amounts of each tax credit differ, so do the qualification guidelines. This chapter reviews the rules for claiming the nonrefundable child tax credit, the refundable additional child tax credit, and the credit for other dependents.

THE CHILD TAX CREDIT (CTC)

To a small degree, the federal government treats child-rearing as an investment in the future. Some of the costs associated with raising children are offset through the income tax system. The child tax credit (CTC) was created to help working families defray some of those costs. Congress also established the CTC to address concerns that the tax structure did not adequately reflect a family's reduced ability to pay taxes as family size increased.

THE CLASSIC VERSION OF THE CTC

The CTC was created by 1997 legislation and first made available in 1998. It started as a small, nonrefundable credit of $400 for each qualifying child under age 17. The

additional child tax credit was refundable for taxpayers with three or more qualifying children, calculated as the excess of a taxpayer's payroll taxes over their earned income tax credit (EITC).

The Economic Growth and Tax Relief Reconciliation Act of 2001 increased the CTC to $1,000 and made it partially refundable for all qualifying families. For lower-income individuals with no tax liability of at least $1,000, the refundable portion became available to families with earned income over $10,000. To help lower-income families, the American Recovery and Reinvestment Tax Act of 2009 temporarily reduced that income threshold from $10,000 to $3,000. The Protecting Americans from Tax Hikes Act of 2015 (PATH Act) made the $3,000 threshold permanent and imposed due diligence requirements on tax practitioners. The PATH Act also required a taxpayer identification number for each child for whom the credit is claimed [IRC Section 24(e)]; valid forms of identification included Social Security numbers (SSNs), individual taxpayer identification numbers (ITINs), and adoption taxpayer identification numbers (ATINs).

The child tax credit, as it was structured in 2017, could be referred to as the "classic" version of the CTC. The classic CTC was worth $1,000 per child with an SSN, ITIN, or ATIN. To the extent the $1,000-per-child credit exceeded the claimant's tax liability, it resulted in a refund of up to $1,000 when the claimant's earned income exceeded $3,000. At the other end of the income spectrum, the classic CTC started to phase out when the claimant's income exceeded $75,000 (or $110,000 for joint filers).

THE CURRENT VERSION OF THE CTC

The TCJA changed the CTC in several ways. It doubled the maximum credit from $1,000 to $2,000 per qualifying child [IRC Section 24(h)(2)]. It increased the maximum refundable portion of the additional child tax credit from $1,000 to an inflation-adjusted amount, which had reached $1,700 per qualifying child by 2024 [IRC Section 24(h)(5)]. The TCJA also lowered the earned income threshold for the refundable credit from $3,000 to $2,500 [IRC Section 24(h)(6)], raised the phaseout thresholds from $75,000 to $200,000 for unmarried taxpayers and from $110,000 to $400,000 for joint filers [IRC Section 24(h)(3)], and required qualifying children to have an SSN rather than an ITIN or ATIN [IRC Section 24(h)(7)].

The TCJA changes were originally scheduled to expire after December 31, 2025. They did not expire, however, because of subsequent legislation.

OBBBA MODIFICATIONS TO CTC

The OBBBA made several permanent changes to the CTC. The most significant for taxpayers is that the maximum CTC has been permanently set at $2,200 per qualifying child (under age 17), beginning with the 2025 tax year, with inflation adjustments each year thereafter. For 2026 tax returns, the maximum credit remains $2,200 per qualifying child, as no upward inflation adjustment was required for this year.

Social Security Number (SSN) requirement. The OBBBA expanded the SSN requirement that the TCJA originally imposed on qualifying children. Before the OBBBA, parents or guardians could claim the CTC regardless of their own immigration status, as long as the qualifying child had a valid SSN. Under the OBBBA, at least one parent or guardian filing the return must also have a valid SSN [IRC Section 24(h)(7)]. For married couples filing jointly, at least one spouse must have an SSN. Families headed by a single undocumented parent cannot claim the CTC even if their child is a US citizen with an SSN.

Income thresholds. The OBBBA makes permanent the higher phaseout amounts introduced by the TCJA. The credit begins to phase out when modified adjusted gross income (MAGI) exceeds $200,000 for single filers and $400,000 for joint filers — far above the classic CTC thresholds of $75,000 and $110,000. The credit is reduced by $50 for every $1,000 (or fraction thereof) of income exceeding these thresholds.

Refundability and the earned income requirement. Families who owe little or no federal income tax may still be eligible for the refundable portion of the credit (the additional child tax credit, or ACTC) of up to $1,700 per child. Families need at least $2,500 of earned income to qualify for the ACTC. The refundable credit phases in at 15% of earnings above $2,500. Both the refundable cap and the phaseout thresholds are indexed for inflation beginning in 2026.

CTC ELIGIBILITY REQUIREMENTS

Before claiming the child tax credit, a taxpayer must first determine whether their child is an eligible dependent. There are several tests to satisfy under IRC Sections 24 and 152(c). Failure to meet any of these tests results in disqualification.

SSN REQUIREMENT IS NOW FOR THE CHILD AND PARENT

To qualify for the CTC, the child must have a valid SSN by the return's due date [IRC Section 24(h)(7)]. A child with only an ITIN or an ATIN will not qualify for the CTC or the ACTC (though such a child may still qualify for the credit for other dependents, discussed later in this chapter).

As mentioned above, the OBBBA now requires that at least one parent or guardian filing the return have a valid SSN. When a joint return is filed, at least one spouse must have an SSN. This requirement has particular implications for mixed-status families: a household headed by two parents who both lack SSNs cannot claim the CTC even if the child is a US citizen. A household with one parent who has an SSN may still qualify.

Example. Lupe and Yahir are married and file a joint return for 2026. Their daughter, Larissa, was born in the US and has a valid SSN issued before the return due date. Lupe has an SSN, but Yahir has only an ITIN. Because at least one spouse has a valid SSN and the child has a valid SSN, the family can claim the CTC, assuming they meet the other requirements. By contrast, if Lupe and Yahir both had only ITINs, they could

not claim the CTC even though Larissa has an SSN. A child with only an ITIN or ATIN also would not qualify for the CTC or ACTC.

AGE TEST
To qualify, the child must have been under age 17 (age 16 or younger) on December 31 of the tax year for which the parent is claiming the credit [IRC Section 24(c)].

Example. Jocelyn's son turns 17 on December 29, 2026. Therefore, he is not a qualifying child for the CTC on Jocelyn's 2026 tax return because he was not under age 17 at the end of the year.

CITIZENSHIP TEST
The child must be a United States citizen, a US national, or a resident alien. For tax purposes, "US national" refers to individuals born in American Samoa or the Commonwealth of the Northern Mariana Islands. Most resident aliens are green card holders and qualify for the CTC (assuming they meet the other tests).

RELATIONSHIP TEST
The list of qualifying children includes biological children, stepchildren, grandchildren, and foster children living in the taxpayer's care. Adopted children qualify if they have an SSN (rather than only an ATIN). Taxpayers can even claim a brother, sister, niece, nephew, stepbrother, or stepsister if they meet all of the tests [IRC Section 152(c)(2)].

RESIDENCE TEST
The child must have lived with the taxpayer for more than half of the year (at least 183 nights). A child born or who died during the tax year is considered to have lived with the taxpayer for the entire year.

Temporary absences by the taxpayer or the child for special circumstances — such as school, vacation, medical care, military service, or detention in a juvenile facility — count as time the child lived with the taxpayer.

Example. A taxpayer's qualifying child lived in the family home for 150 nights, spent 60 nights in a medical facility for treatment, and 155 nights at a boarding school. It might seem that this child has failed the residency test because they physically stayed in the family home for fewer than 183 nights, but this conclusion would ignore the temporary absence rule. Actually, the test is passed because IRC Section 152(c) counts temporary absences for school and medical care as time lived with the taxpayer.

US citizens living abroad may qualify for the CTC if the child lived with the taxpayer for more than half of the year and the parent has taxable earned income on their US tax return.

SUPPORT TEST
The support test for a qualifying child mandates that the child cannot have provided more than half of their own financial support during the tax year [IRC Section

152(c)(1)(D)]. A person's funds are included in self-support only if they are actually spent on living expenses. There is no gross income test for qualifying children, so the self-support amount can be any figure provided it does not exceed 50% of total support.

Example. Raina is eight years old and had a small role in a television series. She earned $60,000 during the tax year, but her parents placed all the money in a trust fund for college. Raina lived with her parents all year and met the age and relationship tests. Raina also meets the support test because the $60,000 was not used for her support.

INCOME TEST

For CTC purposes, MAGI equals AGI plus any foreign earned income excluded on Form 2555 (or similar exclusions for income sourced to Puerto Rico or American Samoa). If the taxpayer has none of these exclusions, their MAGI equals their AGI.

Phaseout thresholds. Under the OBBBA, the CTC begins to phase out when MAGI exceeds $200,000 for all taxpayers except married couples filing jointly, for whom the phaseout begins at $400,000. These are substantially higher than the classic CTC thresholds of $75,000 and $110,000, allowing many more families to benefit.

Credit reduction. The credit does not disappear all at once when MAGI reaches the threshold. When MAGI exceeds the threshold, the credit is reduced by $50 for each $1,000 (or fraction thereof) of income above the threshold [IRC Section 24(b)(1)]. The excess amount is rounded up to the next multiple of $1,000.

Example. Tracey is a single mom with a 13-year-old son. Her tentative CTC is $2,200. Tracey reports MAGI of $228,780 on her 2026 return, which exceeds the $200,000 threshold by $28,780. Rounding up, that excess becomes $29,000. Dividing by $1,000 yields 29, and multiplying by $50 gives $1,450 — the phaseout amount. Tracey's tentative $2,200 credit is reduced by $1,450, leaving her a final credit of $750.

THE ADDITIONAL CHILD TAX CREDIT (ACTC)

The CTC was initially designed as a nonrefundable tax credit — it could help erase a tax bill, but it could not produce a refund. Because many families could not take full advantage of the child tax credit, Congress introduced the additional child tax credit (ACTC). The name does not imply a credit for an additional child; it indicates an additional credit for the same child.

A taxpayer must first compute their CTC before considering the ACTC. The ACTC applies only if the taxpayer is eligible for the CTC but cannot use the full amount because their tax liability is too low.

THE EARNINGS REQUIREMENT

To qualify for the ACTC, the taxpayer must meet or surpass the minimum earned income threshold of $2,500. Starting at $2,500 in earnings, the credit phases in at a

15% rate — meaning for every $100 earned above $2,500, the taxpayer receives $15 in ACTC.

Example. Valerie is a head-of-household filer with a 3-year-old son. She earned $13,500 in 2026. Because of her low income, Valerie owes no federal income tax. The ACTC phases in at 15% of earnings above $2,500. Valerie earned $11,000 above the threshold ($13,500 – $2,500 = $11,000), so her ACTC is $1,650 ($11,000 × 15%). This credit amount is below the $1,700 per-child cap.

The OBBBA maintains the $2,500 minimum earned income threshold for the ACTC. While some lawmakers proposed eliminating the earned income requirement (as was done temporarily in 2021), those proposals were not enacted.

REFUND FORMULA

Under current law, the CTC is $2,200 per child, with up to $1,700 refundable through the ACTC. The ACTC cannot exceed $1,700 per qualifying child. Both the full credit amount and the refundable cap are now indexed for inflation beginning in 2026, so these figures may increase in future years. Although the OBBBA provides for inflation indexing beginning in 2026, the IRS did not increase the refundable cap for 2026; it remains $1,700.

Schedule 8812 is used to compute the ACTC. The precise calculation depends, in part, on the number of qualifying children.

One or two children. The maximum $2,200 credit amount is reduced when the claimant owes little or no tax. The refundable portion is limited to $1,700 per child or 15% of earned income over $2,500 — whichever is less [IRC Section 24(d)(1)(B)]. The $1,700 cap would apply only to parents earning more than $13,829 per year, because $13,829 – $2,500 = $11,329, and 15% of $11,329 roughly equals $1,700.

Example. Alysia earned $13,000 in wages and claims a CTC for her seven-year-old son, but has no tax liability. To find her ACTC refund, she compares:
- Maximum refundable credit for one child = $1,700; and
- 15% of earned income over $2,500 = ($13,000 – $2,500) × .15 = $1,575.

Alysia claims the lesser amount: a $1,575 ACTC refund.

Three or more children. Taxpayers with three or more qualifying children calculate the ACTC refund differently. The alternative formula determines the refund amount as being the lesser of:
- $1,700 per child; or
- The larger of (a) 15% of the taxpayer's earned income over $2,500, or (b) FICA taxes paid minus the earned income tax credit (EITC).

Taxpayers with three or more children can find their ACTC amount using this 5-step method:

Step 1. (Earned income – $2,500) × .15.

Step 2. The amount the taxpayer paid in FICA taxes minus EITC.

Step 3. Tentative credit equals the greater of step 1 or step 2.

Step 4. Find the unclaimed credit amount, which is the maximum child tax credit minus the portion of the CTC claimed on Form 1040.

Step 5. The additional child tax credit equals the lesser of steps 3 or 4.

Example. Tamisha's tentative tax liability was $1,103, which limited her use of the nonrefundable CTC to that amount. She earned $35,152 as an employee and paid $2,689.12 in FICA taxes; her employer also paid $2,689.12, but only Tamisha's portion is used in this calculation. She also claimed an EITC of $5,379.

Step 1. 15% of earned income over $2,500 = ($35,152 – $2,500) × .15 = $4,897.80.

Step 2. FICA of $2,689.12 minus EITC of $5,379 equals –$2,689.88.

Step 3. The tentative credit will be the greater of steps 1 and 2: $4,897.80.

Step 4. The unclaimed child tax credit is $6,600 ($2,200 × 3) minus $1,103, for a total of $5,497.

Step 5. The additional child tax credit will ultimately be the lesser of steps 3 and 4. For Tamisha, the ACTC amount appears in step 3: $4,897.80, which we round up to $4,898.

Tamisha claims a nonrefundable CTC of $1,103 (reducing her tax to zero) and an ACTC refund of $4,898.

THE CREDIT FOR OTHER DEPENDENTS (ODC)

The TCJA established a $500 credit for each eligible dependent who is not a qualifying child [IRC Section 24(h)(4)]. The Tax Code refers to this credit as the "Partial credit allowed for certain other dependents." Form 1040 calls it the "Credit for other dependents," and Form 8867, *Paid Preparer's Due Diligence Checklist*, uses the abbreviation "ODC" (Other Dependents Credit).

The OBBBA made the credit under Section 24(h)(4) permanent. It amends Section 24(h)(1) by simply removing the January 1, 2026, termination date, thereby making all provisions of IRC Section 24(h) — including the ODC — permanent.

The ODC is figured on Schedule 8812, *Credits for Qualifying Children and Other Dependents*. Because it is a nonrefundable credit, it is limited by the claimant's ordinary income tax liability and may be further reduced by other claimed credits.

Taxpayers can claim the ODC for any dependent listed on their return who does not qualify for the CTC or ACTC. For example, the dependent may be over age 16 or may not have a Social Security number. While smaller than the CTC, the ODC applies to a broader range of qualifying relatives. It provides up to $500 for each qualifying dependent, including:

- Dependent parents or other qualifying relatives supported by the taxpayer; and
- Dependents living with the taxpayer who aren't related to the taxpayer.

The $500 credit may apply to a child aged 17 or 18, a full-time student under age 24, and other qualifying relatives. Whereas a child aged 16 or younger with a disability may qualify for the CTC, a parent could claim a special-needs adult child for the $500 ODC.

Type of dependent	Age range	Applicable credit	Credit amount
Qualifying child	Ages 0 to 16	CTC	$2,200
Qualifying child	Ages 17 and 18	ODC	$500
Qualifying child	Full-time student below age 24	ODC	$500
Qualifying child	A disabled child, age 17 or older	ODC	$500
Qualifying relative	Any age, but other requirements apply	ODC	$500

The CTC and ACTC share the same eligibility requirements, but ODC claimants must meet different tests to qualify for the $500 credit.

AGE AND CITIZENSHIP TESTS

There is no age test for the ODC — the dependent can be any age. However, the person must be a US citizen or US resident (such as a green card holder).

If a dependent is a resident of Mexico or Canada, they may qualify as a dependent for federal tax purposes under IRC Section 152(b)(3)(A) even if they are not a US citizen, US national, or US resident. However, both the CTC and the ODC require the dependent to be a US citizen, US national, or US resident.

Example. Roberta's mother lives in Mexico. Roberta provides significant financial support for her, and her mother received no other income in 2026. Roberta's mother could qualify as a dependent (if she has an ITIN), allowing Roberta to file as head of household. However, because her mother is not a US citizen, US national, or US resident, she cannot be claimed for the ODC.

TAXPAYER IDENTIFICATION NUMBER REQUIREMENT

Unlike the CTC and ACTC, there is no strict SSN requirement to claim the ODC for qualifying children and other dependents. Taxpayers can claim the credit for qualifying

dependents with an ITIN or an ATIN if they otherwise qualify. This distinction matters for mixed-status families: a child who lacks an SSN but has an ITIN may qualify for the ODC even though the same child would be ineligible for the CTC.

Feature	CTC	ACTC	ODC
Max per dependent	$2,200	$1,700 refundable	$500
Refundable?	No	Yes	No
Earned income required?	No	Yes ($2,500+)	No
SSN required?	Yes (child + parent rule)	Yes	No
Age limit?	<17	<17	None

RELATIONSHIP AND RESIDENCE TESTS

Qualifying child. The relationship test for the CTC serves as the foundation for the ODC's qualifying child test. Taxpayers can receive a $500 credit for a qualifying child (such as a biological child, an adopted child, a stepchild, or a foster child) who could not be claimed for the CTC — perhaps because the child lacked a Social Security number, or because the child was older than age 16. Claimants can also receive the ODC for grandchildren, siblings, nieces, and nephews, even if they do not live with the taxpayer.

Qualifying relative. Unlike the CTC's relationship test, the ODC's test adds a layer of qualification for relatives. A qualifying relative can be a mother, father, grandmother, grandfather, aunt, or uncle. The group of dependents also includes certain individuals from the "qualifying child" category — such as grandchildren, brothers, sisters, nieces, and nephews. If the taxpayer files a joint return, the qualifying relative can be related to either spouse.

Despite the name, a "qualifying relative" does not necessarily have to be related to the taxpayer. If a dependent is not a relative, that person must satisfy all qualifying-relative rules and an additional requirement: they must live with the taxpayer for the entire year. Blood-related individuals can be dependents even if they do not live with the taxpayer, but unrelated adults must reside in the taxpayer's home all year.

The IRS prohibits taxpayers from claiming their spouse as a dependent or qualifying relative. However, they may be allowed to claim a boyfriend or girlfriend as a dependent (see Example 1 below).

SUPPORT TEST

The support test for the CTC is based on the qualifying child rules in IRC Section 152(c)(1)(D) — the child cannot provide more than half of their own support. The precise amount the parent or claimant must contribute is not expressly stated in the CTC support test.

The support test for the ODC is phrased differently because it adheres to the qualifying relative rules. Under those rules, the parent or claimant must have provided more than half of the prospective dependent's living expenses during the year [IRC Section 152(d)(1)(C)].

INCOME TEST

Threshold for the claimant. The income-based phaseouts for the ODC are the same as those for the CTC: the credit begins to phase out when the taxpayer's income exceeds $200,000 (or $400,000 for married couples filing jointly).

Gross income limit for qualifying relatives. A gross income test applies to qualifying relatives (but not to qualifying children). For ODC purposes, gross income means all income the qualifying relative received in money, goods, property, and services that is not exempt from tax. Gross income includes taxable unemployment compensation and certain scholarship and fellowship grants. It excludes tax-exempt income such as tax-free Social Security benefits.

For 2026, qualifying relatives are limited to a gross income of $5,300 or less [Revenue Procedure 2025-32]. When a qualifying relative's gross income exceeds $5,300, they cannot be claimed as a dependent for ODC purposes — even if someone else paid more than 50% of their annual support.

Example 1. Jaden (age 29) has lived with his girlfriend, Ivonne (age 26), and her 4-year-old son (not Jaden's child) in the same home for the entire year. Jaden provided more than half the financial support for both Ivonne and her son. Ivonne is not required to file a tax return this year. Both Ivonne and her son pass the qualifying relative test and may be claimed by Jaden for the ODC if all other criteria are met.

Example 2. Catalina pays $15,000 toward her father's annual support. Her father receives $12,000 in tax-free Social Security payments and $2,000 in self-employment income. His total annual living expenses are $29,000. For credit purposes, the father's gross income is $2,000 (excluding Social Security payments). Because $2,000 is below the $5,300 gross income limit, and his total income of $14,000 is less than half of his $29,000 in living expenses, Catalina can claim her father as a dependent for the ODC (assuming all other eligibility requirements are met).

QUALIFYING CHILD	QUALIFYING RELATIVE
The child must be related to the taxpayer by blood or adoption; this includes direct offspring, stepchildren, adopted children, and foster children.	No strict relationship requirement exists for this category of dependents, but qualification is somewhat easier for blood-related relatives (such as parents).
For dependency purposes, a qualifying child needs to be under 19 years old, a full-time student under 24 years old, or any age if disabled.	A qualifying relative can be any age.
The child should live with the taxpayer for more than half the year.	A blood-related relative does not need to live with the taxpayer, but an unrelated dependent (such as a girlfriend or boyfriend) needs to live with the taxpayer all year.
The child cannot provide more than half of their own support.	The taxpayer needs to provide more than half of the dependent's financial support.
There is no gross income requirement for qualifying children.	The dependent must have gross income of $5,300 or less in 2026.

REVIEW QUESTIONS

23. Each of the kids listed below is six years old, and their parents hold valid SSNs. Which of them is eligible for the child tax credit on their parents' 2026 return?
{A}. Joel is a green card holder (a resident alien) with a Social Security Number (SSN) and has lived with his parents all year.
{B}. Samantha has an SSN and resides with her custodial parent (the taxpayer seeking to claim the child tax credit) for 200 full days during the year.
{C}. Izaiah had an SSN when he was officially adopted in January (when he started living with his new parents).
{D}. All of the kids above are eligible for the CTC on their parents' 2026 tax returns.

24. Rich and Marylu are married, file jointly, and have two kids under the age of 17. Their joint income is $420,000, meaning they will lose some of their child tax credit. Since Rich and Marylu's MAGI exceeds the $400,000 phaseout threshold for married couples by $20,000, they must reduce their credit by $50 for every $1,000 over the limit. What is Rich and Marylu's final credit amount?
{A}. They can claim a $3,400 child tax credit [($2,200 × 2 kids) – (20 × $50)].
{B}. They can claim a $1,000 child tax credit [($1,000 × 2 kids) – (20 × $50)].
{C}. They can claim a $2,000 child tax credit ($1,000 × 2 kids).
{D}. They can claim a $4,000 child tax credit ($2,000 × 2 kids).

Part E reveals the correct answers to all end-of-chapter review questions while providing feedback on both correct and incorrect responses.

Chapter 8. THE CHILD & DEPENDENT CARE TAX CREDIT

Learning objective: This chapter will develop the reader's understanding of the child and dependent care tax credit — especially the credit rules for claimants, their children or dependents, and which expenses qualify. The chapter will also compare and contrast the child and dependent care tax credit with dependent care FSAs, with particular attention to the new rules enacted by the OBBBA.

Chapter Topics

- Requirements for the claimant
  - » Claimant must be gainfully employed
  - » Claimant must have earned income
  - » Claimant's filing status
- Qualifying person
  - » Qualifying persons under age 13
  - » Child of separated parents
  - » Qualifying persons over age 12
  - » Taxpayer identification number
- Qualifying expenses
  - » Timing of expenses
  - » Not all caregiver expenses qualify for the CDCTC
  - » Household services
  - » Employment taxes for household employers
  - » Camps and school-related fees
- Computing the credit
  - » Determine the amount of allowable expenses
  - » Credit equals 20% to 50% of allowable expenses
  - » Credit percentage depends on claimant's AGI
  - » What happens to CDCTC at low and high incomes?
- Flexible spending accounts
  - » Limits and benefits
  - » FSA versus CDCTC
- Tax forms

The Child and Dependent Care Tax Credit (CDCTC) is the primary federal tax provision designed to offset a portion of work-related childcare and dependent care costs. The credit recognizes that if workers are taxed on their wages, they should receive tax relief for the costs they incur to earn those wages — just as businesses deduct the costs of producing taxable income.

For 2026, the OBBBA has substantially expanded the CDCTC. The maximum credit rate is now 50% (up from 35%). Under the new structure, the credit rate phases down in the following way:

- From 50% to 35% as AGI rises from $15,000 to $43,000;

● Then remains at 35% until AGI reaches $75,000 (for single filers) or $150,000 (for joint filers;
● Then phases down from 35% to 20% as AGI rises to $103,000 (for single filers) or $206,000 (for joint filers).
● As was the case in prior law, the credit never fully disappears regardless of income — only the rate shrinks, not the availability of the credit itself.

REQUIREMENTS FOR THE CLAIMANT

Receiving this tax credit is more complex than adding up dependent care expenses and claiming them on a tax return. Taxpayers must meet stringent and specific criteria before obtaining a tax benefit for their child and dependent care costs. The taxpayer claiming the child and dependent care credit (the claimant), the qualifying person receiving care, and the care provider must each satisfy eligibility requirements.

CLAIMANT MUST BE GAINFULLY EMPLOYED
The CDCTC is a tax credit designed to help offset the expenses of providing care for qualifying persons, provided the claimant is working or searching for work.

Parents cannot claim the CDCTC for the cost of a babysitter while they go out for dinner and a movie. The care must allow the parents to work. Taxpayers would not qualify for the CDCTC if the child or dependent care takes place off-hours for personal reasons.

To qualify for the CDCTC, the claimant — and their spouse, if they are married — must be gainfully employed or seeking work. Gainfully employed means the claimant works full-time or part-time and earns an income.

Gainful employment does not encompass unpaid volunteer work or volunteer work for a nominal salary, but it does include being a full-time student.

Temporary absences from work. A claimant is generally not considered "gainfully employed" during paid vacation time for credit purposes. Also, the claimant may not include expenses for dependent care incurred while off work due to sickness. However, the IRS allows an exception for short-term or temporary absences. As a rule, an absence of up to two consecutive weeks due to illness or vacation is considered short-term. Claimants may count dependent care paid during a short-term or temporary absence toward the CDCTC, but may not count expenses incurred during longer absences.

CLAIMANT MUST HAVE EARNED INCOME
The claimant — and their spouse, if married filing jointly — must have earned income from wages, salaries, other taxable employee compensation, or net earnings from self-employment. Members of the armed forces can elect to include nontaxable combat pay in earned income.

Most types of unearned income — such as unemployment compensation, pensions, annuities, Social Security payments, interest, dividends, or workers' compensation — do not count for the CDCTC.

The claimant cannot take the credit if they have no earned income for the year unless the claimant or their spouse is disabled or is a full-time student. A full-time student is someone enrolled at a school for five months of the calendar year (not necessarily consecutive) for the number of hours considered by that institution to be a full-time course of study [IRC Section 21(e)(7)].

Married couples may not claim this credit if a nonworking spouse can care for the qualifying person. If one spouse had no earned income, was not looking for work, was not a student, and was able to care for themselves, the couple cannot claim the credit, since it is assumed the nonworking spouse would have been providing care.

CLAIMANT'S FILING STATUS

Unmarried individuals must file as single, head of household, or qualifying surviving spouse to be eligible for the CDCTC. Married couples should file a joint return to qualify for the credit.

Taxpayers are generally ineligible for the CDCTC if they file as "married filing separately" (MFS). However, if the claimant is legally separated from or living apart from their spouse, they may be allowed to file a separate return and still claim the credit. The married claimant could be considered "unmarried" if all of the following conditions apply:

- The claimant is living apart from their spouse;
- The claimant does not file a joint return with their spouse;
- The claimant and qualifying child (or dependent) live in the same home for more than half the year;
- The claimant pays more than half the cost of keeping up that home for the year; and
- The claimant's spouse did not live in the claimant's home for the last six months of the year.

If the above tests are satisfied, the taxpayer is treated as unmarried, and the other spouse's income or employment status is irrelevant [IRC Section 21(e)(4)]. Eligible MFS filers should disregard California community property rules when calculating earned income for the CDCTC.

Can an MFS filer claim a child who lives with the other parent? The worker cannot claim care expenses for someone who does not live with them. As noted above, the claimant must share a home with the qualifying person and must pay over half the costs of maintaining that home.

QUALIFYING PERSON

QUALIFYING PERSONS UNDER AGE 13

Expenses must have been incurred for the well-being and protection of a "qualifying person" while the claimant was engaged in a productive activity. In most cases, a "qualifying person" is a child who was under age 13 at the time expenses were incurred for their care [IRC Section 21(b)(1)].

Often conflated with the child tax credit, the CDCTC is a federal benefit that helps working parents cover the costs of caring for children ***under age 13***. The child tax credit, on the other hand, may be granted to parents (and other guardians) regardless of child-related expenses, so long as the child is ***under age 17*** on the last day of the tax year.

With the CDCTC, an individual could be a qualifying person for only part of the tax year. That is because an individual's status as a qualifying person is determined daily. If the child turned 13 during the year, the child is a qualifying person for the part of the year they were under age 13, and only expenses incurred before the child's birthday count.

Example. If a child turns 13 on July 31, the parent may claim childcare costs incurred up to that day but not afterward. If a person is age 13 or older, expenses for this person no longer count toward the tax credit — unless they cannot care for themselves because of a physical or mental disability.

CHILD OF SEPARATED PARENTS

In the case of a child of divorced or separated parents, only the custodial parent may claim the CDCTC. A custodial parent is the parent with whom a child resides for the greater portion of the calendar year; the other parent is the noncustodial parent. The credit is not available to the noncustodial parent.

A common misconception is that a noncustodial parent may claim the CDCTC if they hold Form 8332, which grants permission to claim the child as a dependent. Form 8332 may grant a noncustodial parent access to the child tax credit, but does not permit the noncustodial parent to claim the CDCTC.

Custodial parents may claim the child and dependent care credit even if they are not claiming the child as their dependent. Noncustodial parents cannot claim the CDCTC, even if they would otherwise qualify to treat the child as a dependent.

QUALIFYING PERSONS OVER AGE 12

It is possible to claim the CDCTC for someone older than 12 — such as an older child, or even the claimant's mother, father, sibling, or spouse. However, these older individuals must have been incapable of self-care and should have lived with the claimant for more than half the year [IRC Section 21(b)(1)(C)].

In addition to children aged 12 or younger, the CDCTC could help offset expenses incurred for the care of:

● The claimant's spouse, who lived with the claimant for at least half the year and is not physically or mentally capable of self-care.

● The claimant's dependent, other than a child, who lived with the claimant for at least half the year and is physically or mentally incapable of self-care.

● Someone unable to care for themselves who lived with the claimant for more than half the year and would have been the claimant's dependent except that: (i) the qualifying person received gross income of $5,300 or more in 2026, (ii) the qualifying person filed a joint return, or (iii) the claimant, or the claimant's spouse if filing jointly, could be claimed as a dependent on someone else's return.

In Treasury Regulation 1.21-1(b)(4), the IRS defines someone who can't physically or mentally care for themselves as an individual who "is incapable of caring for the individual's hygiene or nutritional needs, or requires full-time attention of another person for the individual's own safety or the safety of others."

TAXPAYER IDENTIFICATION NUMBER

Claimants must include the qualifying person's name and Social Security number on their return. An ATIN may be used if the qualifying person is an adopted child. If the qualifying person is a nonresident or resident alien who does not have and cannot obtain an SSN, an ITIN may be used. If the child or dependent does not have an ITIN, they should apply for one using Form W-7.

The IRS will check whether the qualifying person's tax identification number was used on another tax return. If a qualifying person is claimed on more than one tax return for the CDCTC, the IRS will apply tiebreaker rules to determine who may claim the credit.

QUALIFYING EXPENSES

TIMING OF EXPENSES

Dependent care expenses are incurred when the services are provided, not necessarily when the claimant is billed for or pays for those services. When a working parent pays for services before they are provided, the parent may include the prepaid expenses only in the year the care is actually received. Thus, if someone paid for childcare in December 2026 for a week in January 2027, that person would use those costs toward the CDCTC on the 2027 tax return.

NOT ALL CAREGIVER EXPENSES QUALIFY FOR THE CDCTC

The CDCTC imposes restrictions on who can be employed to provide care. Expenses must be for a legitimate care provider, such as a licensed childcare facility. The care provider cannot be a spouse, a parent of the child, or a dependent of any age. Payments made to the claimant's child who is under age 19 at the end of the year also will not qualify, even if the child is not the claimant's dependent [IRC Section 21(e)(6)].

Example. Payments made to the claimant's 18-year-old daughter to care for her 12-year-old brother do not count toward the credit, even if the daughter is not claimed as a dependent on the parent's tax return.

HOUSEHOLD SERVICES

Most types of dependent care qualify for the credit. Care provided at the claimant's home and at the caregiver's location (outside the claimant's household) are eligible for the CDCTC.

Payments for household services qualify for the credit when performed in conjunction with the care of the qualifying person. Expenses qualify if they are at least partly for the well-being and protection of a qualifying person.

Qualifying expenses include childcare provided by a nanny, babysitter, au pair, housekeeper, maid, cook, or cleaning person who looks after the qualifying person — although the claimant cannot include anyone paid under the table, nor can they include payments to a gardener.

EMPLOYMENT TAXES FOR HOUSEHOLD EMPLOYERS

When the claimant is not a household employer. The CDCTC claimant will not be considered a household employer if the worker who cares for the qualifying person does so at the worker's home or place of business. If the individuals who work in the claimant's home are self-employed, then the claimant is not liable for any employment taxes. Self-employed persons who are in business for themselves are not household employees.

If the claimant uses a placement agency that exercises control over what work is done and how it is done by a caregiver who works in the claimant's home, the caregiver is not the claimant's employee. The claimant does not have to pay employment taxes.

Federal taxes for household employment. Let's say an agency gives the CDCTC claimant a list of caregivers. Then the claimant hires one from that list and pays the caregiver directly. In that case, the caregiver may be a household employee, and the claimant may be a household employer, requiring an employer identification number (EIN) and potentially the payment of employment taxes.

When the caregiver is a bona fide employee of the claimant, federal employment taxes (FICA and FUTA) and similar state payroll taxes are qualifying expenses for the CDCTC. However, amounts withheld from the employee's wages for federal and state income taxes do not qualify.

CAMPS AND SCHOOL-RELATED FEES

If a child has not yet reached kindergarten, the cost of childcare can count toward the credit — whether it is called preschool, transitional kindergarten, nursery school, or daycare. Nursery school and other pre-kindergarten costs generally qualify for the

CDCTC because the educational benefits are considered incidental to the childcare costs.

Once children hit kindergarten, those tuition fees no longer qualify for the credit. Expenses paid for a child to attend kindergarten (or a higher grade) do not count toward the credit because kindergarten or a higher grade is primarily educational. The part of the expense attributable to the child's care may qualify if it can be separated from the cost of education; for example, before-school or after-school care in kindergarten or a higher grade.

The costs of summer school and tutoring programs do not qualify because they are primarily educational in purpose. An overnight or sleepaway camp never qualifies — no portion of the cost of an overnight camp is considered an employment-related expense [IRC Section 21(b)(2)(A)]. Even if the camp provides childcare, its overnight nature removes it from CDCTC eligibility.

Summer day camp fees, however, may qualify for the CDCTC if parents use the service to provide childcare so that they can work. A day camp may constitute a qualifying expense even when it specializes in a particular activity such as soccer, horseback riding, or basketball.

Example. Madelynne enrolled her 9-year-old son in a local day camp so that she could work. The fee was $280 for a two-week program (Monday through Friday, 8 am to 6 pm). The program offered a variety of recreational activities for children ages 6 through 9. Madelynne may include the $280 expense when considering the CDCTC.

ELIGIBLE COSTS	INELIGIBLE COSTS
Before/after school programs	Tutors and summer school tuition
Preschool or nursery school tuition	Tuition for kindergarten or higher grade
Summer day camp	Overnight camp
Babysitting	Parent pays one of their dependents to care for another one

Expenses for the care of a qualifying person must be for the person's well-being and protection. Generally, the cost of transporting a qualifying person to and from the care location is not a dependent care expense. Amounts paid for clothing, entertainment, food, or schooling generally do not qualify unless they are incidental to and cannot be separated from the cost of caring for a qualifying person.

Example. Ana takes her 3-year-old child to a nursery school that provides lunch and educational activities as part of its preschool childcare service. The lunch and educational activities are subordinate to the childcare, and Ana cannot separate their cost from the cost of care. Therefore, Ana can count the entire expense when she figures the credit.

However, the general rule is that the claimant must separate the cost of caring for the child from the expense of schooling.

COMPUTING THE CREDIT

DETERMINE THE AMOUNT OF ALLOWABLE EXPENSES

To begin calculating the CDCTC, add up the claimant's qualifying expenses. The amount of child and dependent care costs that can be used to compute the credit is limited. Calculating the credit requires taking the claimant's actual expenses or the maximum limit, whichever is less. Families can claim up to $3,000 in care expenses for one qualifying person or $6,000 for two or more qualifying persons [IRC Section 21(c)]. The OBBBA did not change the expense caps.

The maximum amount of qualified expenses for the credit is:	
$3,000 in qualifying costs for 1 dependent	**$6,000** in qualifying costs for 2 or more dependents

Example. Daniella and Rene are married and have one child, for whom they have incurred $6,000 in childcare expenses. Both parents are employed. Because they have expenditures for only one qualifying individual, they are limited to $3,000 in computing their child and dependent care credit. In November, Rene had surgery and couldn't care for himself for three days. If Daniella pays $632 for a caregiver to watch over Rene while she continues working, those expenses qualify as employment-related expenses. As a result, Daniella and Rene can claim $6,000 in CDCTC expenses because there are now two qualifying individuals who were cared for during the year.

The dollar limit on expenses is a yearly limit; the claimant does not need to prorate it based on how long a person was a qualifying person during the year. However, if someone was a qualifying person for only part of the year, care expenses for that part may be applied toward the credit.

If a claimant receives partial reimbursement of expenses from a state agency, they are not entitled to take the CDCTC for the reimbursed amount. Similarly, if an employer offers dependent care benefits, the employee must subtract that amount from their eligible expenses. Employer contributions to a dependent care plan cannot be counted toward the CDCTC.

When the claimant's income is less than expenses. The allowable expenses could be further reduced to the claimant's earned income for the year if that amount is less than the actual expenses. For claimants who file joint returns, the base amount may be limited to the lower-paid spouse's earned income.

If one spouse is disabled or a full-time student, they might not have any earned income. Rather than using $0 as that spouse's income, the IRS imputes earned income for each month the spouse is disabled or a full-time student: $250 per month for one qualifying person or $500 per month for two or more qualifying persons [IRC Section 21(d)(2)]. The deemed income for a student applies only during the months of full-time enrollment; a partial month is treated as a full month.

Example. In 2026, Finley worked full-time and earned a $75,000 salary. His wife, Miriam, was a full-time student for nine months in 2026 and had no actual earned income. Miriam and Finley have two kids under 13. The couple spent $10,000 on childcare expenses during Miriam's time at school. Under the special rule for students, Miriam is deemed to have $4,500 of imaginary earned income for 2026 ($500 × 9 months). So the $10,000 spent on childcare is first reduced to the $6,000 limit for taxpayers with two or more qualifying children, then further reduced to the income of the lower-earning spouse — which, in this case, is Miriam's $4,500 of imputed income. The allowable expenses are $4,500.

CREDIT EQUALS 20% TO 50% OF ALLOWABLE EXPENSES

The CDCTC is a percentage linked to the claimant's adjusted gross income and the amount of work-related childcare expenses paid during the year. The expense limitation amounts and the AGI sliding-scale amounts are not subject to a cost-of-living adjustment and are not indexed for inflation.

Under the OBBBA, effective for 2026 and thereafter, the CDCTC provides a nonrefundable tax credit of 20% to 50% of the first $3,000 spent on care for one qualifying person and the first $6,000 for two or more qualifying persons. The maximum credit is now 50% of $3,000 ($1,500) for one dependent, and 50% of $6,000 ($3,000) for families with two or more dependents. Taxpayers with AGI above $103,000 (for single filers) or $206,000 (for joint filers) receive the minimum credit rate of 20%.

CREDIT PERCENTAGE DEPENDS ON CLAIMANT'S AGI

The dependent care tax credit begins to phase down gradually from 50% for individuals with AGI exceeding $15,000 to 35% for those with AGI of $43,000. There is a plateau at 35% between $43,000 and $75,000 (or between $43,000 and $150,000 for joint filers). It phases down from 35% to 20% for those with an AGI exceeding $75,000 (or $150,000 for joint filers). The credit finally plateaus at 20% for those with an AGI exceeding $103,000 (or $206,000 for joint filers).

PHASE-DOWN RESTRUCTURED BY OBBBA	
50% to 35%	Phases down for AGI between $15,000 and $43,000
35% Plateau	Stays at 35% for AGI between $43,000 and $75,000 for single filers (between $43,000 and $150,000 for joint filers)
35% to 20%	Credit rate gradually reduces until hitting a 20% floor for AGI over $103,000 (single) or $206,000 (joint)

Example. Rosalinda and Herbert have two children, ages 4 and 13. Their combined AGI is $70,000. The older child turned 13 on October 1. They paid $5,000 in nursery school fees for the 4-year-old and $1,500 (for nine months, January through September) for after-school care and summer camp for the 13-year-old, for a total of $6,500. Because they have two qualifying persons, the allowable expense limit is $6,000. With an AGI of $70,000, the applicable credit percentage is 35%. Therefore, the CDCTC that Rosalinda and Herbert can claim in 2026 is $2,100 ($6,000 × 35%). Under the old pre-OBBBA rules, their credit at the same income level would have been only $1,200.

WHAT HAPPENS TO CDCTC AT LOW AND HIGH INCOMES?

Low-income claimants. Lower-income families will not fully benefit from the CDCTC if their tax liability is less than the amount of their allowable credit. The CDCTC is not refundable — the best it can do is reduce the claimant's tax liability to zero. There are no carryovers of the excess credit, so it is limited to the family's tax liability for the year the CDCTC is claimed.

While the OBBBA raised the maximum credit to $3,000 (50% of $6,000), the CDCTC remains nonrefundable. Families with very low incomes who owe little or no income tax will still be unable to utilize the credit fully. Tax professionals should always check whether the sum of other nonrefundable credits on Form 1040 has already eliminated the filer's tax liability before applying the CDCTC.

Example. Elaina has a tax liability of $503. She has a qualifying child and is eligible for $2,200 of the child tax credit (now permanent at that level under the OBBBA). Elaina can also claim a $600 credit based on her childcare expenses. If she takes the CDCTC (a nonrefundable credit), Elaina can claim only $503 of that $600 to eliminate her tax liability — but then she has nothing left for the child tax credit. If Elaina instead takes the nonrefundable portion of the child tax credit ($503), she eliminates her tax liability. She may still receive up to $1,700 in the additional child tax credit (a refundable credit). Therefore, Elaina should claim the child tax credit rather than the CDCTC.

High-income claimants. The CDCTC does not phase out entirely at any income level. Those with a higher AGI receive a smaller credit percentage, but the credit never disappears. Taxpayers with AGI above $103,000 (for single filers) or $206,000 (for joint filers) qualify for the minimum rate of 20% of allowable expenses, meaning a claimant earning $400,000 and a claimant earning $104,000 receive the same 20% rate. The expense caps — $3,000 or $6,000 — apply regardless of income.

What is NOT new under OBBBA
Expense caps of $3,000 (for one dependent) and $6,000 (for more than one dependent) remain unchanged
Nonrefundability remains unchanged
Earned income requirement remains unchanged
Definition of qualifying person remains unchanged
No change to overnight camp rule

FLEXIBLE SPENDING ACCOUNTS

IRC Section 129 describes 'dependent care assistance programs' and provides a tax framework for these DCAPs. The most notable offshoot of Section 129 is the dependent care flexible spending account (FSA).

Dependent care FSAs are set up through the workplace and typically funded through voluntary salary reduction agreements. Money deducted from an employee's pay that goes into an FSA is not subject to payroll taxes.

If an employer offers a dependent care FSA, the employee deposits money into the account each pay period and then uses it for subsequent childcare expenses. The amount is deducted from the employee's paycheck and eventually reimbursed to the employee for qualified expenses — that is, cash paid for services that enable the employee to work, such as at-home care (a nanny or babysitter) and care outside the home (such as preschool or after-school care).

Unlike some medical FSAs, a dependent care FSA does not allow the employer to "front" the money. Working parents pay expenses out of pocket and then apply for reimbursement based on what has been withheld from their paycheck for dependent care. When the employee incurs a qualified expenditure, they submit receipts to their employer (usually with a claim form). Receipts must include the date, the dollar amount, and the care provider's identification. When the employer approves the expenditure, the employer reimburses the employee tax-free.

LIMITS AND BENEFITS

Flexible spending plans operate on a "use it or lose it" basis: funds contributed to the plan should be used by the end of the plan year for qualified dependent care expenses. Funds left unused at the end of the plan year are forfeited. Unlike a health FSA, a dependent care FSA cannot have a carryover feature.

Effective January 1, 2026, the OBBBA permanently increased the annual dependent care FSA contribution limit from $5,000 to $7,500 (or from $2,500 to $3,750 for married couples filing separately). This is the first increase to the FSA limit since it was set in 1986. The new limits are not indexed for inflation. Note that employers are not required

to increase their plan's limit to the federal maximum; employees should verify the limit their employer has adopted.

Employee tax-free FSA contributions (and employer tax-free reimbursements) are now limited to $7,500 annually. A lower limit applies if the employee earns less than $7,500 (or $3,750 if married filing separately). Lower limits may also apply when the employee's spouse is disabled or a full-time student. Any employer assistance that exceeds the applicable threshold is taxable and should be listed on line 1e of Form 1040 ("Taxable dependent care benefits").

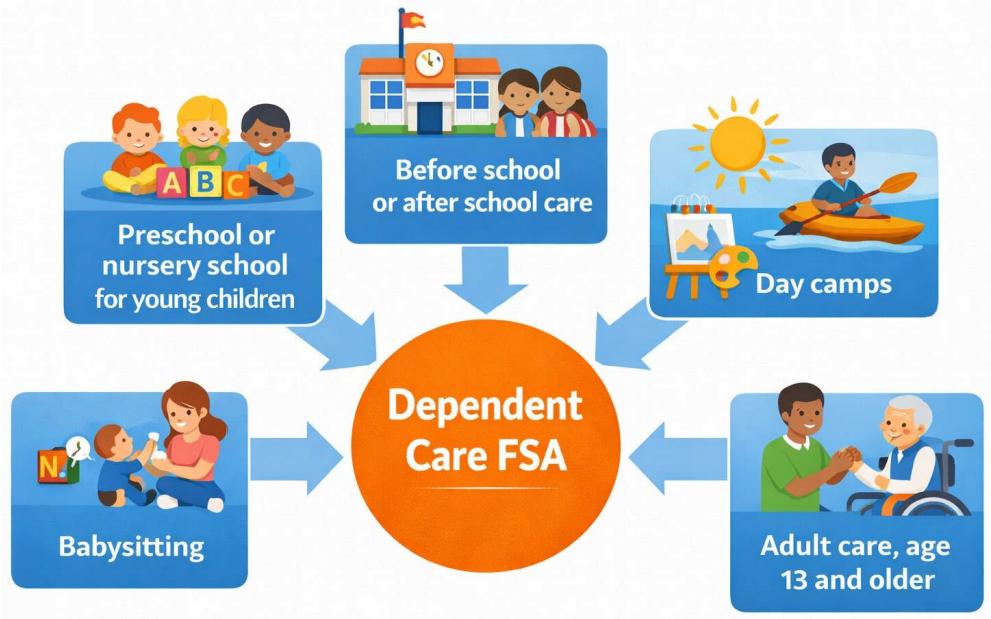
Example. Braelynn files as head of household. After joining her employer's dependent care FSA under the new 2026 limit, she requested that $7,500 be deducted from her $61,910 gross salary, or $625.00 per month. During the first quarter, her FSA contains $1,875. During the quarter, she incurred $1,500 in dependent care expenses and submitted them for reimbursement. The tax-free payment that Braelynn will receive from her employer at the end of the first quarter is $1,500.

The money set aside in the FSA is subtracted from the employee's paycheck before income taxes are calculated. The amount contributed also bypasses the 7.65% Social Security and Medicare taxes. In other words, if the employee is in the 22% tax bracket, they will not pay the 22% income tax or the 7.65% FICA tax on the FSA contribution. At the maximum $7,500, a 22%-bracket employee saves approximately $2,224 in combined federal taxes ($7,500 × 29.65%). In contrast, the CDCTC reduces income tax but does not lower FICA taxes.

FSA VERSUS CDCTC

The FSA eligibility requirements are similar to those of the tax credit. Provided the dependent care expenses are necessary for the employee to work, the FSA participant will recover those out-of-pocket costs as tax-free reimbursements from their employer. If the employee is married and files jointly, the expenses must be necessary for both spouses to work (or for one to work while the other attends school full-time for at least five months). As with the tax credit, those expenses cannot exceed the earned income of the lower-paid spouse.

Like the CDCTC, a dependent care FSA requires the qualifying person to be a child under age 13 or an older disabled individual who has lived with the employee for more than half of the year. The FSA and the CDCTC share the same definition of eligible care providers.



Employees cannot claim the same expenses for both the FSA and the CDCTC. Each dollar of childcare expenses must be assigned to one tax break or the other. Dependent care costs reimbursed through an employer-sponsored FSA cannot be claimed for the CDCTC. Dependent care costs that exceed FSA benefits may qualify for the CDCTC.

Important shift in 2026. Before the OBBBA, the FSA almost always outperformed the CDCTC for middle-income families (assuming those families had access to an FSA). With the OBBBA raising the credit's maximum rate to 50% and the FSA limit to $7,500, the analysis is now considerably more complex. Tax professionals should run the numbers for their client's specific situation.

Example 1. A married couple with two children and a combined AGI of $84,907. After accounting for the standard deduction, their taxable income falls in the 12% bracket. They spent $7,500 on childcare. Their employer offers the full $7,500 in FSA benefits. Using the FSA strategy, the couple contributes $7,500 to the FSA. Here the tax savings are ($7,500 × 12%) + ($7,500 × 7.65%) = $900 + $573.75 = $1,473.75. What if the couple uses the CDCTC-only strategy? With an AGI of $84,907, the credit rate is 35%. The CDCTC equals $6,000 × 35% = $2,100 in income tax savings. The CDCTC strategy wins here due to the OBBBA's higher credit rate (at the pre-OBBBA rate of 20%, the FSA would have generated a greater tax benefit).

CDCTC often wins when	Taxpayer qualifies for a credit rate ≥ 35%
	and has two or more dependents
FSA often wins when	Taxpayer has significant FICA savings
	with one dependent (where the $7,500 FSA expense limit is greater than the $3,000 CDCTC expense limit)

Example 2. Candee files as head of household with an AGI of $70,000. After accounting for the standard deduction, her taxable income falls in the 12% bracket. Candee has one dependent for whom she pays $5,000 in childcare expenses. First, she considers the CDCTC. With an AGI of $70,000, her credit rate is 35%. With one dependent, her expenses are capped at $3,000. The CDCTC equals $3,000 × 35% — which results in income tax savings of $1,050. Next, she considers the FSA. Candee contributes $7,500 to an FSA. She saves ($7,500 × 12% income tax) + ($7,500 × 7.65% FICA) = $900 + $573.75 = $1,473.75. The FSA strategy wins here due to the higher amount of allowable expenses for one dependent and FICA savings.

FSA and CDCTC coordination rules under OBBBA. Because the FSA limit ($7,500) now exceeds the CDCTC two-dependent expense cap ($6,000), a family that maximizes an FSA for two children eliminates all CDCTC eligibility — there are no unreimbursed expenses left to claim. Families with two or more dependents who want to use both benefits should limit FSA contributions to an amount below $6,000 and claim the CDCTC on the balance up to $6,000. For a family with one child, the CDCTC cap is $3,000, meaning up to $4,500 in FSA contributions can be made beyond that cap without affecting CDCTC eligibility.

TAX FORMS

To qualify for the CDCTC, the claimant must provide the care provider's name, address, and tax identification number on Form 2441. Most childcare providers will give the taxpayer this information, and many will provide the total amount paid during the year.

If the care provider is an individual, the tax identification number is their Social Security number or ITIN. If the care provider is an organization, like a for-profit daycare center, they should provide their EIN. If the care provider is a tax-exempt organization, such as a school or church, the claimant does not need to give an ID number; instead, type or write "tax-exempt" in the appropriate box on Form 2441.

With the care provider's tax identification number, the IRS can match a claim against records that some childcare providers are required to submit and cross-check to verify that the childcare provider reports payments as income and pays taxes.

If the claimant does not provide correct or complete information, their credit may be disallowed unless they show they used due diligence to obtain the required information.

Whenever claimants do not receive any dependent care benefits from an employer, they complete only the front of Form 2441 (Parts 1 and 2). If the claimant received any dependent care benefits from their employer, they must complete the entire form, including Part 3 on the second page. Dependent care benefits received as an employee should be shown in box 10 of Form W-2.

	a Employee's social security number	OMB No. 1545-0029	Safe, accurate, FAST! Use — IRS e-file — Visit the IRS website at www.irs.gov/efile.
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 See instructions for box 12 Code
		14a Other	12b Code
			12c Code
			12d Code
f Employee's address and ZIP code		14b Treasury Tipped Occupation Code(s)	

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 B—To Be Filed With Employee's FEDERAL Tax Return.
This information is being furnished to the Internal Revenue Service.

Example. Hannah is a single mom with a three-year-old son, Hayden. She will use the head-of-household filing status on her 2026 return. Hannah's AGI is $103,000, so her CDCTC credit rate is 20% of allowable expenses. While Hannah works as a registered nurse, Hayden goes to preschool. Hannah's employer does not offer a dependent care FSA. She paid $14,400 in 2026 for qualifying childcare expenses, but the CDCTC permits her to count only $3,000 toward the credit. Since 20% of $3,000 equals $600, this is the amount Hannah will transfer from Form 2441 to Schedule 3. The $600 CDCTC will combine with Hannah's $2,200 child tax credit, and the $2,800 total will help reduce her gross tax liability. Note that Hannah's actual childcare cost of $14,400 dwarfs the $3,000 expense cap — a reminder of the significant gap between actual childcare costs and the modest support offered by the CDCTC.

SCHEDULE 3 (Form 1040)
Department of the Treasury
Internal Revenue Service

Additional Credits and Payments

▶ Attach to Form 1040, 1040-SR, or 1040-NR.
▶ Go to *www.irs.gov/Form1040* for instructions and the latest information.

OMB No. 1545-0074
Attachment Sequence No. **03**

Name(s) shown on Form 1040, 1040-SR, or 1040-NR: Hannah Davis
Your social security number: 123-45-6789

Part I Nonrefundable Credits

1	Foreign tax credit. Attach Form 1116 if required	1	
2	Credit for child and dependent care expenses from Form 2441, line 11. Attach Form 2441	2	600
3	Education credits from Form 8863, line 19	3	

REVIEW QUESTIONS

25. Dominic and Silvia are joint filers who work as teachers for nine months during the year. They pay $300 per month for childcare (they do not work for three months of the year). For purposes of the child and dependent care credit, their allowable expenses are limited to:
{A}. $300 per month for the three months of vacation ($900 of allowable expenses)
{B}. $300 per month for all 12 months of the year ($3,600 of allowable expenses)
{C}. $0; none of Dominic and Silvia's expenses qualify for the child and dependent care credit
{D}. $300 per month for the nine months of work ($2,700 of allowable expenses)

26. Ida has a 4-year-old daughter and will file as a head of household. Her earned income and AGI equal $60,578. Her taxable income is $36,428, which puts her in the 12% tax bracket. Ida spends about $6,000 annually on childcare for the one dependent. Her employer has recently offered her a dependent care FSA. Which one of the two tax breaks would bring about a greater reduction in Ida's federal taxes?
{A}. The FSA is better than the CDCTC because it can reduce Ida's federal tax liability by about $1,179 [($6,000 × .12 income tax) + ($6,000 × .0765 FICA tax)].
{B}. The CDCTC is better than the FSA because it can reduce Ida's federal tax liability by $1,050 ($3,000 × 35%).
{C}. Ida can use the same childcare expenses for both the FSA and the CDCTC, so she will save $2,229 in federal taxes by claiming both benefits simultaneously.
{D}. None of the above; the FSA is only for healthcare, and Ida's AGI is too high for the CDCTC.

Part E reveals the correct answers to all end-of-chapter review questions while providing feedback on both correct and incorrect responses.

Chapter 9. THE ADOPTION TAX CREDIT

Learning objective: Upon completion of this chapter, learners should understand the adoption tax credit sufficiently to advise potential claimants on eligibility, qualified expenses, timing rules, income limitations, and the credit amount applicable to their circumstances.

Chapter Topics

- OBBBA's improvements to the adoption credit
  - » Partial refundability
  - » Permanent inflation indexing
  - » Indian tribal government recognition
- Types of adoptions
- A federal tax credit to help with adoption costs
- Claimant's filing status
- Claimant's eligible child
  - » Adoption Taxpayer Identification Number (ATIN)
- The maximum credit is $17,670 in 2026
- Credit amount is often tied to adoption expenses
  - » Qualifying expenses
  - » Nonqualifying expenses
- Credit limited by claimant's income & tax liability
  - » Claimant's income
  - » Partial refundability and carryforwards
- When to claim the credit
  - » International adoptions
  - » Domestic and special needs adoptions
  - » Extended example
- Forms and recordkeeping
  - » Form 8839 and Schedule 3
  - » Adoption documents and receipts

OBBBA'S IMPROVEMENTS TO THE ADOPTION CREDIT

The OBBBA made a few changes to the federal adoption tax credit under IRC Section 23. Beginning in tax year 2025, the credit became partially refundable, and the 2026 inflation adjustment set the refundable ceiling at $5,120. In February 2026, the IRS posted a fact sheet on its website explaining these OBBBA changes to the adoption credit: https://www.irs.gov/newsroom/fact-sheets

PARTIAL REFUNDABILITY

For the first time, up to $5,120 of the credit is refundable, meaning eligible adoptive parents can receive money back even if they owe little or no federal tax.

Example. Adeline finalizes an adoption in 2026 and incurs $19,000 of qualified expenses. Her federal income tax liability is only $1,200. Under the OBBBA changes, $5,120 of her adoption credit may be refunded.

PERMANENT INFLATION INDEXING

Inflation indexing of the adoption credit already existed before 2025, but the OBBBA expanded it to include the newly created refundable portion.

INDIAN TRIBAL GOVERNMENT RECOGNITION

Indian tribal governments now have the same authority as state governments to determine whether a child has special needs for purposes of the adoption credit.

TYPES OF ADOPTIONS

Adoption is a legal process where parental rights and responsibilities are permanently transferred from a child's birth parents (or the state) to someone else, creating a new parent-child relationship, even if they are not biologically related. Children may be adopted from other countries (international adoptions) or within the United States (domestic adoptions).

Adoptions may be facilitated through public or private agencies, and sometimes through independent arrangements. Private agencies are privately operated businesses licensed by the state in which they operate to conduct adoptive parent home studies and to place American or foreign children for adoption. Private agencies often focus on placing newborns. For tax purposes, private agency adoptions are categorized as either international or domestic.

Public agencies are operated by state, county, or Tribal governments and place children who cannot safely remain with their biological families. These children are often older and frequently meet the definition of special needs for tax purposes. Public agency adoptions are categorized as special needs or domestic (non-special-needs).

An independent adoption occurs when the biological parent and the adoptive parents arrange the adoption without agency involvement. For tax purposes, independent adoptions are categorized as either domestic or international.

FOR TAX PURPOSES, ADOPTIONS FALL INTO THREE CATEGORIES
1. DOMESTIC SPECIAL NEEDS
2. DOMESTIC BUT NOT SPECIAL NEEDS
3. FOREIGN (NEVER SPECIAL NEEDS)

A FEDERAL TAX CREDIT TO HELP WITH ADOPTION COSTS

IRC Section 23 provides the adoption credit. The credit applies to qualified adoption expenses incurred for the adoption of an eligible child. The rules differ depending on whether the adoption is domestic or foreign, final or not final, and whether the child has been determined to have special needs.

CLAIMANT'S FILING STATUS

To claim the credit, individuals generally must file as single, head of household, or qualifying surviving spouse. In most cases, married couples must file a joint return to claim the adoption credit.

A married taxpayer may be able to claim the credit using married filing separately status if the taxpayer lived apart from the spouse during the last six months of the tax year and provided the home for the adopted child for more than half of the tax year while paying more than half of the cost of maintaining the home.

CLAIMANT'S ELIGIBLE CHILD

To be eligible for the credit, a child must generally be under age 18. An exception applies to an adoptee who is physically or mentally incapable of self-care.

A "stepparent adoption" is a common type of adoption in which someone gets married and then adopts their new spouse's child or children. However, a stepchild would not be eligible for credit purposes, so taxpayers who adopt their spouse's child cannot claim the adoption credit.

Section 23 does not exclude relatives. Kinship adoptions can qualify for the federal adoption tax credit. So a grandmother adopting her grandson would not be excluded on the basis of the biological relationship. The only exclusions are for:
- Stepparent adoptions (explicitly disallowed by statute); and
- Surrogate parenting arrangements (discussed later).

The adoption credit requires the child to have a taxpayer identification number. If the child does not have a Social Security number or there is not enough time to obtain one, the adopting parent can apply for an Adoption Taxpayer Identification Number (ATIN).

ADOPTION TAXPAYER IDENTIFICATION NUMBER (ATIN)

Adopting parents will often ask if they can claim their child as a dependent on their tax return when the domestic adoption is still in progress and not finalized in a court of law. Many adoptees obtain an SSN only after adoption is finalized, yet Form 1040 and related tax forms require the child's taxpayer identification number.

An ATIN is a temporary nine-digit number issued by the IRS to individuals who are legally adopting a US citizen or resident child but cannot get an SSN for that child in

time to file their tax return. The ATIN allows adoptive parents to claim the child as a dependent and to claim adoption-related tax benefits while waiting for the child's Social Security number.

An ATIN is rarely used for international adoptions. In foreign adoptions, the child will often receive documentation allowing the adoptive parents to seek a Social Security number after entry into the United States.

The ATIN is valid for two years. If the adoption is not finalized before the ATIN expires, the adopting parents may apply for an extension.

THE MAXIMUM CREDIT IS $17,670 IN 2026

For 2026, the maximum adoption credit is $17,670 per eligible child. The maximum amount is indexed annually for inflation. The ceiling applies per child, not necessarily per return. If taxpayers adopt two eligible children in 2026, the maximum credit could be $35,340, subject to the other limitations in the law.

Remember that up to $5,120 of the credit is refundable in 2026.

CREDIT AMOUNT IS OFTEN TIED TO ADOPTION EXPENSES

QUALIFYING EXPENSES

In general, the credit equals 100% of qualified adoption expenses per child or $17,670 per child, whichever is less. So if costs are less than $17,670, the adoptive parents claim only the actual expenses. If expenses exceed $17,670, the maximum credit is $17,670 per child.

Qualifying adoption expenses are reasonable and necessary expenses directly related to the legal adoption of an eligible child. Qualified expenses include expenses paid before identifying the child, such as home study costs, because the IRS expressly includes pre-identification expenses. Qualifying expenses also include adoption agency fees, attorney fees, court costs, and travel costs covering transportation, lodging, and meals [IRC Section 23(d)(1)].

QUALIFYING EXPENSES FOR ADOPTION TAX CREDIT
Adoption fees
Attorney fees
Court costs
Travel costs (transportation, lodging, and meals)
Re-adoption expenses related to the intercountry adoption of a foreign child
Other reasonable and necessary expenses directly related to the adoption

Special needs adoptions. Effective beginning with tax year 2025, Indian tribal governments have the same authority as state and county governments to determine whether a child has special needs for purposes of claiming the adoption credit. This change, enacted by the OBBBA, means that children in tribal communities receive the same recognition and tax benefit as children placed by state and county child welfare agencies.

For purposes of the adoption tax credit, "special needs" is a legal and regulatory status rather than a medical or clinical diagnosis. A child's disability, while a factor that may influence a state or tribal agency's decision, does not automatically confer "special needs" status. To qualify for the credit under this designation, a state, county, or Indian tribal government must officially determine that the child cannot or should not be returned to their birth parents and that, because of specific factors — such as age, membership in a sibling group, or a physical, mental, or emotional condition — the child would not be adoptable without financial assistance. Special needs children are those who receive adoption assistance or adoption subsidy benefits, which may include Medicaid (Medi-Cal in California) or reimbursement of certain expenses, because the state believes the child would not otherwise be adoptable.

This kind of adoption is only available for US children and is almost exclusively for children adopted from foster care. A foreign adoptee is not considered "special needs" for tax credit purposes. According to the IRS, a child is considered to have special needs (for the adoption tax credit) if:

- They are a US citizen or resident;
- The state, county, or tribal government determines that they cannot or should not be returned to their parents' home; and
- The state, county, or tribal government determines that the child (or siblings) will not be adopted without certain assistance being given to the adoptive family.

Families who adopt a child determined to have special needs by a state, county, or tribal government can claim the full credit of $17,670 without having any adoption expenses. Receiving government assistance does not reduce the adoption credit, but families may have their credit amount limited by their federal tax liability. If this happens, the adoptive parents should carry forward the unused nonrefundable credit for up to five years.

Example. Fresno Human Services is the child welfare department of Fresno County (in the State of California). Betsy, Willard, and Aidan are siblings. When Betsy was 10, Willard was 8, and Aidan was 6, Fresno Human Services removed the children from the home of the biological parents. After placing the children in foster care, the agency determined that these kids would face challenges in being adopted because of their ages and sibling relationships. To facilitate adoption, Fresno Human Services offered, and then provided, adoptive parents with monthly subsidy payments for each child. The adoption assistance agreements are evidence that a political subdivision of California has determined that Betsy, Willard, and Aidan are children with special needs. Therefore, even if the adoptive parents paid no qualifying adoption expenses and

received government assistance, they may claim the full credit of $17,670 per child for a total of $53,010 (or up to their tax liability, whichever is less). If the credit amount exceeds their tax liability, up to $5,120 of the credit per child is refundable in 2026, for a potential total refundable amount of $15,360 ($5,120 × 3). If the adoptive parents have zero tax liability, they could potentially receive a total refund of $15,360, with the remaining balance of the credit ($12,550 × 3 = $37,650) carrying forward to future years.

Although the terms “foster care adoption” and “special needs adoption” are often used interchangeably, they do not mean the same thing 100% of the time. About 10% of children adopted from foster care do not receive adoption assistance and are not determined to have special needs.

Failed or incomplete adoptions. Sometimes, adoption does not work out as planned. Depending on the type of adoption, taxpayers may still be eligible for the Section 23 credit even if the process is not completed successfully.

● Foreign adoptions. Failed or incomplete foreign adoptions do not qualify for the adoption credit because the statute allows foreign-adoption expenses only in the year the adoption becomes final [IRC Section 23(e)(1)]. If finalization never occurs, the credit never becomes available. There is no partial credit, no deduction, and no carryforward available for a failed foreign adoption.

If a foreign adoption is eventually successful, all qualified expenses paid in prior years are claimed together on the tax return for the year it becomes final.

● Domestic adoptions. Taxpayers can claim the adoption tax credit for domestic adoptions that have failed or are not final. Eligibility for the credit does not depend on whether a domestic adoption attempt was successful. If a taxpayer was on the path to becoming an adoptive parent but was derailed for whatever reason, they may claim expenses for an unsuccessful attempt to adopt a US child.

Taxpayers must generally wait one year ***after*** paying qualifying expenses before claiming them for a domestic adoption that is not yet final. Thus, expenses paid in 2026 for a domestic adoption that is not finalized in 2026 would generally be claimed on the 2027 return.

NONQUALIFYING EXPENSES

Not all expenses incurred during an adoption are qualifying expenses. Expenditures not eligible for the tax credit include those unrelated to the adoption process itself, such as daycare, formula, a stroller, clothing, or nursery furniture.

Exclusion of employer’s adoption assistance. Many employers offer adoption assistance benefits through a written adoption assistance program. A qualified adoption assistance program provides payments or reimbursements to help employees with adoption-related costs.

Employer reimbursements for qualified adoption expenses may be excluded from gross income under IRC Section 137. For 2026, the exclusion limit is $17,670, the same as the credit ceiling. Employer adoption assistance is excluded from federal income tax, but it remains subject to FICA.

Sometimes the tax credit may be more advantageous because employer reimbursements are subject to FICA (but the tax credit is not). But sometimes the employee may be better off obtaining reimbursement from the employer; for example, if the employee has insufficient tax liability to take full advantage of the credit.

Employees with sufficient qualifying expenses could receive both their employer's reimbursement and the federal tax credit. However, employees cannot double-dip by obtaining a reimbursement from their employer and a federal tax credit for the same expense. The tax credit and the exclusion of employer-provided adoption assistance are mutually exclusive with respect to the same expenses.

The credit and exclusion cannot be taken for the same expense, but both may be claimed for the same adoption. An adopting employee can exclude up to $17,670 and then claim the tax credit for additional unreimbursed expenses.

Example 1. Hazel paid $20,000 in qualified adoption expenses for the adoption of an eligible child, including $7,000 in legal fees. Under a qualified adoption assistance program, Hazel's employer reimbursed the $7,000 in legal fees. Hazel may exclude the $7,000 employer reimbursement from her income. However, because of the employer reimbursement, $7,000 of Hazel's expenses no longer qualify for the tax credit. As a result, Hazel's maximum adoption credit is limited to $13,000 ($20,000 – $7,000).

Example 2. Darcy and Cameron paid $40,000 in qualified adoption expenses to adopt an eligible foreign child, and the adoption became final in 2026. Under a qualified adoption assistance program, Darcy's employer reimbursed $17,670 of those expenses in 2026. He may exclude the $17,670 reimbursement from income. The remaining $22,330 of unreimbursed expenses may still qualify for the credit, but the credit is capped at $17,670.

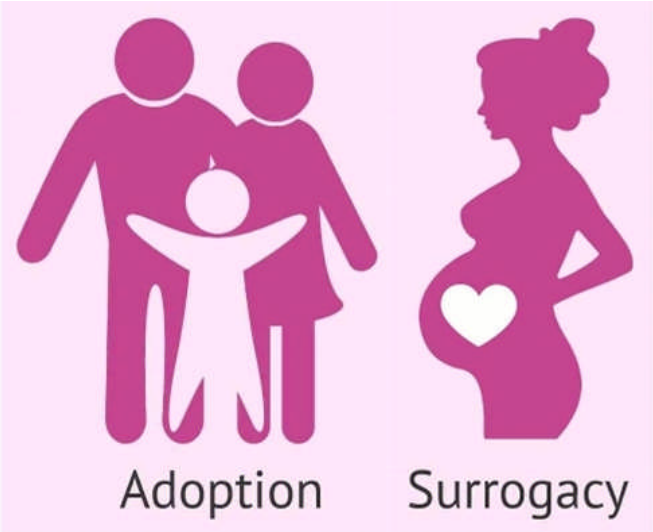
For domestic adoptions, employer adoption assistance is generally excluded in the year the employer reimburses the expense or pays it. For foreign adoptions, the exclusion is generally taken in the year the adoption becomes final, and the exclusion amount includes assistance provided during and before that year.

Example 3. Arianna began the adoption process for an American child in 2025. Under her employer's adoption assistance program, she received $2,500 that same year to cover the adoption fees, court costs, and medical exams. The adoption becomes final in 2026. Under the adoption assistance exclusion, Arianna can exclude this employer-provided reimbursement from income in 2025 but not in 2026.

Example 4. Theo and Henrik began the adoption process for a foreign child in 2025. That year, Theo received $5,000 under his employer's adoption assistance program to cover qualifying expenses. The adoption becomes final in 2026. Theo and Henrik must report the $5,000 as income in 2025 and then claim the exclusion in 2026, the year the international adoption became final.

It should be noted that many employers with an adoption assistance program only accept claims for reimbursement after a domestic or foreign adoption is legally finalized. This common employer requirement means that employees who adopt a US or foreign child will often claim the exclusion in the same year the adoption is finalized.

Surrogacy expenses. The IRS considers adoption and surrogacy as two different options for building a family. Taxpayers cannot get an adoption credit for surrogacy expenses. Qualified adoption expenses do not include costs incurred in carrying out a surrogacy arrangement, such as attorney fees for drafting the surrogacy agreement, medical fees for intrauterine insemination or in vitro fertilization, and surrogate mother reimbursement.



CREDIT LIMITED BY CLAIMANT'S INCOME & TAX LIABILITY

CLAIMANT'S INCOME

The adoption credit and the exclusion of employer adoption assistance are subject to an income limitation based on modified adjusted gross income, or MAGI. MAGI is generally adjusted gross income plus foreign earned income exclusions and certain foreign housing deductions or exclusions. For most taxpayers, MAGI is the same as AGI. For 2026, the credit begins to phase out at $265,080 and is fully phased out at $305,080.

When MAGI Is… (2026)	Effect on the Adoption Tax Credit
≤ $265,080	Credit could be up to $17,670
Between $265,080 and $305,080	Credit amount is reduced
≥ $305,080	No credit is allowed

PARTIAL REFUNDABILITY AND CARRYFORWARDS

Nonrefundable part of the adoption credit. The traditional adoption credit can lower the claimant's federal tax bill to zero, but it will not generate a refund. If the nonrefundable credit is more than the claimant's tax liability this year, they may be able to use the new refundable component of the credit.

Refundable part of the adoption credit. Up to $5,120 of the adoption credit is refundable in 2026. The refundable amount is calculated separately for each eligible child.

Carryforward feature of the adoption credit. If the nonrefundable credit reduces the claimant's tax bill to zero and they claim the $5,120 refundable credit, any leftover credit can be carried forward and used in future years.

Any credit carried forward from a previous year retains its nonrefundable character. A carryforward amount cannot be used to get a refund in later years. The nonrefundable part of the credit can be carried forward for up to five years. After five years, any unused credit is lost.

Example. Arlene finalized a domestic adoption in 2026 and paid $17,670 in qualified adoption expenses. Her federal tax liability for the year is $5,718. Applying the credit works as follows:

- The nonrefundable portion of the credit first offsets Arlene's $5,718 tax liability, reducing it to zero.
- The refundable portion then provides Arlene with a refund of up to $5,120 (the 2026 refundable ceiling), even though she now owes no tax.
- The remaining unused nonrefundable credit ($17,670 – $5,718 – $5,120 = $6,832) carries forward to reduce her tax liability for the next five years. This carryforward amount cannot generate a refund in future years.

WHEN TO CLAIM THE CREDIT

The time for claiming the adoption tax credit depends on whether the taxpayer pursues a foreign or domestic adoption. In terms of credit timing, a special needs adoption is treated the same as a domestic adoption.

INTERNATIONAL ADOPTIONS

For international adoptions, the credit is generally claimed in the year the adoption becomes final, even if qualifying expenses were paid in earlier years.

Example. Elen and Darius are adopting a baby from abroad. The couple began the process in 2024 when they paid initial agency fees and continued incurring expenses in 2025. They brought the baby home and finalized the adoption in 2026, incurring expenses for travel, attorney, agency, and court fees. Elen and Darius will report all eligible adoption expenses incurred from 2024 to 2026 on their 2026 tax return and apply the $17,670 maximum credit to reduce their 2026 tax liability. If the primary credit reduces their tax bill to zero, Elen and Darius may claim the refundable component, and any excess credit may be carried forward for up to five years.

IRS Revenue Procedure 2005-31 describes in detail the rules for determining when the adoption of a foreign-born child becomes final. The final adoption date depends on when the foreign-born child receives an "Immediate Relative" (IR) visa from the Department of State.

DOMESTIC AND SPECIAL NEEDS ADOPTIONS

An adoptive parent who paid qualifying expenses in the current year for an adoption that became final in the current year may be eligible to claim the credit on the current year's return.

For incomplete domestic adoptions, the tax credit is generally allowed for the year following the year in which the expenses are paid. So, if an adoptive parent had expenses for a domestic adoption in 2026 that have not been finalized in 2026, they will have to wait to claim a credit for these expenses on their 2027 tax return (to be filed by April 15, 2028).

Failed or incomplete special needs adoptions are subject to the same tax rules as failed or incomplete domestic adoptions. Notably, a failed or incomplete special needs adoption becomes similar to a regular domestic adoption in that it does not automatically qualify for the maximum tax credit.

ADOPTING A CHILD WHO IS A US CITIZEN OR RESIDENT	
IF the adoptive parents pay qualifying expenses in:	**THEN** they claim the adoption credit in:
Any year before the year the adoption is final	The year after the year of the payment.
The year the adoption is final	The year the adoption is final.
Any year after the year the adoption is final	The year of the payment.
ADOPTING A FOREIGN CHILD	
IF the adoptive parents pay qualifying expenses in:	**THEN** they claim the adoption credit in:
Any year before the year the adoption is final	The year the adoption is final.
The year the adoption is final	The year the adoption is final.
Any year after the year the adoption is final	The year of the payment.

FORMS AND RECORDKEEPING

FORM 8839 AND SCHEDULE 3

To claim the adoption tax credit (or the exclusion for employer-paid expenses), the adoptive parent must complete Form 8839, *Qualified Adoption Expenses*, and attach it to their Form 1040. Form 8839 was significantly updated beginning with the 2025 tax year to reflect the new partial refundability rules.

Those who adopt children with special needs can write $17,670 on line 5 of Form 8839, which asks for qualified adoption expenses. Other adoptive parents must include every qualified expenditure from the appropriate tax year.

Form 8839 now includes separate calculations for the refundable portion (reported on Form 1040, line 30) and the nonrefundable portion. The nonrefundable adoption tax credit is transferred to Schedule 3, line 6c. The sum of tax credits on Schedule 3 is included on Form 1040, line 20.

SCHEDULE 3 (Form 1040)
Department of the Treasury
Internal Revenue Service

Additional Credits and Payments
Attach to Form 1040, 1040-SR, or 1040-NR.
Go to *www.irs.gov/Form1040* for instructions and the latest information.

OMB No. 1545-0074
Attachment Sequence No. **03**

Name(s) shown on Form 1040, 1040-SR, or 1040-NR | **Your social security number**

Part I Nonrefundable Credits

1	Foreign tax credit. Attach Form 1116 if required		1	
2	Credit for child and dependent care expenses from Form 2441, line 11. Attach Form 2441		2	
3	Education credits from Form 8863, line 19		3	
4	Retirement savings contributions credit. Attach Form 8880		4	
5a	Residential clean energy credit from Form 5695, line 15		5a	
b	Energy efficient home improvement credit from Form 5695, line 32		5b	
6	Other nonrefundable credits:			
a	General business credit. Attach Form 3800	6a		
b	Credit for prior year minimum tax. Attach Form 8801	6b		
c	Adoption credit. Attach Form 8839	6c		
d	Credit for the elderly or disabled. Attach Schedule R	6d		

ADOPTION DOCUMENTS AND RECEIPTS

Taxpayers should keep records supporting the credit because the IRS may request proof that the expenses were qualified and that the adoption met the legal requirements.

For special-needs adoptions, taxpayers should keep the adoption assistance agreement or a letter from the state, tribal government, or local child welfare agency showing the special-needs determination.

In private domestic and international adoptions, adoptive parents should keep all receipts for attorney's fees and travel expenses, as well as documents relating to the adoption, such as the final adoption decree, home study paperwork, a foreign child's visa, and copies of any court orders associated with the adoption.

Because the credit is now partially refundable, the IRS may scrutinize the refundable portion with particular care. Thorough documentation is more important than ever.

REVIEW QUESTIONS

27. In 2026, Elsa finalizes the adoption of two non-special-needs foreign children, incurring $14,000 of qualified adoption expenses per child ($28,000 total). All credit requirements are met, and Elsa's MAGI is well below the income threshold. Before considering tax liability, what is the allowable credit for these two adoptions?
{A}. $0; foreign children do not qualify.
{B}. $17,670; the annual ceiling applies per return, not per child.
{C}. $28,000; in this case, the credit equals $14,000 per child (covering the qualified adoption expenses).
{D}. $35,340; Elsa receives the maximum credit ($17,670) for each child, regardless of actual expenses.

28. Reece and Lane try to adopt a US infant through an independent adoption in 2026. Throughout the year, the couple pays $12,693 in qualified adoption expenses (such as attorneys' fees), but their 2026 adoption effort ultimately fails. Reece and Lane can claim the adoption credit for the costs incurred in 2026 on:
{A}. the amended version of their 2025 tax return
{B}. the 2026 tax return
{C}. the 2027 tax return
{D}. none of the above; this couple cannot claim a tax credit for a failed domestic adoption

Part E reveals the correct answers to all end-of-chapter review questions while providing feedback on both correct and incorrect responses.

Chapter 10. REPEALED, EXPIRED, & RESTRICTED CREDITS

Learning objectives: After finishing this chapter, you will be able to recognize the main tax credits that the OBBBA ended, limited, or let expire. You will also know how to advise clients on compliance and audit risks for 2026 and later tax years.

Chapter Topics

- Clean vehicle credits
  - » New clean vehicle credit
  - » Previously owned clean vehicle credit
  - » Alternative fuel vehicle refueling property
- Home energy credits
  - » Energy-efficient home improvement credit
  - » Residential clean energy credit
- Premium Tax Credit (PTC)
  - » Income level determines the amount of PTC
  - » Expiration of the enhanced PTC
  - » Elimination of the PTC repayment caps
  - » Restriction on special enrollment period credits
  - » The noncitizen eligibility change
- Employee Retention Tax Credit (ERTC)
  - » The ERTC in 2020 and 2021
  - » Post-pandemic tsunami of ERTC claims
  - » OBBBA fully ends the ERTC program

One way Congress plans to pay for the tax cuts in the OBBBA is by dramatically scaling back many of the tax credits in the Inflation Reduction Act of 2022. The OBBBA accelerates the sunset of numerous tax credits that the Biden-era law had made available until the early 2030s. As we will see below, it introduces early terminations or new restrictions for taxpayers seeking these credits.

CLEAN VEHICLE CREDITS

NEW CLEAN VEHICLE CREDIT

The Inflation Reduction Act created the Section 30D Clean Vehicle Credit for buying new plug-in electric or fuel cell vehicles, with a maximum credit of $7,500. This credit was supposed to last until the end of 2032, but the OBBBA moved the end date earlier. Now, taxpayers cannot claim the Section 30D credit for any vehicle bought after September 30, 2025. The IRS says a vehicle is “acquired” when taxpayers sign a binding contract and make a payment, which can include a small down payment or a trade-in. If taxpayers meet these requirements by September 30, 2025, they can still claim the credit, even if they get the car later.

Example. A taxpayer signs a binding written contract on September 29, 2025, pays a $500 deposit, and trades in an old vehicle. Delivery is scheduled for January 10, 2026. The vehicle is acquired before the cutoff date of September 30, 2025, so the Section 30D credit remains available on the 2026 return. If the same taxpayer signs the contract on October 1, 2025, no credit is allowed. A reservation, waitlist placement, or informal order without a binding written contract and payment does not constitute acquisition for this purpose.

PREVIOUSLY OWNED CLEAN VEHICLE CREDIT

The Inflation Reduction Act created the Section 25E Previously Owned Clean Vehicle Credit, mirroring the new clean vehicle credit rules but applying to qualifying used EVs or fuel cell vehicles. This credit was 30% of the sale price, up to $4,000, and imposed income limits on taxpayers.

The OBBBA changed the law to move the end date from December 31, 2032, to September 30, 2025. To qualify, taxpayers must have signed a binding contract and made a payment by that date, even if they didn't have the car yet.

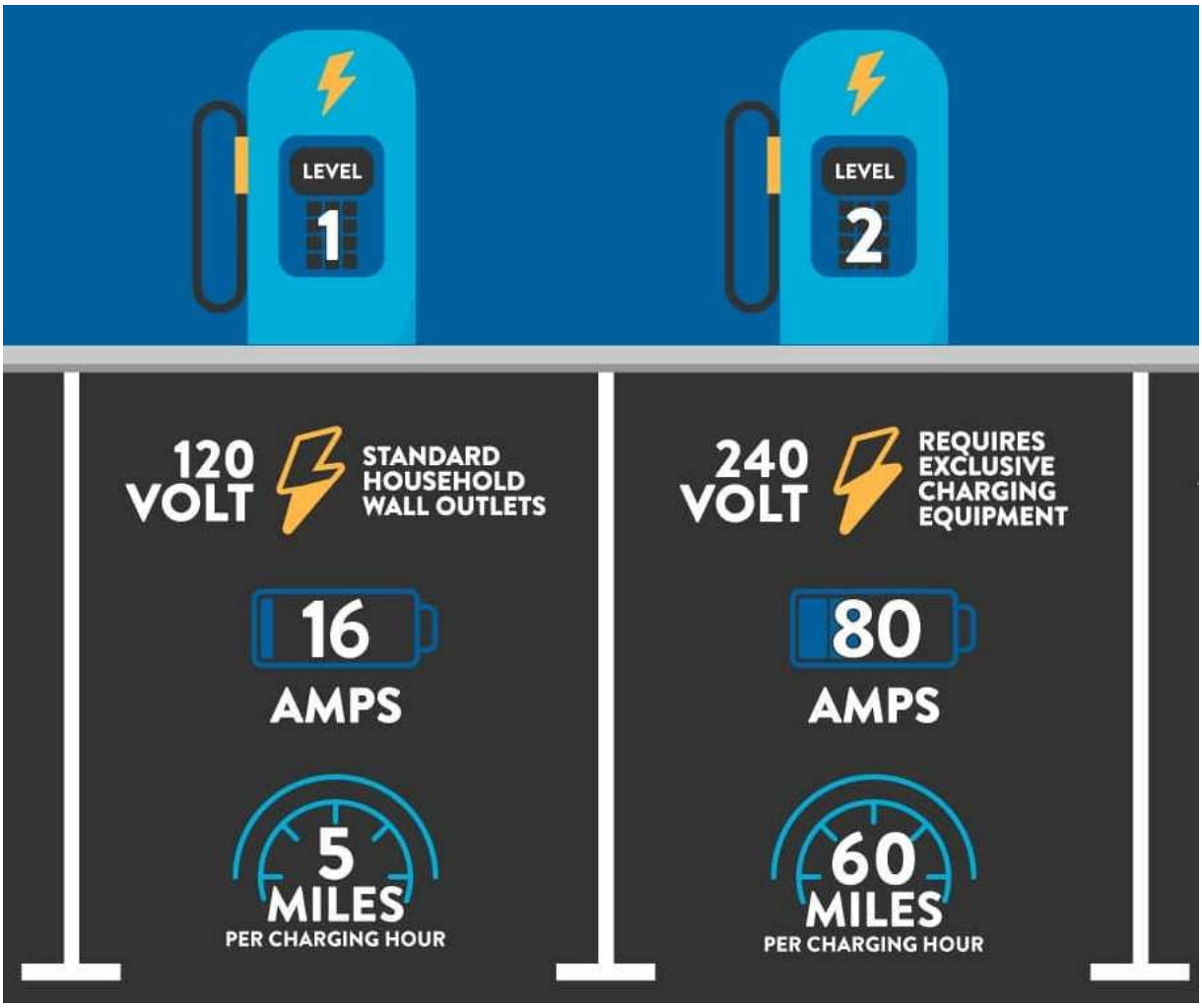
ALTERNATIVE FUEL VEHICLE REFUELING PROPERTY

This incentive is designed to increase the availability of electric vehicle charging stations and other alternative fueling stations.

Residential EV charging equipment. IRC Section 30C offers a tax credit for the cost of equipment used to fuel clean vehicles with alternative fuels. These refueling setups could be for non-electric clean-burning fuels, but they are increasingly associated with electric vehicle charging stations.

One benefit of owning an electric vehicle is that you don't have to go to the gas station to refuel. Since charging at home is easy and usually cheaper, most EV owners do over 80% of their charging at home.

It's possible to recharge an electric vehicle by using the cable that came with the car and plugging it into a nearby 120-volt outlet. For most drivers, trickle charging overnight may be sufficient to meet the range needs of a typical commute. However, some EV owners may find it helpful to install a wall charger, enabling them to complete charging in a few minutes rather than overnight.



Claiming the credit. This federal tax credit covers up to 30% of the cost of buying and installing EV equipment. Both the equipment price and labor costs count toward the credit.

For personal-use property, the credit is usually the smaller of 30% of the property's cost or $1,000. The charger must be placed in service during the tax year and have original use beginning with the taxpayer. It must be installed on property used as the taxpayer's primary residence and located in an eligible census tract (low-income or non-urban). Taxpayers can use the 30C Tax Credit Eligibility Locator (https://www.anl.gov/esia/refueling-infrastructure-tax-credit) to check if their location qualifies.

Expiration date. The OBBBA moved the end date for the Section 30C credit from December 31, 2032, to June 30, 2026. Taxpayers cannot claim this credit for refueling equipment put into use after June 30, 2026. For this credit, the important date is when the equipment is put into use, not when it is bought. Tax professionals should check both the installation date and area eligibility for clients claiming this credit on 2026 returns.

Example. A homeowner installs a Level-2 EV charger. Installation is completed, and the charger is placed in service on July 2, 2026. No Section 30C credit is allowed because the placed-in-service date is after June 30, 2026. Assuming the charger is installed at the taxpayer's principal residence in a qualifying census tract and is completed on June 29, 2026, the 30% credit (up to $1,000) would apply. If the residence is not in a qualifying census tract, no credit is available regardless of the installation date. Unlike the Section 30D credit, where the operative date is ***acquisition***, the Section 30C credit turns entirely on when the property is ***placed in service***.

CREDIT	IRC SECTION	QUALIFYING EVENT	TERMINATION DATE
New Clean Vehicle	30D	Acquired under binding contract and payment	9/30/2025
Previously Owned Clean Vehicle	25E	Acquired under binding contract and payment	9/30/2025
Energy Efficient Home Improvement Credit	25C	Placed in service	12/31/2025
Residential Clean Energy Credit	25D	Expenditures treated as made when installation is completed	12/31/2025
Alternative Fuel Refueling Property	30C	Placed in service	**6/30/2026**

HOME ENERGY CREDITS

ENERGY-EFFICIENT HOME IMPROVEMENT CREDIT

The energy-efficient home improvement credit (also referred to as the 25C tax credit) was designed to encourage homeowners to install energy-efficient components and properties to combat long-term energy costs and usage.

The Inflation Reduction Act had extended the energy-efficient home improvement credit for a period of 10 years (until December 31, 2032). Generally, the energy-efficient home improvement credit for 2025 was 30% of eligible expenses up to a maximum of $3,200 per year. However, to reach the $3,200 maximum credit, a homeowner had to make at least two home improvements, as Section 25C placed different dollar limits on various projects. The 25C credit could be split up into four categories of home improvements: one for home energy audits with a $150 credit limit, another for building envelope components with a $1,200 credit limit, a third category for interior upgrades

with a $600 credit limit, and a final category for interior upgrades with a $2,000 credit limit.

The OBBBA officially expired the 25C tax credit for any qualifying expenditures made after December 31, 2025. This change removes the annual credit for energy-efficient doors, windows, and biomass stoves. Because the law ended this credit earlier than planned, there is no longer a federal incentive for home weatherproofing or HVAC upgrades. If a taxpayer plans to make improvements in 2026, they won't get these tax benefits, and there is no transition period for projects started but not finished before the cutoff. Tax professionals should tell clients that 2025 was the last year to claim these energy savings.

Example. A homeowner signs a contract for new energy-efficient windows in December 2025. The homeowner paid in full in December 2025, but installation was not completed until January 10, 2026. No Section 25C credit is allowed because the property was not placed in service before December 31, 2025. Prepayment alone does not preserve the credit.

RESIDENTIAL CLEAN ENERGY CREDIT

The "residential energy efficient property credit" was renamed the "residential clean energy credit" by the Inflation Reduction Act. Since IRC Section 25D authorized this credit, many in the tax community referred to it as the "Section 25D credit."

The Section 25D credit was worth 30% of the cost of new, qualified clean energy equipment installed at a taxpayer's home. The full 30% credit was supposed to be available for eligible expenditures through the end of 2032. Then, the credit was scheduled to decrease to 26% in 2033 and 22% in 2034. There was no annual or lifetime dollar limit — except for fuel cell property, which was capped at $500 per half-kilowatt.

Qualifying expenses included solar panels, solar water heaters, small wind turbines, geothermal heat pumps, and battery storage. Unlike Section 25C, this credit had no annual cap and allowed unused credits to be carried forward, making it especially useful for large solar projects.

The OBBBA terminated the residential clean energy credit after December 31, 2025. It did not include a phase-down period, meaning the credit was eliminated on January 1, 2026. The important date is when the installation is finished, not when taxpayers buy or pay for the equipment. If the installation wasn't done by December 31, 2025, taxpayers can't claim the credit, no matter when they paid or signed the contract.

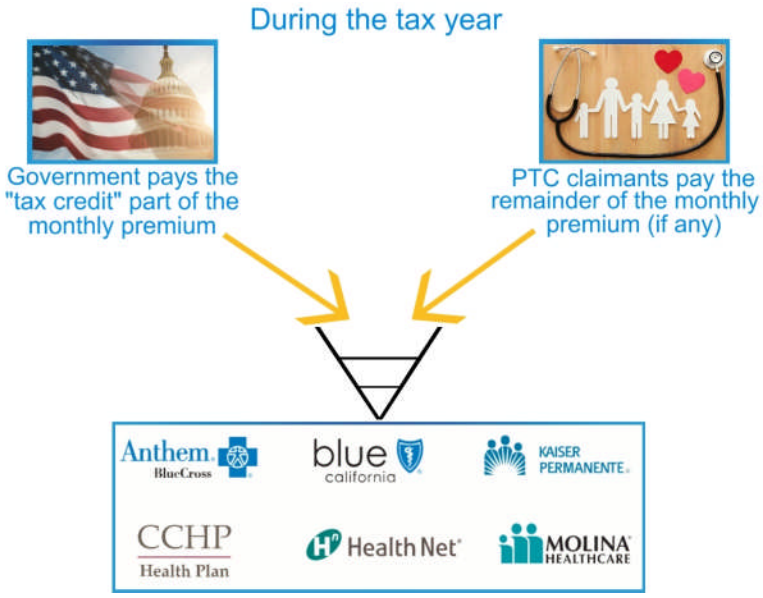
In the OBBBA amendments to Section 25D, Congress revised subsections (g) and (h), which govern the Inflation Reduction Act's phase-down schedule and termination date. However, lawmakers made no changes to subsection (c), the provision that authorizes the carryforward of unused credits. Because subsection (c) remains intact, the statutory carryforward rule continues to apply even after the credit itself expires, allowing taxpayers to use any remaining Section 25D credit in later years.

Example. A taxpayer pays $20,000 for a solar installation in October 2025, but the contractor does not complete the installation until February 2026. No Section 25D credit is allowed because installation was not completed by December 31, 2025. If installation had been completed on December 30, 2025, the taxpayer would receive a 30% credit and could carry forward any unused amount to 2026.

PREMIUM TAX CREDIT (PTC)

The Affordable Care Act — also known as Obamacare or the ACA — is a 2010 law that issued new rules and guidelines on the offering, administration, and acceptance of healthcare coverage in the United States. Obamacare created health insurance marketplaces where individuals learn about health insurance options, sign up for health plans, and, when eligible, obtain help paying premiums. The health insurance marketplace for ACA-compliant plans in California is called "Covered California" [CoveredCA.com].

Under the ACA, if the cost of health insurance purchased in the marketplace is too high for the taxpayer's income, then part of the taxpayer's monthly premium will be covered by a premium tax credit (PTC). This federal credit could be an advanceable, refundable tax credit available to eligible individuals to help offset the cost of insurance bought through healthcare exchanges.



INCOME LEVEL DETERMINES THE AMOUNT OF PTC

Rules before 2021. For purposes of the premium tax credit, MAGI is the adjusted gross income on one's federal income tax return plus any excluded foreign income, nontaxable Social Security benefits, and tax-exempt interest received or accrued during the year.

The PTC is determined by the relationship of the taxpayer's MAGI to the federal poverty level (FPL). In states that did not expand Medicaid, tax credit eligibility ranges from 100% to 400% of the FPL. In states that decided to expand Medicaid — such as California — credit eligibility effectively ranges from 138% to 400% of the poverty level. California residents with incomes below 138% of the FPL are eligible for Medicaid (Medi-Cal is California's Medicaid program) and, therefore, do not need or qualify for subsidized marketplace coverage.

FPL RANGES 2026			
Family size	**100% of FPL**	**138% of FPL**	**400% of FPL**
1	$15,650	$21,597	$62,600
2	$21,150	$29,187	$84,600
3	$26,650	$36,777	$106,600
4	$32,150	$44,367	$128,600
5	$37,650	$51,957	$150,600
6	$43,150	$59,547	$172,600
7	$48,650	$67,137	$194,600
8	$54,150	$74,727	$216,600
Tax credit eligibility for the 2026 coverage year is based on 2025 federal poverty guidelines. Higher thresholds are in place for Alaska and Hawaii.			

The rules before 2021 regarding federal assistance with health insurance costs essentially divided taxpayers into three groups:
● Households earning above 400% of the federal poverty level had to pay the full cost of their insurance.
● Households making between 138% and 400% of the FPL could receive a PTC to reduce out-of-pocket costs.
● Households with income below 138% of the federal poverty level could be covered by Medi-Cal without paying any premiums.

Before 2021, even lower-income people had to contribute something toward the cost of the benchmark silver plan (i.e., the second-lowest-cost silver plan in their area). For instance, individuals with an income at 150% of the FPL had to contribute 4.14% of their household income toward a benchmark plan.

Enhanced PTC available between 2021 and 2025. For 2021 and 2022, ARPA provided relief to taxpayers buying health insurance on a marketplace exchange via:

● An increase in the amount of the credit; and
● The elimination of the income cut-off for the subsidy.

These provisions were scheduled to expire at the end of 2022, but the Inflation Reduction Act extended them through 2025. So, the 400% FPL cliff was suspended until December 31, 2025.

ARPA also lowered the applicable percentages for PTC claimants. With the enhanced PTC, claimants could contribute a lower percentage of their household income toward health insurance premiums.

EXPIRATION OF THE ENHANCED PTC

ARPA expanded PTC eligibility and increased credit amounts for tax years 2021 and 2022. The Inflation Reduction Act then extended these enhanced provisions for three additional tax years, 2023 through 2025. The OBBBA did not extend them further.

What expired on January 1, 2026, were the temporary enhancements:
● Elimination of the 400% FPL cliff for subsidy eligibility;
● A premium cap reduction from 9.83% to 8.5% of household income for benchmark coverage;
● More generous subsidies across all income bands; and
● The zero-premium bronze plans for households at 100% through 150% of FPL.

Starting in 2026, the old income cap of 400% of the federal poverty level and higher contribution percentages return. Many people will get much smaller credits or none at all. Taxpayers who qualified under the expanded rules before may lose eligibility or get less credit, and they might have to repay advance subsidies if those were based on old limits. This change will raise net premium costs for many middle-income families who previously benefited from capped contributions.

Example. A taxpayer with household income equal to 420% of the federal poverty line qualified for a partially subsidized premium under temporary rules in 2025. In 2026, after the expiration of the enhanced PTC, the taxpayer no longer qualifies for the credit and must repay all advance payments received.

ELIMINATION OF THE PTC REPAYMENT CAPS

Under prior law, taxpayers who received excess advance PTC payments were protected by income-based repayment caps.

For tax years after December 31, 2025, the OBBBA removes the repayment limits that previously protected lower-income taxpayers from large tax bills when their actual income was higher than expected. Now, everyone must repay the full amount of any extra advance premium tax credits they got, no matter what their final income is compared to the federal poverty level.

Example. A household with 2025 income at 120% FPL received advance PTC based on ARPA-era rules. In 2026, their income rises to 420% FPL, putting them above the 400% cap. They receive no PTC for 2026 and must repay all advance payments received in 2026 (with no cap on repayment).

RESTRICTION ON SPECIAL ENROLLMENT PERIOD CREDITS

For tax years after December 31, 2025, the OBBBA does not allow the PTC for any health insurance plan that was enrolled in through a special enrollment period based solely on expected household income. The special enrollment period must be linked to a specific event or change, like losing coverage, getting married, or having a baby, as defined by the Department of Health and Human Services.

Example. A taxpayer enrolls in Covered California in March 2026 under an income-only special enrollment period (with no qualifying life event). The taxpayer is not eligible for the PTC for that coverage period.

THE NONCITIZEN ELIGIBILITY CHANGE

The OBBBA removes PTC eligibility for some lawfully present noncitizens who are not eligible for Medicaid because of their immigration status. This change cuts off their main way to get subsidized health coverage.

FEATURE	2021–2025 (ENHANCED PTC)	2026+ (REVERTED PTC)
Income cap	No 400% FPL cliff under temporary rules	400% FPL limit restored
Applicable percentage range	0%–8.5% of household income	Approximately 2%–9.8% (indexed; pre-ARPA table restored)
Zero-premium bronze plans	Available for 100%–150% FPL	No longer available
Repayment caps for excess PTC	Repayment limits apply under temporary rules	Eliminated for tax years beginning after 12/31/2025
Special Enrollment Period income-only eligibility	Allowed	Disallowed beginning 2026
Lawfully present noncitizens barred from Medicaid	Eligible for PTC	Eligibility removed under OBBBA rules

EMPLOYEE RETENTION TAX CREDIT (ERTC)

THE ERTC IN 2020 AND 2021

The Employee Retention Tax Credit (ERTC) was established in the CARES Act of 2020 to incentivize, encourage, and support employers to keep their workers on payroll

during the pandemic by providing a refundable tax credit of up to $5,000 per employee, effective through the end of 2020.

After initial uptake was slower than expected, lawmakers expanded the credit to up to $14,000 per employee in businesses that lost 20% of revenue (as opposed to 50% under the CARES Act).

ARPA extended the ERTC until December 31, 2021, raising the maximum credit to $28,000 per employee. However, the Infrastructure Investment and Jobs Act ended the ERTC early for most employers on September 30, 2021, and lowered the maximum credit to $21,000 per employee. Only "recovery startup businesses" could still claim the credit for the fourth quarter of 2021.

POST-PANDEMIC TSUNAMI OF ERTC CLAIMS

If the ERTC "ended" in September 2021, why did businesses continue to claim it in 2022, 2023, 2024, and even 2025? Although the credit only applied to payroll between March 2020 and September 2021, employers had until April 15, 2025, to claim the credit retroactively through amended returns (specifically, on Form 941-X).

After the pandemic, take-up rates increased when third-party "ERTC promoters" began raising awareness of the credit and offering to file for it on behalf of businesses. Thanks to the aggressive marketing tactics of promoters, a surge of employers began claiming retroactive ERTC refunds in 2022.

In September of 2023, the flood of applications became so large that the IRS ordered an immediate stop to processing claims and announced a moratorium. The agency's moratorium did not prevent claims from continuing to come in. In fact, the backlog of claims increased significantly after the IRS announced its moratorium. The claims backlog grew to 1.3 million in December 2023. An amassed backlog, extended reviews, and ongoing fraud investigations set the stage for unprecedented wait times for ERTC refunds.

OBBBA FULLY ENDS THE ERTC PROGRAM

The OBBBA did not repeal the ERTC, since it had already expired for new wages. Instead, it focused on the backlog of old claims and enforcement issues.

The new law significantly tightened ERTC rules, primarily blocking new claims after January 31, 2024. It extends the IRS audit window to six years and expands the scope of existing penalties to address ERTC-specific misconduct.

Denial of refunds filed after January 31, 2024. The OBBBA stops the IRS from allowing or refunding ERTC claims for the third and fourth quarters of 2021 if those claims were filed after January 31, 2024, even if the employer met the eligibility requirements. If an employer filed an ERTC claim after January 31, 2024, but was refunded before July 4, 2025, this rule does not apply.

Expanded penalties. The OBBBA requires ERTC promoters to comply with due diligence requirements concerning a taxpayer's eligibility for (or the amount of) an ERTC. A $1,000 penalty will be imposed per violation for failing to meet due diligence requirements in determining ERTC eligibility.

The new law also amends the Tax Code to apply the 20% penalty for erroneous refunds to employment taxes, including the ERTC, which was previously only applicable to income taxes.

Extended statute of limitations. The OBBBA also extends the statute of limitations on IRS assessments relating to the ERTC. The IRS now has six years (an additional three years from the standard three-year limit) to audit ERTC claims, providing the IRS with extra time to review and make adjustments or denials. The six years start from the later of the original return filing date or the date the ERTC claim was filed.

Example. A business that improperly claimed the ERTC for 2021 wages without a qualifying governmental shutdown may still face disallowance, repayment of the refund with interest, and a 20% penalty under Section 6676 on the erroneous claim — even in 2026, despite the credit's expiration.

Tax professionals should tell business clients that the ERTC program is now completely closed. Any remaining issues are about proving claims, audit defense, or repayment — not new credits. In practice, the OBBBA's rules mark the final end of the ERTC, so it should not be part of employer tax planning for 2026 or later.

ERTC FILING SCENARIO	TREATMENT UNDER OBBBA
Filed on or before 1/31/2024	Eligible for normal processing (subject to audit and 6-year statute of limitations)
Filed after 1/31/2024	Credit generally not allowed; IRS prohibited from issuing refunds after 7/4/2025
Filed after 1/31/2024 but refund issued before 7/4/2025	Refund stands under the grandfathered refund rule
Any ERTC claim	Subject to extended 6-year statute of limitations

REVIEW QUESTIONS

29. Arman's income is 420% of the federal poverty level. He continues to receive advance PTC payments in 2026 based on an outdated 2025 income estimate. Upon filing his 2026 return, what is Arman's repayment obligation regarding the excess PTC received?
{A}. Repayment continues to be limited by income-based caps.
{B}. Arman must now repay the full amount of excess PTC received.
{C}. Thanks to the OBBBA, no repayment is required beginning in 2026.
{D}. Repayment is now capped at $1,000, regardless of Arman's income.

30. In 2024, a small business owner claimed a retroactive credit for pandemic-era payroll expenditures. Specifically, they filed a Form 941-X in March 2024 claiming an ERTC for the fourth quarter of 2021. The IRS had not issued a refund as of July 4, 2025. Under the OBBBA, what is the status of the claim in 2026?
{A}. The refund claim is still valid because it was filed before April 15, 2025, the statutory deadline for 2021 ERTC claims.
{B}. The claim is disallowed because it was filed after January 31, 2024, and no refund was issued before July 4, 2025.
{C}. The 2024 refund claim remains eligible for processing under the extended six-year statute of limitations.
{D}. The 2024 refund claim expired on July 4, 2025, so you should help this client submit a new Form 941-X in 2026.

Part E reveals the correct answers to all end-of-chapter review questions while providing feedback on both correct and incorrect responses.

Part B. Federal Tax Law Update (3 CE Hours)

Chapter 11. IRS GUIDANCE INTERPRETING OBBBA

Learning objectives: By the end of this chapter, you will be able to identify IRS guidance on key OBBBA rules for individuals and small businesses. You will also know how to follow documentation and reporting rules for car loan interest deductions, qualified overtime pay, qualified tips, Trump Accounts, and adoption credit refundability. Finally, you will be able to help clients with compliance and planning for 100% bonus depreciation and qualified production property.

Chapter Topics

- Introduction
- Individual OBBBA provisions
  - » Car loan interest deduction
  - » Qualified overtime pay
  - » Qualified tips deduction
  - » Trump Accounts
  - » Adoption credit refundability
- Small-business OBBBA provisions
  - » 100% bonus depreciation
  - » Qualified Production Property

INTRODUCTION

Tax rules can change in different ways. On the legislative side, old laws are either repealed or expire, existing laws are amended, and new rules are added to the Tax Code. The IRS and the Treasury Department could issue new tax regulations or remove old ones. Or, the judicial branch could strike down a law or regulation that was challenged by a taxpayer in court.

THREE BRANCHES OF THE US FEDERAL GOVERNMENT

LEGISLATIVE	Makes laws	Congress	Senate
			House of Representatives
EXECUTIVE	Carries out laws	President	15 executive departments, including Treasury
JUDICIAL	Evaluates laws	Supreme Court	13 appellate courts
			94 district courts

The Department of the Treasury, part of the executive branch, is responsible for implementing tax laws passed by Congress and codified in the Internal Revenue Code. Treasury regulations, also known as federal tax regulations, are the Treasury Department's official guidance for specific sections of the Internal Revenue Code.

While these regulations are often associated with the Treasury Department, they are usually written by the Treasury bureau specializing in taxes — the IRS. These regulations and other official guidance often explain tax rules in more detail and provide useful examples.

The One Big Beautiful Bill Act (OBBBA) of 2025 created some of the most significant federal tax law changes enacted in recent years. The OBBBA established new deductions and incentives, but many provisions could not be administered effectively until the IRS issued guidance on how to apply them.

Because of this, in late 2025 and early 2026, the IRS released numerous notices, proposed and final regulations, fact sheets, FAQs, draft forms, and other guidance explaining how taxpayers and tax professionals should apply the new rules. Sometimes, this guidance answered questions that the law did not make clear. Other times, the guidance imposed documentation requirements and reporting obligations.

This chapter examines the most significant IRS guidance on key OBBBA provisions affecting individuals and small businesses. It focuses on what taxpayers need to do to stay compliant, which documents are required, how to report information, and what audit issues might arise.

INDIVIDUAL OBBBA PROVISIONS

CAR LOAN INTEREST DEDUCTION

Background. Before the OBBBA, interest on personal automobile loans was unambiguously "personal interest" under IRC Section 163(h) and thus nondeductible. The OBBBA reversed that rule for a four-year window by inserting a new paragraph (4) into Section 163(h), effective for indebtedness incurred after December 31, 2024, and applicable only to tax years beginning after December 31, 2024, and before January 1, 2029.

The deduction is limited to $10,000 per tax return each year. It is claimed on Schedule 1-A, a new form made to combine the OBBBA's new below-the-line deductions.

While most people would refer to this provision as a write-off for "car loan interest," the law calls it a tax deduction for "qualified passenger vehicle loan interest" (QPVLI). Moreover, the vehicle must be an "applicable passenger vehicle" (APV): a new, US-assembled car, minivan, van, SUV, pickup truck, or motorcycle with a gross vehicle weight of less than 14,000 pounds, first used by the taxpayer. Leased vehicles do not qualify. Used vehicles do not qualify. Income limits apply. The deduction decreases for taxpayers with modified adjusted gross income (MAGI) over $100,000 for single filers or $200,000 for joint filers. Those filing separately are not eligible.

The IRS issued proposed regulations on December 31, 2025, and published them in the Federal Register on January 2, 2026 (IR-2025-129). The regulations are comprehensive, filling in several significant gaps left by the statute.

Deduction is available without itemizing. One of the most important clarifications is how this deduction works with the standard deduction. Historically, personal interest has generally been nondeductible unless specifically authorized by statute. When interest deductions were allowed, they were often itemized deductions. So many taxpayers thought the new car loan interest deduction would not be available if they took the standard deduction.

The proposed regulations confirm otherwise. Taxpayers who take the standard deduction can still deduct qualified vehicle loan interest because of a special exception in the law. This clarification greatly increases the number of taxpayers who might qualify. For tax professionals, this means they should consider this deduction for almost every eligible client, not just those who itemize.

Income limits. While many taxpayers may qualify in theory, the deduction decreases for higher-income individuals. The annual deduction is strictly limited to $10,000 per tax return. It begins to phase out when MAGI exceeds $100,000 for single filers (or $200,000 for married filing jointly).

Vehicle requirements. The proposed regulations also give detailed rules about which vehicles qualify. The deduction usually applies only to vehicles that meet the law's rules about where they were made, when they were bought, and how they are used. Certain commercial vehicles, specialty vehicles, and other categories may be excluded. Tax professionals should carefully review purchase documents to ensure the vehicle meets all legal requirements before claiming the deduction.

To prevent fraudulent double-dipping — claiming the same vehicle on multiple tax returns — the proposed regulations require taxpayers to report the vehicle's unique 17-character Vehicle Identification Number (VIN) on Schedule 1-A. If a valid, verified VIN is not entered, an automatic error notice will be sent, and the deduction will be denied.

Personal use standard. The law requires that the APV be bought for personal use. The proposed regulations state that this means the vehicle must be used for personal purposes more than 50% of the time. This personal use test is done only once at the start. Later changes in how the vehicle is used, such as using it more for business, do not affect eligibility or the deduction amount.

Mixed-use vehicles. An important part of the proposed regulations covers vehicles used for both personal and business purposes. Many sole proprietors use one vehicle for both purposes. Similar situations happen with partners, LLC members, and S-corp owners.

The regulations require taxpayers to split the interest between business and personal use. Only the personal-use part qualifies for the special deduction. The business part follows existing business-interest rules. This split stops taxpayers from getting a double benefit by claiming both business and personal deductions.

The interest related to business miles is deducted on Schedule C or Form 1065 as normal business expenses and is not limited by OBBBA rules. The personal-use portion of the interest counts as QPVLI under the law, so only that portion is subject to the $10,000 cap and the income phaseouts at MAGI of $100,000 or $200,000.

Example. Masen is a sole proprietor who uses the actual expense method to deduct vehicle costs. In 2026, he pays $4,800 in interest on his car loan. Masen's business use is 40% and personal use is 60%. The business portion ($1,920) is deducted on Schedule C under Section 162. The personal portion ($2,880) is eligible QPVLI under Section 163(h), subject to the $10,000 cap and MAGI phaseout. Masen enters his VIN on Schedule 1-A and claims the $2,880 deduction.

If a sole proprietor uses the standard mileage rate to deduct vehicle expenses, the business interest is already included in that rate. In these cases, the proposed regulations state that the taxpayer cannot claim the same interest twice; they must either reduce the personal QPVLI by the business-use percentage or use the actual expense method to separate business and personal interest.

Which loans (and interest payments) qualify? The debt must be incurred after December 31, 2024, and must be secured by a first lien on an APV purchased for personal use.

Loans within a family or from a closely held family business do not produce deductible interest. Interest paid to a related person or entity does not qualify. The proposed regulations do not allow exceptions.

A refinanced loan qualifies only if the new loan amount does not go over the original loan amount. If the refinancing includes extra cash taken out, the interest on that extra amount is not deductible personal interest.

Information reporting. The OBBBA added a new rule [under IRC Section 6050AA] requiring lenders to report the QPVLI they receive from individuals. The proposed regulations put this lender reporting rule into effect. Taxpayers should check that their deduction claims match the amounts reported by lenders.

The American Bankers Association submitted public comments in February 2026 requesting transition relief through tax year 2027, citing feasibility concerns with lender systems. The public hearing on REG-113515-25 was held on February 24, 2026, and final regulations had not been issued as of the press date.

PRACTITIONER CHECKLIST FOR CAR LOAN INTEREST DEDUCTION	
Task	***Requirement***
Verify APV status	New, US-assembled, <14,000 lbs GVWR; original use by taxpayer
Confirm personal-use >50% at origination	Determined once; later changes are irrelevant
Check MAGI limits	Phaseout begins at $100k/$200k
Confirm lender reporting	IRC Section 6050AA lender reporting; reconcile with Schedule 1-A
Validate VIN	Required; missing VIN triggers a math-error notice

QUALIFIED OVERTIME PAY

Overview. The OBBBA added a new rule [under IRC Section 225] allowing a below-the-line deduction for "qualified overtime pay" for tax years 2025 through 2028. The deduction is limited to $12,500 per year (or $25,000 for joint filers) and begins phasing out when MAGI exceeds $150,000 for single filers or $300,000 for joint filers. It is available to those who itemize and those who take the standard deduction; it is claimed on Schedule 1-A. A valid Social Security number is needed, and married taxpayers must file jointly to claim it.

The deduction generated immediate questions about the definition of overtime compensation, employers' reporting responsibilities, and taxpayers' substantiation requirements.

Notice 2025-69 (November 21, 2025). For 2025, Notice 2025-69 allowed individuals to reconstruct their qualifying overtime deductions in the absence of explicit employer information reporting.

FS-2026-01 (January 23, 2026). The key point for practitioners in FS-2026-01 is that 2026 is the first year with strict reporting. Starting in 2026, employers must report qualified overtime pay separately on Form W-2, Box 12, using the new Code "TT." This new code is a major tracking challenge for payroll managers because it reports only the premium portion of time-and-a-half pay. The IRS released a draft of the 2026 Form W-2 instructions reflecting this requirement.

The 2026 Form W-4 includes a new Section 1b worksheet that lets employees adjust tax withholding for expected overtime deductions. Forms 1099-NEC and 1099-MISC will also be updated to report overtime separately.

Definition of qualified overtime compensation. The statutory definition of qualified overtime compensation under Section 225 is strictly narrow: it encompasses only the overtime premium required by Section 7 of the Fair Labor Standards Act (FLSA) that exceeds the worker's regular rate of pay. In simple terms, only the extra "half" of a

"time-and-a-half" calculation qualifies for the income tax deduction. The base hourly wage remains fully taxable. If an employee earns $20 per hour and is paid $30 per hour for overtime, the deductible premium is $10 per hour, not $30 per hour. Overtime compensation remains fully subject to Social Security and Medicare taxes (FICA).

Many employees mistakenly believe that all overtime pay qualifies. The guidance confirms that only the excess premium portion is eligible.

QUALIFIED TIPS DEDUCTION

The OBBBA added IRC Section 224, allowing a below-the-line deduction for qualified tips received during tax years 2025 through 2028. The deduction is limited to $25,000 per year and phases out when MAGI exceeds $150,000 for single filers or $300,000 for joint filers. The deduction is available whether the taxpayer itemizes or takes the standard deduction and is claimed on Schedule 1-A.

The IRS released proposed regulations in September 2025 and Notice 2025-69 in November 2025 — covering both tips and overtime for the 2025 tax year. Final regulations (TD 10044) were published in the Federal Register on April 13, 2026. The 2026 final regulations apply retroactively for tax years beginning after December 31, 2024.

Definition of qualified tips. The final regulations confirm that a "qualified tip" must satisfy all of the following requirements:

- It is received by a worker in a qualifying occupation;
- It is paid in cash or an equivalent medium (check, credit card, debit card, or gift card);
- It is paid voluntarily by the customer without compulsion; and
- It is not paid in digital assets.

Service charges and required automatic tips do not qualify. This issue often comes up in audits of large restaurant bills that include a service charge. The tip must be truly voluntary, not just in name.

The occupation list and the TTOC System. The final regulations establish an exhaustive list of qualifying occupations organized using a new Treasury Tipped Occupation Code (TTOC) system. Each occupation carries a three-digit TTOC, a description, illustrative examples, and a cross-reference to Standard Occupational Classification codes. The final regulations confirm 71 qualifying occupations organized in eight categories:

- Beverage and food service (100-series);
- Entertainment and events (200-series);
- Hospitality and guest services (300-series);
- Home services (400-series);
- Personal services (500-series);
- Personal appearance and wellness (600-series);
- Recreation and instruction (700-series); and
- Transportation and delivery (800-series).

The final regulations expanded the occupation list beyond the proposed regulations by adding three new codes: Visual Artists (TTOC 509) and Floral Designers (TTOC 510) in the personal services category, and Gas Pump Attendant (TTOC 810) in the transportation and delivery category. Several occupation titles were also renamed to clarify their scope — "Pet Caretaker" became "Pet and Show Animal Caretaker," and "Eyebrow Threading and Waxing Technicians" was expanded to "Eyebrow and Eyelash Technicians" (TTOC 606) to cover eyelash services.

A worker not in one of the 71 listed jobs cannot claim the deduction, no matter how much tip income they get. This makes checking the occupation list the first step in the deduction process.

Anti-abuse rules and SSTB transition. The OBBBA limits the tips deduction for workers in "specified service trades or businesses" (SSTBs) — the same group used to limit the Section 199A business income deduction. People working in SSTBs (like law, health, accounting, consulting, or financial services) cannot claim qualified tips.

Advising restaurant owners of the FICA tip credit interaction. The FICA Tip Credit is a valuable tax incentive available to restaurants and other businesses that employ tipped workers. It allows eligible employers to claim a federal income tax credit for a portion of the FICA taxes they pay on tips that employees receive directly from customers. This tax credit was created to help offset the employer's FICA tax burden on tip income that they are required to report, even though that income is not paid directly by the business. The credit applies only to tips earned after an employee's base pay meets the baseline minimum wage. Eligible businesses can claim this nonrefundable general business credit by filing IRS Form 8846 and attaching it to their annual federal tax return.

The final regulations explain that tips qualifying for the employee's income tax deduction are still treated as regular wages for FICA taxes. So, the employer continues to calculate its Section 45B credit based on all tips the employee reports on Form 4070, regardless of how much the employee deducts on Schedule 1-A.

Example. Yolanda is a full-time bartender (a qualifying food service occupation). In 2026, she earns a base salary of $30,000 and brings home $28,000 in cash and credit card tips, all of which is reported to her employer. Yolanda's MAGI is $58,000, and she files her taxes as a single person. Yolanda can deduct $25,000 of her tips. Even though she made $28,000 in tips, the law caps the deduction at $25,000 per year. Because Yolanda's MAGI ($58,000) is well below the $150,000 threshold for single filers, her deduction does not phase out.

Yolanda's employer still pays regular FICA payroll taxes on the full $28,000 she reported, but the employer can also claim the full FICA Tip Credit (Form 8846) on those tips. Yolanda gets her tax break, and the business owner doesn't lose theirs.

QUALIFIED TIPS DEDUCTION	
Topic	***Summary***
Deduction amount	Up to $25,000 per year (2025–2028).
Phase-out thresholds	Begins at $150,000 MAGI (Single); $300,000 (MFJ).
Where claimed	Schedule 1-A, available to itemizers and standard-deduction filers.
Regulatory history	Proposed regs (Sept 2025); Notice 2025-69 (Nov 2025); Final regs TD 10044 (Apr 10, 2026), retroactive to tax years after 12/31/2024.
Definition of qualified tips	Must be: (1) from a qualifying occupation, (2) cash or equivalent, (3) voluntary, (4) not digital assets.
Nonqualifying payments	Service charges, automatic gratuities, mandatory fees.
Occupation requirement	71 occupations in 8 categories under the TTOC system; expanded to include Visual Artists (509), Floral Designers (510), Gas Pump Attendants (810).
SSTB exclusion	Workers in SSTBs (law, health, accounting, consulting, financial services) cannot claim the deduction.
Employer FICA interaction	Tips remain FICA-taxable; employer may still claim the Section 45B FICA Tip Credit on all reported tips.

TRUMP ACCOUNTS

The OBBBA added IRC Section 530A, creating a new type of traditional IRA for minors known as a "Trump Account." A Trump Account is established for the exclusive benefit of an "eligible individual" — a person under age 18 with a valid Social Security number. An "authorized individual" (a parent, legal guardian, adult sibling, or grandparent) must file IRS Form 4547 to elect to open the account. The election window remains open through December 31 of the year the beneficiary turns 17.

Contributions to a Trump Account by individuals are made with after-tax dollars, while the account's growth is tax-deferred. Once the beneficiary turns 18, the growth period ends, and the account becomes fully subject to standard traditional IRA distribution rules under Section 408. Consequently, while the original after-tax contribution basis is recovered tax-free, all accumulated earnings (and any pretax government or employer contributions) are taxed as ordinary income upon withdrawal. A Trump Account is essentially a tax-deferred investment account funded with after-tax dollars, where investment gains are taxed when withdrawn rather than each year.

During the "growth period" (before the beneficiary turns 18), contributions may be made by parents, grandparents, other family members, friends, and employers, subject to an annual aggregate limit of $5,000 (indexed for inflation after 2027). Of that $5,000, employers may contribute up to $2,500 on a pretax basis for employees' children.

Employer contributions. IRC Section 128 is the gross-income exclusion for employer contributions to Trump Accounts, enacted by the OBBBA in July 2025 alongside Section 530A. An employer may contribute to a Trump Account on behalf of an employee's child (or dependent), and Section 128 excludes that contribution from the employee's gross income, up to the $2,500 cap (indexed after 2027). Without Section 128, an employer payment into the child's account would be compensation income to the parent under ordinary Section 61 principles. Because the contribution does not increase the parent's AGI or MAGI, it does not push the parent toward the income phaseouts that apply to other OBBBA provisions.

The excluded amount still counts against the $5,000 annual aggregate contribution limit under Section 530A.

The $1,000 Pilot Program contribution. The federal government's "pilot program" will make a one-time $1,000 contribution to Trump Accounts opened for children born between January 1, 2025, and December 31, 2028, who are US citizens with valid Social Security numbers. Contributions under the pilot program may not be deposited before July 4, 2026.

Guidance timeline. Notice 2025-68 (December 2, 2025) provided initial operational rules and announced that proposed regulations were forthcoming. The first public release of Draft Form 4547, *Trump Account Election(s)*, occurred on January 8, 2026, establishing the required data-entry fields for taxpayers and tax professionals.

In May 2026, the Treasury Department began mailing physical account activation and validation packets to eligible families based on recent birth certificate registrations and Social Security rolls. Taxpayers who have filed Form 4547 can now complete the identity authentication process and activate their child's account through the Trump Accounts app.

The official statutory opening of the contribution window is on July 4, 2026. Under the text of the OBBBA, no monetary contributions or deposits of any kind may be accepted into a Trump Account before July 4, 2026. Any attempt to move capital into an account before this date will be rejected by the custodial interface or treated as an invalid transaction.

IMPLEMENTATION TIMELINE	
December 2, 2025	Notice 2025-68 announces intent to issue regulations and provides interim rules.
January 8, 2026	Draft Form 4547 released.
May 2026	Treasury began distributing account activation information.
Late May 2026	Trump Accounts app launches.
July 4, 2026	The earliest date contributions may be deposited.

Where does the money go? The Treasury Department designated The Bank of New York Mellon (BNY) as the federal financial agent for the Trump Accounts program. BNY has partnered with Robinhood, which serves as the brokerage and initial trustee for the accounts. So, BNY manages the initial accounts, and Robinhood serves as the brokerage. Families may subsequently move funds to a different trustee (through a Trump Account rollover) under the rules in Notice 2025-68.

The Trump Accounts app — developed by BNY and Robinhood in partnership with the National Design Studio — launched on May 28, 2026, and is available through the Apple App Store and Google Play.

Form 4547. Draft Form 4547 collects the authorized individual's identifying information, the beneficiary's name and Social Security number, and the election to participate in the pilot program. The election is independent of the income tax return — filing Form 4547 does not constitute the filing of a tax return, and the credit for the pilot program contribution is not a refundable credit on Form 1040. Tax year 2026 returns will not generate a federal tax deduction for Trump Account contributions (they are after-tax), and no income is recognized on contributions received.

Because clients will look to their tax professionals to execute these elections, practitioners must master the specific data fields and structural limitations built into Draft Form 4547. The form is broken into four parts, described below.

Because a Trump account is opened for a minor, Part I asks for the "Authorized Individual" — the person who will serve as the responsible party and make investment and rollover decisions for the account. When the only election is to open the account, the IRS applies a priority order: legal guardian, then parent, then adult sibling, then grandparent. A person in a lower-priority category may make the election only if no higher-priority person is available.

If more than one person exists within the same priority category, any of them may make the election. If two individuals at the same priority level attempt to file Form 4547, the IRS will treat the earliest valid filing as controlling.

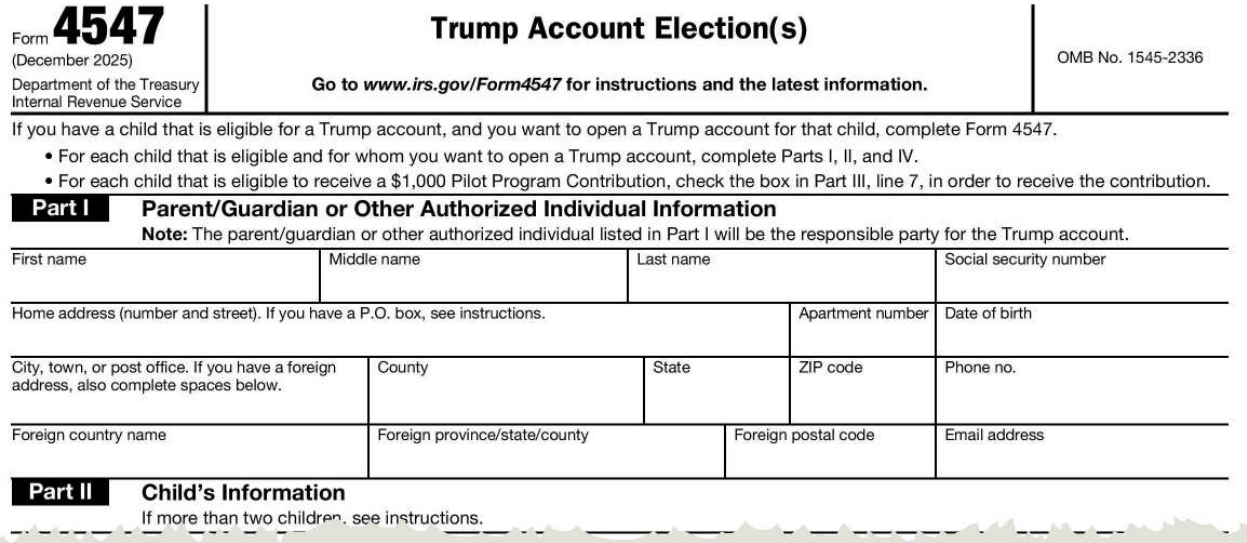
Part II identifies the child who will be the beneficiary of the account. Generally, an election may be made only for a child who:

- Is under age 18 at the end of the year the election is filed;
- Has a valid Social Security number issued before the election is made; and
- Has not previously been the subject of a Trump Account election.

Part II allows an authorized individual to make elections for up to two children. If elections are being made for more than two children, additional Forms 4547 must be attached. Although multiple children may appear on the same form, each child receives a separate Trump account and a separate election is made for each child.

Part III contains the election to request the one-time $1,000 Pilot Program Contribution from the US Treasury. To qualify, the child generally must be born between January 1, 2025, and December 31, 2028, be a US citizen, have a valid Social Security number, and be the qualifying child of the individual making the election. Eligible children receive the contribution only if the box in Part III is checked.

Part IV is the consent and signature block. By signing, the authorized individual authorizes the IRS, Treasury, and their agents to create and maintain the Trump account for the child(ren) in Part II and to disclose the account's existence to any parent, guardian, or authorized individual eligible to request its creation. The signature is made under penalties of perjury. A paid preparer may complete the preparer section, but the filer remains responsible for the form's accuracy.



Form **4547** (December 2025)
Department of the Treasury
Internal Revenue Service

Trump Account Election(s)

Go to *www.irs.gov/Form4547* for instructions and the latest information.

OMB No. 1545-2336

If you have a child that is eligible for a Trump account, and you want to open a Trump account for that child, complete Form 4547.

- For each child that is eligible and for whom you want to open a Trump account, complete Parts I, II, and IV.
- For each child that is eligible to receive a $1,000 Pilot Program Contribution, check the box in Part III, line 7, in order to receive the contribution.

Part I **Parent/Guardian or Other Authorized Individual Information**

Note: The parent/guardian or other authorized individual listed in Part I will be the responsible party for the Trump account.

First name	Middle name	Last name	Social security number

Home address (number and street). If you have a P.O. box, see instructions.	Apartment number	Date of birth

City, town, or post office. If you have a foreign address, also complete spaces below.	County	State	ZIP code	Phone no.

Foreign country name	Foreign province/state/county	Foreign postal code	Email address

Part II **Child's Information**

If more than two children, see instructions.

ADOPTION CREDIT REFUNDABILITY

Before the OBBBA, the adoption tax credit was entirely nonrefundable. Unused credit could be carried forward for up to five years, but it could never be refunded. The OBBBA made two targeted changes. First, up to $5,120 of the adoption tax credit per child (indexed for inflation) is now refundable. Second, Indian tribal governments are now recognized on equal footing with state governments for the purpose of making "special needs" determinations.

FS-2026-03 (February 27, 2026). Fact Sheet 2026-03 issued on February 27, 2026, addressed these two changes in Q&A format. The FAQs confirmed that the maximum credit for 2025 is $17,280 per qualifying child (the credit is $17,670 in 2026). Of that amount, up to $5,000 per child may be refundable in 2025 if all requirements are met

(the refundable amount is $5,120 in 2026). The nonrefundable portion of the credit retains a five-year carryforward — but the carryforward applies only to the nonrefundable portion. Once the five-year carryforward expires, any remaining unused nonrefundable credit is forfeited. The carryforward credit cannot, in any subsequent year, cause a refund; it can only offset tax liability.

The adoption credit now has both refundable and nonrefundable parts, so tax professionals need to track each one separately on Form 8839. For example, someone who adopts two children in 2026 could receive a refundable credit of up to $10,240, plus a larger nonrefundable amount that can be carried forward, depending on their qualified adoption costs.

Special Needs and Tribal Government Parity. Before the OBBBA, only a state government could determine that a child had "special needs" for purposes of claiming the maximum adoption credit regardless of actual expenses. The OBBBA provided parity for Indian tribal governments. This change applies to tax years beginning after December 31, 2024. For a child to be considered to have "special needs," a state or Indian tribal government must determine:

- The child cannot or should not be returned to the parents' home;
- A specific factor or condition exists making placement without assistance unreasonable; and
- The child is a US citizen or resident.

For tax professionals representing tribal families, the tribal parity rule matters because it allows families adopting through tribal child welfare programs to claim the full credit ($17,670 per child in 2026) without the burden of tracking or proving actual out-of-pocket costs.

Income phaseouts. The adoption tax credit phases out based on MAGI. The OBBBA did not change the phaseout structure. For 2026, the phaseout range begins at $265,080 and ends at $305,080. The adoption credit is one of the few credits that apply identical phaseout thresholds regardless of filing status.

The phaseout applies to the full credit before it is divided into refundable and nonrefundable components. Because the refundable $5,120 portion is subject to the same MAGI limits, high-income taxpayers cannot use the new refundability rules to claim a benefit that has otherwise phased out.

SUMMARY OF MAGI PHASEOUTS		
Provision	***MAGI phaseout begins for Singles / MFJ***	***Filing Status Notes***
Car loan interest	$100,000 / $200,000	Maximum deduction is $10,000 per return (deduction is not doubled for MFJ)
Overtime	$150,000 / $300,000	Maximum deduction can be doubled for MFJ
Tips	$150,000 / $300,000	Maximum deduction is $25,000 per return (deduction is not doubled for MFJ)
Adoption credit	$265,080	Same MAGI thresholds for all statuses

SMALL-BUSINESS OBBBA PROVISIONS

100% BONUS DEPRECIATION

Background. The Tax Cuts and Jobs Act (TCJA) of 2017 allowed 100% bonus depreciation through the end of 2022. After that, the percentage phased down: 80% in 2023, 60% in 2024, 40% in 2025, and 20% in 2026, with full sunset in 2027. The OBBBA reversed the phase-down entirely and made 100% bonus depreciation permanent for qualified property acquired and placed in service on or after January 20, 2025. Property acquired on or before January 19, 2025 does not qualify for the 100% rate.

Notice 2026-11. The IRS released Notice 2026-11 on January 14, 2026, to address certain practical issues that small businesses face when claiming bonus depreciation on capital asset purchases. Rather than write new rules, the notice keeps the existing regulatory framework. The IRS confirmed that the existing TCJA regulatory framework under Treasury Regulation Section 1.168(k)-2 continues to apply to qualified property, simply substituting the new statutory acquisition and timing dates.

Qualified property. Qualified property generally means depreciable tangible personal property with a recovery period of 20 years or less under MACRS, including machinery, equipment, business vehicles, furniture, computers, and qualified improvement property (QIP). QIP — improvements to the interior of a nonresidential building already placed in service — carries a 15-year MACRS life and therefore falls within the bonus depreciation universe.

Used property. One major benefit for small businesses is that used property can still get 100% bonus depreciation if it follows the rules set by the TCJA and preserved by the OBBBA. For instance, the property cannot have been used by the taxpayer (or a predecessor entity) before the purchase, and it cannot be bought from a related party under Section 267. Notice 2026-11 also explains that buying assets through secondary-market equipment brokers qualifies for a 100% immediate tax deduction.

Sound productions and self-constructed assets. The OBBBA and later IRS guidance set new timing rules for two types of assets.

The OBBBA expanded the Section 168(k) definition of qualified property to cover qualified sound recording productions for tax years ending after July 4, 2025. This gives entertainment industry taxpayers a new opportunity for bonus depreciation.

For self-constructed property, meaning equipment or machinery a business builds for itself, Notice 2026-11 ties eligibility to when the property is placed in service. The 100% rate applies only if major construction began after the OBBBA effective date.

Interaction with new Section 168(n). Notice 2026-11 states that making the election under Section 168(n), described below, for a given property automatically opts the taxpayer out of Section 168(k) bonus depreciation for that property — the two provisions are mutually exclusive on a property-by-property basis.

QUALIFIED PRODUCTION PROPERTY

Section 168(n), added by the OBBBA, creates a separate 100% special depreciation allowance for "qualified production property" (QPP). The provision is designed to encourage domestic manufacturing, production, and refining by allowing taxpayers to deduct 100% of a qualifying property's unadjusted depreciable basis in the year it is placed in service rather than depreciating the property over the normal 39-year recovery period.

QPP must be nonresidential property that plays a key role in a qualified production activity (QPA). Construction needs to begin after January 19, 2025, but before January 1, 2029. The property must also be placed in service before January 1, 2031.

A QPA includes the manufacturing, production, or refining of a qualified product where the activity results in a substantial transformation of the inputs. Activities such as stamping, molding, chemical synthesis, and agricultural processing generally qualify. Mere packaging, labeling, minor assembly, or storage of finished goods do not. Storage of raw materials may qualify if it is integral to the production process.

The 95% physical-space test. Notice 2026-16, issued February 20, 2026, provides interim guidance on Section 168(n). Notice 2026-16 introduces a favorable 95% physical-space de minimis test, allowing taxpayers to treat an entire property as satisfying the Section 168(n) integral-part requirement if at least 95% of the property's physical space is used for a qualified production activity when the property is placed in service.

If non-production space makes up more than 5% of the building's total area, the building's basis must be allocated between qualifying and nonqualifying areas. The production area still qualifies for Section 168(n), but the rest is depreciated under the normal rules for nonresidential property. Notice 2026-16 permits any reasonable method to divide the space, but specifically rejects employee headcount and employee time methods.

Example. A new 100,000-square-foot manufacturing facility has 97,000 square feet of production floor and 3,000 square feet of executive offices. Because production space exceeds 95% of the total physical area, the taxpayer may elect to treat the entire building as a QPP and deduct 100% of its cost in the year it is placed in service.

Anti-abuse rule. Notice 2026-16 has a rule to prevent people from cheating the 95% physical-space test. If someone uses fake subleases, temporary walls, or similar tricks just to separate space that does not qualify, the IRS can reject these setups. If the IRS decides a setup was only made to get around the rules, QPP treatment will be denied.

TOP AUDIT TRIGGERS UNDER OBBBA GUIDANCE
Missing or invalid VIN on Schedule 1-A (automatic math-error disallowance).
Overtime deductions inconsistent with W-2 Box 12 Code TT.
Tips claimed by workers not on the TTOC occupation list.
Trump Account elections filed by unauthorized individuals.
QPP elections where non-production space exceeds 5% without proper allocation.

The 10-year recapture rule. The biggest risk with the QPP deduction is the 10-year recapture rule. If a property that received the deduction stops qualifying as QPP within 10 years of being put into use, a recapture event happens. This can occur if the business changes, production activities end, the facility is used for another purpose, or the property is transferred and no longer serves as a qualifying production facility.

When recapture is triggered, the property is treated as if it was sold when it stopped qualifying. The taxpayer must report ordinary income under Section 1245 for the difference between the accelerated QPP depreciation taken and what would have been allowed under regular rules.

Since the recapture amount can be significant, tax professionals should consider how long the client plans to keep the property, their future business plans, and whether the property is likely to remain in qualifying production use for the full 10 years.

SUMMARY OF GUIDANCE ITEMS CITED IN THIS CHAPTER (SORTED BY DATE)		
Guidance Document	Date Issued	Topic
Notice 2025-69	November 21, 2025	Deduction computation methods for qualified tips and qualified overtime
Notice 2025-68	December 2, 2025	Initial operational rules for Trump Accounts [Section530A]
REG-113515-25	December 31, 2025	Proposed regs that outline the deduction for QPVLI
Notice 2026-11	January 14, 2026	Interim guidance for 100% bonus depreciation [Section168(k)]
FS-2026-01	January 23, 2026	FAQs on 2026 reporting requirements for overtime deduction
Notice 2026-16	February 20, 2026	Interim guidance on qualified production property [Section168(n)]
FS-2026-03	February 27, 2026	FAQs on adoption credit refundability and tribal parity
TD 10044	April 10, 2026	Final regs on tip deduction (including occupation list and definitions)

REVIEW QUESTIONS

31. A married couple files jointly for 2026. They purchase a new US-assembled SUV for personal use and finance the purchase with a qualified loan. Their MAGI is below the phaseout threshold, and they claim the standard deduction. Which statement is correct?
{A}. The deduction may be claimed even though they take the standard deduction.
{B}. The deduction is allowed only for used vehicles financed after 2024.
{C}. The deduction is available only for vehicles used in a trade or business.
{D}. The deduction is available only if the taxpayers elect to itemize deductions.

32. A sole proprietor purchased a qualifying passenger vehicle in 2026 and uses it 30% for business and 70% for personal purposes. During 2026, he paid $6,000 of interest on the vehicle loan. He deducts the business-use portion of the interest ($1,800) on Schedule C. His MAGI is below the phaseout threshold. What amount can he deduct as qualified passenger vehicle loan interest (QPVLI)?
{A}. $4,200, because only personal-use interest is deductible.
{B}. $0, because the vehicle is not used primarily for business.
{C}. $1,800, because only business-use interest is deductible.
{D}. $6,000; the total interest paid.

33. Marcy opens an IRC Section 530A Trump Account for her 5-year-old child. By June 10, 2026, Form 4547 has been filed, and the child's identity has been verified through the Trump Accounts app. Marcy wants to fund the account **as soon as possible**. When may she first make a valid monetary contribution?
{A}. Immediately after identity verification is completed (June 10, 2026).
{B}. On or after July 4, 2026, when contributions first become permissible
{C}. Monetary deposits cannot legally begin until January 1, 2027.
{D}. When Marcy files her 2026 tax return on April 15, 2027.

34. In 2026, Irma adopts a child, and her qualified adoption expenses support the full $17,670 adoption credit. Irma's tax liability is $2,000. She has no withholding or other credits, and her MAGI is below the phaseout range. What is the maximum refundable portion of Irma's adoption credit for 2026?
{A}. $0, because the adoption credit remains entirely nonrefundable.
{B}. $5,120, the 2026 refundable limit per qualifying child.
{C}. $15,670, because all credit exceeding tax liability becomes refundable.
{D}. $17,670, because the OBBBA made the entire credit refundable.

35. Sprocket Rocket LLC constructs a 100,000-square-foot manufacturing facility. The building contains 96,000 square feet of production space and 4,000 square feet of office and breakroom space. Assuming all other requirements are met, how is the facility treated under IRC Section 168(n)?
{A}. The building is depreciated over 39 years.
{B}. The building must be partitioned; only production space receives QPP treatment.
{C}. The building is treated as qualified production property; a 100% deduction is allowed.
{D}. The building does not qualify for a deduction because it includes administrative space.

Part E reveals the correct answers to all end-of-chapter review questions while providing feedback on both correct and incorrect responses.

Chapter 12. OTHER IRS DEVELOPMENTS IN 2026

Learning objectives: After reading this chapter, you should recognize the new reporting thresholds for certain 1099 forms, tell the difference between real and mistaken CP53E notices, use IRS digital authorization and online account tools, understand the expanded disaster-relief rules and the Math and Taxpayer Help Act requirements, and help ERTC claimants avoid missing the two-year deadline to file a refund lawsuit.

Chapter Topics

- Information returns and Notice CP53E
  - » Information reporting changes
  - » CP53E Notices: Real, fake, or issued in error?
- The continuing digital transformation of the IRS
  - » IRS Individual Online Account
  - » EFTPS sunset for individual taxpayers
  - » Tax Pro Account expansions
- Legislative changes affecting IRS administration
  - » Filing Relief for Natural Disasters Act (PL 119-29)
  - » The IRS Math and Taxpayer Help Act (PL 119-39)
- Disallowed ERTC claims: Extensions and appeals
  - » Where things stand
  - » The problem: The two-year refund clock
  - » The solution: Streamlined Form 907 extension

In 2026, while most tax professionals focused on new guidance for the OBBBA, the IRS made several other administrative changes that affected tax practice. Some changes updated information reporting rules, others pushed the agency further into digital processes, and still others reflected Congress's efforts to improve taxpayer rights and IRS accountability. This chapter covers the main IRS administrative changes that impact taxpayers and tax professionals in 2026.

INFORMATION RETURNS AND NOTICE CP53E

INFORMATION REPORTING CHANGES

The OBBBA made the most significant overhaul of federal information-reporting in decades, and the IRS has begun implementing those changes through new and revised forms and instructions.

Changes to Form W-2 (Tips and Overtime Tracking). The OBBBA's "No Tax on Tips" deduction requires employers to report additional payroll information regarding tip income. Under current IRS guidelines, information returns furnished to workers must isolate qualifying tip amounts alongside occupation-related data. For tax year 2026, qualifying tips are reported on Form W-2 in Box 12 using Code TP, with the corresponding tipped occupation code noted in Box 14.

Similarly, the “No Tax on Overtime” deduction requires employers to separately track and report qualified overtime compensation. This aggregate overtime amount is reported to both the employee and the IRS on Form W-2 in Box 12 using Code OV.

Form 1098-VLI (Vehicle Loan Interest Statement). The OBBBA added IRC Section 6050AA, creating a new information-reporting requirement for persons receiving interest on certain specified passenger-vehicle loans. The IRS released draft Form 1098-VLI on October 16, 2025. A filer must issue the form when a borrower pays at least $600 in qualifying interest during the calendar year, paralleling the Form 1098 mortgage-interest threshold.

The IRS has released the final layout for Form 1098-VLI. Lenders must file Form 1098-VLI to report:
● The borrower’s TIN and outstanding principal balance.
● The total qualified vehicle loan interest received (Box 1).
● Vehicle specifics, including the year, make, model, and vehicle identification number (Boxes 2a–2d).
● The loan origination and acquisition dates (Boxes 3a–3b).

The Impact of “Trump Accounts” on IRS Forms. The OBBBA created “Trump Accounts,” which allow annual contributions up to $5,000 (with employers permitted to contribute up to $2,500 tax-free). The IRS built on existing IRA reporting infrastructure but issued a new variant for contributions. Annual contributions will be reported on Form 5498-TA, and distributions will be reported on Form 1099-R, like other IRAs. The draft Form 1099-R adds box 7c (checked when the distribution is from a Trump Account) and box 7d (earnings on excess contributions being distributed).

Forms 1099-NEC and 1099-MISC threshold increases. For tax year 2026 and later, the reporting threshold for Form 1099-NEC and Form 1099-MISC increases from $600 to $2,000 per payee per calendar year. Beginning in 2027, the threshold will be indexed for inflation.

The obligation to backup-withhold at 24% is tied to the same $2,000 reporting floor. Backup withholding applies only to payments that would otherwise require a Form 1099. Payments below $2,000 per payee annually are not subject to either the information-reporting requirement or the associated backup-withholding obligation.

This change reduces paperwork for taxpayers who hire independent contractors for small or occasional jobs. For example, paying $700 to a part-time bookkeeper or $650 to a graphic designer no longer triggers a Form 1099-NEC, provided total payments remain under $2,000 for the year.

The reporting change does not alter the taxability of income below the threshold. All compensation remains fully taxable, and freelancers must report all earnings regardless of whether a Form 1099 is issued.

Form 1099-K reversion. The OBBBA permanently repealed the American Rescue Plan Act's threshold for Form 1099-K. ARPA had lowered the reporting limit from $20,000 and 200 transactions to $600 with no transaction minimum, but the IRS repeatedly delayed implementation.

Beginning in 2025, the Form 1099-K threshold reverts to more than $20,000 in aggregate payments and more than 200 transactions per year. The IRS has updated its FAQs accordingly. The volume of Forms 1099-K will drop significantly beginning in 2026.

FORM	WHAT THE OBBBA CHANGED	TRIGGER	FIRST YEAR
W-2	New fields for qualified tips and qualified overtime	All covered wages	2025 (transition relief); full 2026
1099-NEC	Threshold raised $600 to $2,000, indexed after 2026	$2,000 per payee, per year	2026
1099-MISC	Threshold raised $600 to $2,000, indexed after 2026	$2,000 per payee, per year	2026
1099-K	ARPA $600 rule repealed; threshold restored	> $20,000 and > 200 transactions	2025 (retroactive)
1098-VLI (new)	New form for qualified passenger vehicle loan interest	$600 interest per loan, per year	2025 (transition relief); full 2026
5498-TA (new)	New form for Trump Account contributions (Section 530A)	A Trump Account contribution	2026
1099-R	Now also reports Trump Account distributions (new boxes 7c, 7d)	Trump Account distribution	2026

CP53E NOTICES: REAL, FAKE, OR ISSUED IN ERROR?

Background. On March 25, 2025, President Trump signed Executive Order 14247, *Modernizing Payments To and From America's Bank Account*, requiring federal agencies — including the IRS — to move away from paper checks and money orders and switch to fully electronic payments. For individual taxpayers, this meant the IRS would no longer automatically send a paper refund check when a return was processed. Instead, taxpayers without direct deposit information on file would receive a notice requesting bank details. That notice is the CP53E.

The IRS created the CP53E notice for the 2026 filing season. Its purpose is simple: when the IRS cannot send a refund by direct deposit — because bank information is missing, wrong, or rejected by the bank — it holds the refund and mails the notice to the taxpayer. The notice gives the taxpayer 30 days to log in to their IRS Individual Online Account and add or fix their bank account information. If the taxpayer does nothing in that time, the IRS will mail a paper check after about six weeks.

1.4 million CP53E notices mailed in the first quarter of 2026. Most individual refunds already arrive electronically. For the 2025 filing season (covering 2024 returns), the IRS issued more than 93.5 million individual refunds, of which about 87 million were issued via direct deposit. The remaining 6.5 million refunds were issued as paper checks through the mail. It was this paper-check population that the electronic-payment

mandate under Executive Order 14247 targeted. As the 2026 filing season got underway, the IRS began issuing CP53E notices in volume to filers who had not supplied direct-deposit information. Members of the House Ways and Means Committee reported that more than 830,000 notices had been sent by early March 2026, and by March 24, the cumulative total had reached 1.4 million.

Distinguishing legitimate from erroneous CP53E notices. The large number of notices, while unusual, was not the main problem. The real issue was that the IRS's automated system sent CP53E notices to many taxpayers who were not owed a refund. Some taxpayers got the notice even though they owed money on their 2025 returns.

For practitioners, the first step is to tell a real CP53E from a mistaken one. A real CP53E notice means the IRS has approved a refund but cannot deliver it electronically because:

- The taxpayer did not provide direct deposit information when filing the return.
- The financial institution rejected the direct deposit due to an invalid or closed account number.
- The IRS could not validate the bank account information provided.

A real notice tells the taxpayer to log in to their IRS Individual Online Account at IRS.gov and add or update their bank account info within 30 days. The online account will show an "Add bank account" message when a CP53E has been sent. After the taxpayer completes the process, allow two to five business days for the refund status to update in the account. Taxpayers can monitor progress through the "Where's My Refund" tool.

Example. Dan filed a tax return showing a $1,800 refund but entered an incorrect routing number. The IRS issues CP53E. Dan logs in to his IRS Individual Online Account, updates his banking information, and the refund is reissued electronically after the update. If he had ignored the notice, the IRS would eventually have mailed a paper check.

IRS employees cannot change bank account information by phone or in person. All changes must be made through the IRS Individual Online Account. The toll-free number on the CP53E notice only plays a recorded message — callers are not connected to a customer service agent and cannot give banking information by phone.

When a client gets a CP53E but thinks they are not owed a refund, the first step is to check the account status directly. The safest way is to have the client log in to their IRS Individual Online Account at IRS.gov — by typing the web address directly into a browser, not by clicking any link from the notice — and check their account balance and refund status. If the account shows no refund is due, the notice was sent by mistake, and the taxpayer can safely ignore it. Both the IRS and the Taxpayer Advocate Service (TAS) say, "If it was received in error, you're okay to ignore it."

Example. A client who owes $1,200 receives a CP53E. They panic because the notice demands banking information. You verify the filed return, confirm no refund is pending,

and have the client check their IRS Individual Online Account. The account shows a balance due and no refund. You advise them to ignore the notice and retain it.

The phishing and fake QR code problem. Any new IRS letter requesting bank account information can invite fraud, and the CP53E was no exception. Scammers sent fake versions of the notice to trick taxpayers into visiting harmful websites that stole banking details. Taxpayers should never scan a QR code from any unexpected letter or use the link to enter bank or personal information. Instead, they should go directly to IRS.gov, check their account status, and take any needed steps inside their secure online account.

THE CP53E TIMELINE TRAJECTORY		
Day 1	Notice Dispatched	The IRS freezes the client's refund due to missing, rejected, or unvalidated direct deposit banking data and issues the CP53E notice via mail.
Day 30	Digital Authentication Deadline	The absolute cutoff for the taxpayer to log into their IRS Individual Online Account and use the "Add bank account" notification.
Days 32–35	System Status Update	Allow two to five business days after a successful digital submission for the online account status and the "Where's My Refund" portal to update.
Week 6	Paper Check Fallback	If no digital action is taken within the initial 30 days, the IRS automatically defaults to processing and mailing a physical paper check.

THE CONTINUING DIGITAL TRANSFORMATION OF THE IRS

The IRS developments of 2026 reveal a tax administration system undergoing rapid transformation. Expanded digital services and online taxpayer accounts are steadily replacing traditional paper-based methods. At the same time, the IRS continues to encourage taxpayers and professionals to interact with the agency through secure online platforms rather than by mail or telephone.

Knowing how to navigate online portals, manage digital authorizations, and access transcripts is now essential for competent tax practice. Mastery of these digital tools is no longer optional; it is now a basic requirement for representing clients under Circular 230.

IRS INDIVIDUAL ONLINE ACCOUNT

Online notices. The IRS Individual Online Account now lets taxpayers see and download over 200 types of IRS notices electronically, without waiting for mail. This feature has grown over several years and is now reliable enough to be the main way many taxpayers get their notices if they opt in.

The IRS recently expanded the Individual Online Account to allow taxpayers to view and download certain information return documents directly, including Forms W-2, 1095-A,

1099-NEC, 1099-DIV, 1099-INT, and 1099-MISC. These documents are available for tax years 2023, 2024, and 2025 under the Records and Status tab.

For the CP53E situation, the online account's "Where's My Refund" function and the account balance summary provide a reliable, real-time verification of whether the refund notice is legitimate.

Tax debt management. The IRS Individual Online Account now offers taxpayers a way to handle unpaid federal taxes without calling the IRS. As of the 2026 filing season, individual online accounts let users:

● View balance by tax year. Account users can see what they owe, broken down by tax period.

● Payment scheduling. Account users can make and cancel one-time payments, schedule future payments, and track payment history.

● Setting up and changing payment plans. Account users who qualify for a streamlined installment agreement (generally balances up to $50,000 with up to 72 months to pay) can set up or modify a plan completely online. The online system does not require a call to the IRS collections office, which used to have long wait times.

● Offer in Compromise pre-qualifier. The IRS website's OIC pre-qualifier tool helps account users assess whether they might qualify for a reduced settlement before investing in a formal application.

EFTPS SUNSET FOR INDIVIDUAL TAXPAYERS

For many years, the Electronic Federal Tax Payment System (EFTPS) has helped people schedule their federal tax payments online. It lets taxpayers plan estimated payments, pay balances due, and make employment tax deposits up to a year in advance. Now, this option is ending for individuals.

The IRS stopped accepting new individual EFTPS enrollments on October 17, 2025. If the taxpayer signed up before that date, they can still use EFTPS for now. However, the IRS plans to close EFTPS.gov for individuals sometime in 2026.

Businesses with employer identification numbers (EINs) can still use EFTPS. While individuals are being phased out, businesses can continue using EFTPS for federal tax deposits, such as payroll and corporate income taxes.

Why is EFTPS ending for individual taxpayers in 2026? The IRS has not said there is a problem with the system, nor has it given a detailed reason for removing EFTPS for individuals. Instead, the agency connects this change to the federal government's push for modern electronic payment systems under Executive Order 14247. This order requires agencies to update and consolidate payment systems and move away from older technology.

EFTPS was created in the 1990s and requires users to enroll, receive PINs by mail, and undergo a double-login process (first with a regular login, then with Login.gov). The IRS appears to be consolidating individual payments into Direct Pay and Online Accounts

rather than maintaining multiple overlapping systems. Streamlining individuals into a unified "Online Account" environment helps the IRS better track balances and secure payment pathways against identity theft.

Replacing EFTPS: Payment options for individual taxpayers. Many self-employed people liked EFTPS because it let them schedule all four quarterly estimated tax payments in advance. As the system ends for individuals, tax professionals should help clients find other payment options.

Paper checks accompanied by Form 1040-ES vouchers remain available for now. However, Executive Order 14247 marks the beginning of the end for this traditional payment format, as the federal government continues its transition toward fully digital processing for both inbound and outbound transactions.

Individual taxpayers can also pay by card through approved third-party services or use cash-based retail networks such as VanillaDirect, but these options incur convenience fees. Because of the fees, these methods are usually less attractive for individuals making large quarterly payments.

The IRS is encouraging individuals to use two no-fee bank account options:

● IRS Direct Pay. A free service requiring no registration, Direct Pay pulls directly from a bank account and handles both Form 1040 balance-due payments and Form 1040-ES estimates. Payments may now be scheduled up to 365 days in advance. However, Direct Pay is subject to a few limitations. Notably, only one payment can be made or scheduled per session; identity must be re-verified using prior-year return information for each payment; and there is no consolidated view of scheduled payments — taxpayers must retain each confirmation number to look up, modify, or cancel a future payment.

● IRS Individual Online Account. Taxpayers can use this option by logging in to their secure portal at IRS.gov using ID.me credentials. The IRS calls this its most complete online payment service. Users can schedule payments up to a year in advance, make multiple payments in one session, store multiple bank accounts, and view a real-time list of all pending, scheduled, and processed payments. A self-employed taxpayer can log in once and schedule all four quarterly estimated payments for the year. For those who want to replace EFTPS's advance scheduling and payment tracking, the Individual Online Account is the best option.

EFTPS TRANSITION TIMELINE FOR INDIVIDUAL TAXPAYERS	
Event	***Date***
New individual enrollments end	October 17, 2025
Full discontinuation for individual users	"EFTPS payment options will be sunset for individual taxpayers in late 2026."*
*IRS Fact Sheet (FS-2026-02), updated January 27, 2026	

TAX PRO ACCOUNT EXPANSIONS

The IRS Tax Pro Account is a free online portal that allows authorized tax professionals to request and manage client authorizations digitally, bypassing the paper-based Forms 2848 (Power of Attorney) and 8821 (Tax Information Authorization) that have historically required weeks of IRS processing time. When a practitioner submits a digital authorization request through the Tax Pro Account, the request posts to the Centralized Authorization File (CAF) database in real time rather than waiting for manual review.

There is no need for a handwritten signature. The taxpayer logs in to their IRS Individual Online Account with ID.me and approves the request online.

Two types of authorizations. The Tax Pro Account supports two types of authorizations:

● Form 8821, *Tax Information Authorization*. A TIA allows the practitioner to view tax records and account information. Any practitioner may request a TIA through the Tax Pro Account.

● Form 2848, *Power of Attorney*. A POA allows the practitioner to represent the taxpayer before the IRS. Only those authorized to practice before the IRS may submit a POA request through the Tax Pro Account.

Once an authorization is active, the practitioner gains access to the client's prior-year transcripts, wage and income records, balance due information, payment history, and any notices accessible through the account. The digital workflow eliminates the delays that once stretched paper processing into weeks or months, enabling faster resolution of notices, audit correspondence, and collection matters.

DIGITAL AUTHORIZATION WORKFLOW
The practitioner submits a TIA or POA request in the Tax Pro Account.
The IRS posts a request to CAF in real time.
The client logs in to their Individual Online Account.
The client approves the authorization electronically.
The practitioner gains access to transcripts and notices immediately.

The February 2026 business-level expansion. On February 9, 2026, the IRS announced (in IR-2026-22) the next expansion of the Tax Pro Account, introducing business-level digital capabilities for firms that use a business CAF number. Before this update, the Tax Pro Account was primarily designed for individual practitioners who maintain their own CAF relationships. Sole proprietors were not materially affected by this expansion, but for multi-practitioner firms, the new capabilities are significant.

Under the February 2026 release, designated business representatives can:

● Manage business CAF access, including specifying which employees within the firm are authorized to act under the business CAF.

● Link the firm's business CAF number to its Employer Identification Number through the Tax Pro Account.
● View taxpayer information associated with the business CAF within the scope of active authorizations.
● View and withdraw active authorizations on behalf of the tax professional business.

This extension of digital authorization management to the firm level sets the stage for future improvements the IRS has announced, such as offering more options to act on behalf of individual clients.

LEGISLATIVE CHANGES AFFECTING IRS ADMINISTRATION

FILING RELIEF FOR NATURAL DISASTERS ACT (PL 119-29)
The 2025 Filing Relief for Natural Disasters Act (PL 119-29) amended IRC Section 7508A so that federal tax deadline relief now covers more than just disasters declared by the President. Previously, the IRS could only extend tax filing and payment deadlines if the President declared a major disaster. If a state recognized a disaster but the President did not, there was no automatic federal tax relief.

PL 119-29 updates the rules for disaster declarations made after July 24, 2025. Now, governors can ask the IRS (in consultation with FEMA) to give federal tax deadline relief for disasters declared by states, even if the President does not declare them as major disasters. This change acknowledges that many local or regional disasters, such as wildfires, can seriously affect communities even without a presidential declaration.

PL 119-29 works in tandem with the OBBBA, which modestly expands casualty loss rules under IRC Section 165(c)(3). The OBBBA allows people to claim casualty loss deductions for the same state-declared disasters, so the tax deadline relief lines up with the deductions available.

New 120-day postponement period. The law also extends the postponement and automatic suspension period from 60 days to 120 days. Previously, the postponement period for estimated tax payments and certain other deadlines lasted 60 days after the disaster was declared or ended, whichever was later. Now, the 120-day period gives affected taxpayers and their advisors more time to manage tax matters while recovering from a disaster.

Example. A state declares a wildfire emergency in August 2026 that does not receive a presidential major-disaster declaration. Under PL 119-29, the governor requests IRS relief. The IRS grants postponement relief for taxpayers in designated counties, extending filing and payment deadlines for 120 days from the later of the declaration date or the end of the incident period. So, if the incident period ends on August 18, the 120-day postponement runs from August 18 through December 16, 2026.

What this means for tax professionals. When a client is affected by a wildfire or other state-declared disaster, tax professionals must determine whether the governor

has requested IRS relief and whether the IRS has issued a postponement notice for the affected area. This determination may affect filing deadlines, estimated tax payment due dates, penalty relief, casualty-loss planning, and the timing of taxpayer communications. Tax professionals who monitor disaster-relief announcements can identify filing extensions and deduction opportunities that might otherwise be overlooked.

THE IRS MATH AND TAXPAYER HELP ACT (PL 119-39)

On November 25, 2025, Congress passed the Internal Revenue Service Math and Taxpayer Help Act (PL 119-39) to address a long-standing issue. In the past, IRS math-error notices were often unclear and brief, and they did not give taxpayers enough information about what went wrong or what steps to take. This new law requires the IRS to improve these notices starting in late 2026.

Math error authority and its problems. Under IRC Section 6213(b), the IRS can quickly assess additional tax without sending a formal notice if a return contains certain mathematical or clerical errors. This is a powerful tool for the IRS because the assessment is made right away and becomes final unless the taxpayer requests an "abatement" within 60 days. A tax abatement refers to the reduction or elimination of tax liabilities, penalties, or interest that a taxpayer owes to the IRS.

For decades, the notices that accompanied these quick assessments, such as the CP11 (changes to tax return, balance due), CP12 (changes to tax return, overpayment), and similar letters, provided very little detail. A typical notice might just say "math error on line 12" or mention a code section, but not explain what the IRS changed, why they did it, or how they calculated the adjustment.

As a result, many taxpayers did not understand the notice, could not tell if the IRS was right or wrong, or sometimes set the letter aside, intending to deal with it later. After 60 days, the assessment becomes final. At that point, the only option is to pay the full amount first and then sue for a refund, which most people cannot afford to do.

What the Act requires. Beginning with notices issued on or after November 25, 2026 (12 months from enactment), math-error and clerical-error notices must include:

- A clear description of the specific error in plain language, identifying the type of error and the exact line of the tax return on which it occurred.
- An itemized computation of all adjustments, including any direct or incidental changes to tax liability, credits, and other affected items.
- Explicit notice of the 60-day abatement deadline, prominently displayed.
- Clear procedures for requesting an abatement and what documentation may be required.

The new notices will look different and include more detail. The 60-day window will be clearly marked and strictly enforced.

The law also establishes a pilot program to send certain math-error notices by certified or registered mail, thereby creating a verifiable delivery record. The IRS must report

tracking data from the pilot to Congress to evaluate whether certified mail should become the permanent standard for these notices.

DISALLOWED ERTC CLAIMS: EXTENSIONS AND APPEALS

WHERE THINGS STAND

The Employee Retention Tax Credit (ERTC) compliance saga has consumed significant IRS resources since 2022 and remains unresolved for tens of thousands of businesses as of mid-2026.

Tax professionals know the timeline well. In summer 2024, the IRS sent out 28,000 notices rejecting claims (mainly Letter 105-C and 106-C) after reviewing ERTC claims with its risk-scoring system. A second ERTC Voluntary Disclosure Program ran until November 2024, allowing businesses that received ERTC refunds by mistake to pay back 80% and avoid penalties and interest.

Now, there is a large and growing number of disputed ERTC claims. These are cases where taxpayers received rejection letters and do not agree with the IRS's decision. The administrative process for handling these cases has been complicated by procedural anomalies that the National Taxpayer Advocate identified as the number-one most serious problem in her 2024 Annual Report to Congress.

THE PROBLEM: THE TWO-YEAR REFUND CLOCK

The biggest issue is the two-year time limit set by IRC Section 6532. After the IRS sends a notice rejecting a claim (Letter 105-C or 106-C), taxpayers generally have two years from that date to file a refund lawsuit in federal court if the matter is not resolved through the IRS. When a taxpayer sends a written protest and asks for a review by the IRS Independent Office of Appeals, it does not pause or extend this two-year deadline.

The way the IRS handles ERTC protests has created a timing trap. Instead of sending disputed cases directly to Appeals, the IRS first sends protests to its Compliance team for a review that is similar to an audit. Instead of the IRS looking for mistakes that increase tax, the IRS is now looking for mistakes that may have caused the taxpayer to miss a benefit (the ERTC). The National Taxpayer Advocate has called this a "reverse audit-like process," and it can take many months. In fiscal year 2025, the average time from when a taxpayer requested an appeal to when the case was resolved was over a year. Only after this review does the case go to an Appeals Officer.

For some taxpayers, this Compliance review took up so much of the two-year period that by the time the case reached Appeals, the legal deadline had already passed or was very close.

THE SOLUTION: STREAMLINED FORM 907 EXTENSION

Under current law, the IRS and a taxpayer can agree in writing to extend the time to file a lawsuit. However, there was no clear or standard way for ERTC claimants to request this extension before their deadline passed.

On April 27, 2026, the IRS announced a new, simpler process (in IR-2026-58) that allows taxpayers with pending ERTC denial cases to extend the two-year deadline by signing Form 907, *Agreement to Extend the Time to Bring Suit*. To be eligible, the taxpayer must be awaiting the IRS's review of their response to a Letter 105C or 106C disallowance and have six months or less remaining before the two-year period expires.

The IRS is sending Notice CP320B to taxpayers it has identified as eligible, but those who did not receive a CP320B may still qualify. Eligible taxpayers, whether or not they received a CP320B, can send a signed Form 907 through the IRS Document Upload Tool at IRS.gov. If the IRS agrees to the extension, it will countersign the Form 907 and return it to the taxpayer or their authorized representative.

The IRS has set up a specific point of contact for ERTC-related Form 907 requests. If a case is already assigned to an Appeals Officer, the request will be sent to that officer. If a case is not yet assigned, the request will go to a designated Appeals point of contact.

REVIEW QUESTIONS

36. A wildfire is declared a state-level disaster in August 2026 but receives no presidential major-disaster declaration. Following the governor's request under PL 119-29, the IRS grants relief to taxpayers in designated counties. What suspension period applies?
{A}. 60 days from the disaster declaration date.
{B}. 90 days from the end of the incident period.
{C}. 120 days from the later of the declaration date or the end of the incident period.
{D}. 180 days from the disaster declaration date.

37. A business taxpayer received Letter 106-C disallowing its ERTC claim on December 1, 2024. His practitioner immediately filed a written protest, but the case remains pending in IRS Compliance review. Without a Form 907 extension, when does the taxpayer's right to file a refund suit expire?
{A}. December 1, 2026.
{B}. The taxpayer lost the right to sue on December 1, 2025.
{C}. The limitations period is suspended while the protest is pending.
{D}. December 1, 2027 (the protest automatically extends the refund-suit period by one year).

Part E reveals the correct answers to all end-of-chapter review questions while providing feedback on both correct and incorrect responses.

Chapter 13. SECURE 2.0 UPDATES FOR 2026

Learning objectives: After finishing this chapter, you will be able to identify the SECURE 2.0 provisions starting in 2026 and 2027, such as mandatory Roth catch-up contributions for high earners and qualified long-term care distributions. You will also be able to explain the replacement of the Saver's Credit with the Saver's Match and the new exclusion for disabled first responders.

Chapter Topics

- Refresher on retirement plans & terminology
  - » Defined benefit vs. defined contribution plans
  - » "Vesting" in defined contribution plans
  - » Defined contribution options
- SECURE 2.0's Roth revolution in workplace plans
  - » Roth 401(k) contributions made by employers
  - » Roth options for SEP & SIMPLE plans now available
  - » Roth contributions made by employees age 50+
- Other SECURE 2.0 rules requiring attention in 2026
  - » Long-term care distributions from retirement plans
  - » Improving coverage for part-time workers
- Changes scheduled for 2027
  - » Saver's Credit ending for retirement contributions
  - » Saver's Match coming in 2027
  - » Tax relief for retired, disabled first responders

Many Americans are approaching retirement on financially shaky ground. According to data from the Federal Reserve's Survey of Consumer Finances, over half of American households (54%) have no dedicated, employer-sponsored retirement savings. For those aged 55 to 64 who have managed to save, the median retirement account balance sits at just $185,000. In an era where workers estimate they will need an average of $1.46 million to retire comfortably, this severe savings gap highlights exactly why legislation was desperately needed to expand workplace plan access and automate savings.

In 2019, Congress passed the Setting Every Community Up for Retirement Enhancement Act, known as the SECURE Act or SECURE 1.0, to improve the US retirement system. SECURE 1.0 included 29 provisions. The following changes were especially important for tax professionals and their clients:

- Penalty-free withdrawals for birth or adoption expenses;
- Elimination of the age limit for traditional IRA contributions;
- Elimination of the "Stretch IRA" for most nonspouse beneficiaries;
- Increase in the required minimum distribution (RMD) age from 70½ to 72; and
- Expanded access to employer retirement plans for long-term part-time employees.

The SECURE Act 2.0 (SECURE 2.0), enacted on December 29, 2022, represents the most significant expansion of retirement-plan law since the original SECURE Act. It has reshaped the retirement savings landscape through a phased rollout of provisions spanning 2023 through 2027. Early changes gave employers more reasons to start plans, including larger startup cost credits, a new employer contribution credit, and a $500 credit for covering military spouses. The law further raised the age for RMDs and lowered penalties for failing to take them.

The 2024 changes aimed to make retirement plans more flexible and user-friendly. These updates introduced starter 401(k) plans, allowed employers to match student loan payments, and let people move money from 529 college savings plans to Roth IRAs. They also added emergency savings accounts linked to retirement plans and created new rules for penalty-free withdrawals in cases of emergencies, domestic abuse, serious illness, and government-declared disasters.

Beginning in 2025, SECURE 2.0 turned toward expanding coverage and accelerating savings, with mandatory automatic enrollment for new 401(k) plans, “super” catch-up contributions for participants ages 60 through 63, and eligibility for long-term part-time employees.

The final provisions of SECURE 2.0 are set to take effect in 2026 and 2027, completing the law’s multi‑year overhaul of retirement policy. These final updates affect both low-income savers and high-earning plan participants. This chapter unpacks the SECURE 2.0 changes most likely to affect individual taxpayers and employers that sponsor retirement plans during these last two years.

SECURE 2.0 TIMELINE HIGHLIGHTS
PROVISIONS IMPLEMENTED IN 2023
Increase to startup cost tax credit under IRC Section45E
$500 small plan tax credit for military spouses
New employer contribution tax credit
Optional Rothification of employer contributions
New Roth option for SEP and SIMPLE IRA plans
Public safety age-50 exception expanded to additional categories
Distributions related to FEMA-declared disasters
Penalty-free distributions for terminal illness
Return of excess contributions and earnings
RMD age increased (again)
RMD penalties decreased
PROVISIONS IMPLEMENTED IN 2024
Starter 401(k) plans and safe-harbor 403(b) plans
Student loan payments as elective deferrals
Moving funds from a 529 savings plan to a Roth IRA
Plan-linked emergency savings accounts
New emergency withdrawal exception
Withdrawals for victims of domestic abuse
IRA catch-up contributions indexed for inflation
New option for spouse beneficiary of 401(k) plan
No more Roth 401(k) RMDs
PROVISIONS IMPLEMENTED IN 2025
Auto-enrolling employees in a 401(k) plan
Super catch-up contributions for ages 60-63
SECURE 2.0 LTPT employees eligible to contribute in 2025
PROVISIONS IMPLEMENTED IN 2026
Roth catch-up contributions for high-earners
Qualified long-term care distributions
CHANGES SCHEDULED FOR 2027
Saver’s Credit to be converted to Saver’s Match
Disability payments for retired first responders

REFRESHER ON RETIREMENT PLANS & TERMINOLOGY

DEFINED BENEFIT VS. DEFINED CONTRIBUTION PLANS

The US retirement system is divided into two primary categories: defined benefit plans and defined contribution plans.

Defined benefit plan. A defined benefit plan, more commonly known as a pension, promises a specified monthly benefit at retirement. These plans are generally funded solely by the employer. A pension plan requires an employer to contribute to its employees' retirement income by investing in a pool of funds.

One notable trend in the US retirement system over the past five decades is that private-sector employees have become less likely to be covered by defined benefit pension plans and more likely to be covered by defined contribution plans.

Defined contribution plans. A defined contribution plan is one in which the employee and/or employer contribute to the employee's individual account under the plan. With defined contribution plans, the payout in retirement depends on how the employee invests the money (the employer does not promise a specified monthly benefit at retirement).

Examples of defined contribution plans include 401(k), 403(b), and 457 plans. Since IRAs (Roth, SEP, SIMPLE, and traditional) often entail defined contributions into tax-advantaged accounts with no promised benefit, they could also be considered defined contribution plans.

Most SECURE 2.0 changes affect defined contribution plans, especially workplace plans like 401(k), 403(b), and 457 plans. Many updates also apply to IRAs, including Roth, SEP, SIMPLE, and traditional accounts. Defined benefit plans are rarely mentioned in SECURE 2.0.

In this chapter, when we use the terms "workplace retirement plan" or "employer-sponsored retirement plan," we mean a defined contribution plan such as a 401(k), 403(b), or 457 plan. For the purposes of certain SECURE 2.0 provisions, these terms also encompass small-business IRA-based plans, specifically SEP and SIMPLE IRAs.

"VESTING" IN DEFINED CONTRIBUTION PLANS

In the context of defined contribution plans like 401(k), 403(b), and 457 plans, vesting refers to a participant's legal ownership of the funds in their retirement account. A participant is always 100% immediately vested in their own salary deferrals, including any catch-up contributions; those dollars and their earnings belong to the employee permanently from day one.

However, employer contributions — such as matching funds or non-elective profit-sharing allocations — may be subject to a vesting schedule, which requires the employee to complete a specific period of service before gaining full ownership of those

employer-provided dollars. If an employee terminates employment before becoming fully vested, any unvested employer funds are forfeited back to the plan.

Example. Rebekah participates in her employer's retirement plan. Rebekah's own salary deferrals are always 100% vested, so she keeps those amounts and all related earnings regardless of when she leaves the company. The plan's employer matching contributions follow a three-year cliff vesting schedule. After two years of service, Rebekah is 0% vested in employer contributions; if she terminates employment at that point, the employer-funded portion of her account is forfeited. When Rebekah completes her third year of service, she becomes 100% vested, and all employer contributions (and their earnings) become permanently hers.

DEFINED CONTRIBUTION OPTIONS

401(k) plan. A 401(k) is a company-sponsored retirement account named after the tax law section that created it. It offers important tax benefits by allowing workers to invest part of their pay before taxes are withheld.

In 2026, employees can contribute up to $24,500 to their 401(k), plus an extra $8,000 catch-up if they are 50 or older. The total combined limit for employee and employer contributions is $72,000, or $80,000 if the employee is 50 or older. People aged 60 to 63 can make an even bigger catch-up contribution of $11,250.

403(b) plan. A 403(b) is a tax-advantaged retirement plan for public education employers (such as public schools and colleges) and tax-exempt 501(c)(3) organizations, including churches. For 2026, the standard contribution limit for a 403(b) is the lesser of 100% of employee compensation or $24,500. Employees aged 50 and older can contribute an additional $8,000 per year. An employer may add money to a 403(b) account via matching or non-matching contributions. In 2026, the maximum combined 403(b) contribution for both employee and employer is $72,000 (catch-up contributions are on top of this limit).

457 plan. The 457(b) plan is offered by state and local government agencies as well as certain non-governmental tax-exempt organizations. Many SECURE 2.0 provisions include language linking the new retirement benefits to 457 plans used by government employees. Many SECURE 2.0 retirement benefits are not available to participants in 457 plans offered by non-governmental entities.

With a government 457(b) account, an employee can contribute up to the lesser of $24,500 or their total pay in 2026. Unlike a 401(k) or 403(b), this limit includes both employee and employer contributions, so there is just one combined limit. Employees who are 50 or older can add an extra $8,000, raising the total limit to $32,500. While employers are allowed to contribute to their employees' 457(b) plans, most choose not to.

SEP IRA. A Simplified Employee Pension IRA (SEP IRA) is an employer-sponsored retirement plan that small business owners can set up. It lets participants delay paying

taxes on contributions and investment growth. Only the employer makes contributions. For 2026, contributions can be up to 25% of pay or $72,000, whichever is less.

SIMPLE IRA. A SIMPLE IRA is a retirement plan for small businesses with 100 or fewer employees. Both employers and employees can make tax-deferred contributions. As a general rule, employees can contribute up to $17,000 in 2026. However, SECURE 2.0 increases the contribution limit to $18,100 for certain small employers with 25 or fewer employees, or for larger employers that choose enhanced contributions.

Traditional IRA. A traditional IRA is an individual retirement account not connected to an employer's plan. The traditional IRA allows deductible contributions on Form 1040 (through an entry on Schedule 1). The earnings in these plans are not taxed annually; instead, investment gains are taxed when they are withdrawn. Earnings in a traditional IRA are, therefore, tax-deferred.

Roth IRA. There is no upfront tax break with a Roth IRA, but account holders do not have to pay income taxes on qualified withdrawals in retirement. This is the opposite of a traditional IRA, which may permit individuals to deduct at least part of their contributions (if they qualify) but requires them to pay income tax on the money they withdraw in retirement. Both accounts allow their investments to grow without being clipped by taxes each year.

With traditional IRAs, taxpayers must take required minimum distributions every year after reaching a certain age. However, RMDs are not required during the lifetime of the original owner of a Roth IRA, so the money can stay in the account and keep growing tax-free. Taxpayers can leave amounts in their Roth IRA for as long as they live. Those who don't need their Roth IRA assets in retirement can let the money accrue indefinitely and pass the assets to heirs.

Roth participants do not have to pay tax on earnings they withdraw as long as the withdrawal is qualified. A qualified distribution is one made after the five-year period beginning with the first tax year for which the individual made any Roth IRA contribution, and after at least one of the following conditions has been met:

- The taxpayer reaches age 59½;
- The taxpayer passes away;
- The taxpayer becomes disabled; or
- The taxpayer withdraws up to $10,000 (lifetime cap) to purchase a first home.

The "Rothification" Trend. "Rothification" is the conversion of some or all traditional defined-contribution plans to Roth-like plans. It involves a shift away from tax deductions or tax-free deferrals for retirement savings. Rothification shifts tax benefits from the contribution year to the distribution year. This removes the immediate tax deduction in exchange for future tax-free growth.

SECURE 2.0 expands Roth options in workplace plans. Employers can now offer Roth contributions, Roth SEP, and Roth SIMPLE IRAs. Starting in 2026, employees aged 50

or older who earned more than $150,000 in FICA wages the previous year must make their catch-up contributions as Roth (after-tax) contributions.

Plan	2026 employee limit	Age-50 catch-up	Age 60–63 catch-up	Overall employee + employer limit
401(k)	$24,500	$8,000	$11,250	$72,000
403(b)	$24,500	$8,000	$11,250	$72,000
Governmental 457(b)	$24,500	$8,000	$11,250	$24,500
SEP IRA	Employer-only	N/A	N/A	Lesser of 25% of comp or $72,000
SIMPLE IRA	$17,000 / $18,100	$4,000 / $3,850	$5,250	Employee limit + employer match/nonelective
Traditional / Roth IRA	$7,500	$1,100	N/A	$7,500 + catch-up

SECURE 2.0's ROTH REVOLUTION IN WORKPLACE PLANS

ROTH 401(k) CONTRIBUTIONS MADE BY EMPLOYERS

In the past, all employer contributions to 401(k) plans were made before taxes, so participants did not pay taxes on these contributions or their earnings until they withdrew the money.

SECURE 2.0 allows workplace retirement plans to offer participants the option to receive employer matching or other contributions as after-tax Roth contributions. Employers can decide whether to offer this, and participants can choose whether to accept it.

This optional Rothification of employer contributions became available for matching and nonelective contributions made after December 29, 2022, provided participants are 100% vested in employer Roth contributions at the time of contribution. However, putting this into practice has been slow as plan managers set up systems to handle Roth employer contributions.

If a 401(k) plan offers this employer Roth option and participants choose it, the employer contributions will count as taxable income for the employee right away. The benefit is that future earnings on these Roth contributions won't be taxed if certain rules are met.

According to IRS Notice 2024-2, Roth employer contributions count as taxable income but are not subject to withholding of FICA and income taxes. Since these are employer contributions, they are not treated as regular wages when deposited and are exempt from certain payroll taxes. They are reported on Form 1099-R instead of Form W-2.

Example. A 401(k) plan offers an optional feature that allows participants to receive employer matching contributions on a designated Roth basis. Jace, age 45, is fully vested in employer contributions. In 2026, Jace contributes $10,000 in elective deferrals and receives a $3,000 employer match, which he elects to receive as a Roth employer contribution. Because the match is designated Roth:
● The $3,000 is included in Jace's taxable income for 2026.
● It is not subject to federal income tax withholding, Social Security, Medicare, or FUTA, because it is an employer contribution rather than wage compensation.
● The plan reports the $3,000 on Form 1099-R, not Form W-2.
● Future earnings on the $3,000 Roth employer contribution may be tax-free if qualified distribution rules are satisfied.

Plan amendment deadline. A plan that has adopted SECURE 2.0 changes — including the optional Roth employer contribution feature — must eventually conform its written plan document, but the amendment deadline is a paperwork backstop rather than the date the provisions take effect; the amendment simply documents what the plan has been doing. Notice 2024-2 extended the general deadline for adopting SECURE 2.0 amendments to:
● December 31, 2026, for most plans;
● December 31, 2028, for collectively bargained plans; and
● December 31, 2029, for governmental plans.

TAX AND REPORTING TREATMENT OF ROTH EMPLOYER CONTRIBUTIONS		
Feature	***Roth Employer Contribution***	***Traditional Employer Contribution***
Taxability to Employee in Year Contributed	Included in taxable income immediately	Not taxable until distribution
Federal Income Tax Withholding	Not subject to withholding	Not subject to withholding
Social Security & Medicare (FICA)	Not subject to FICA	Not subject to FICA
FUTA	Not subject to FUTA	Not subject to FUTA
Reporting Form	Form 1099-R (taxable amount)	No Form W-2 or 1099-R until distribution
Vesting Requirement	Must be 100% vested at the time of contribution	Vesting schedule permitted
Tax Treatment of Earnings	Tax-free if qualified Roth distribution	Taxable when distributed
Plan Requirement	Optional plan feature; participant election required	Standard plan feature

ROTH OPTIONS FOR SEP & SIMPLE PLANS NOW AVAILABLE

Before SECURE 2.0, SEP and SIMPLE IRAs were not permitted to have Roth "buckets" because of restrictions under IRC Section 408A(f). They were strictly pretax vehicles.

SECURE 2.0 removed that barrier. Employees can now elect to treat their own salary-reduction contributions to a SIMPLE IRA as after-tax Roth contributions.

Furthermore, the law permits employers to make matching or nonelective contributions as Roth contributions across SEP and SIMPLE plans. When an employer makes a Roth contribution to an employee's SEP or SIMPLE IRA, the amount is treated as taxable income to the employee for that year, and is reported on Form 1099-R.

These options have been technically legal since 2023, but in practice, they are finally gaining widespread traction. Because multi-bucket IRAs require massive programmatic changes, financial institutions have spent the last few years updating their software, custody agreements, and reporting systems to fully support the new Roth infrastructure.

Choosing the Roth option does not mean the contribution limits for SEP and SIMPLE will be lowered to the IRA level of $7,500 (plus $1,100 catch-up). In 2026, SEP IRA contributions can be up to 25% of pay or $72,000, with no catch-up allowed. SIMPLE IRA employees can contribute up to $17,000, or $18,100 for certain small employers or those offering enhanced contributions. The catch-up limit for SIMPLE IRAs is $4,000 in 2026, rising to $5,250 for ages 60 to 63.

Not all financial institutions are ready to accept Roth contributions for existing SEP or SIMPLE IRAs. Employers should check with their current custodian before advising employees to choose Roth SIMPLE or Roth SEP contributions.

Extended example. Katia, age 47, is a self-employed marketing consultant who has maintained a SEP IRA since 2019. For 2026, her compensation supports a maximum SEP contribution of $30,000, which she has historically made on a pretax basis and deducted on Schedule 1 of Form 1040. Anticipating higher tax rates in retirement, Katia asks her tax advisor whether she can designate her 2026 SEP contribution as a Roth contribution.

Following the repeal of IRC Section 408A(f) by SECURE 2.0, the answer is yes — provided the infrastructure cooperates. The custodian will need to establish a Roth SEP account alongside Katia's existing pretax SEP IRA, since the two balances must be held separately. She then designates her full $30,000 contribution as Roth.

The contribution limit is unaffected by the Roth election — $30,000 remains within the lesser of 25% of compensation or $72,000 for 2026 — but the tax treatment changes significantly. Katia claims no deduction for the contribution; instead, the $30,000 is included in her 2026 gross income, and under Notice 2024-2, the custodian reports it on Form 1099-R for 2026. In exchange, the contribution and its future earnings will be distributed tax-free in retirement, assuming the Roth qualification requirements are met.

Had Katia's custodian not yet supported Roth SEP contributions, she could have kept making pretax contributions as before or move her SEP plan to a company that does allow Roth contributions. Even though the Tax Code has allowed Roth SEP contributions since 2023, custodial readiness still governs what is achievable in practice.

FEATURE	ROTH SEP SCENARIO
Age / Status	47, self-employed taxpayer
Existing plan	SEP IRA since 2019
2026 allowable SEP contribution	$30,000 (within 25% of comp / $72,000 limit)
Roth eligibility	Yes; SECURE 2.0 repealed Section408A(f)
Contribution limit affected?	No. Roth election does not change the SEP contribution limit
Custodial requirement	Custodian must support Roth SEP and maintain separate Roth account
Included in income?	Yes, $30,000 is included in gross income
Deduction allowed?	No
Form required by Notice 2024-2	Form 1099-R reports the contribution for 2026
Long-term benefit	Contribution and future earnings potentially tax-free if Roth rules met
If custodian lacks Roth capability	Make a traditional pretax SEP contribution or move to a custodian that supports Roth SEP contributions

ROTH CONTRIBUTIONS MADE BY EMPLOYEES AGE 50+

A catch-up contribution is extra money that employees aged 50 or older can contribute to their workplace retirement plan beyond the regular limit of $24,500 for 2026. For 2026, they can add up to $8,000 more. Before SECURE 2.0, catch-up contributions could be made to pretax accounts.

Basics of the mandatory Roth catch-up. SECURE 2.0 changed the rules [under IRC Section 414(v)(7)] so that anyone who earned more than $145,000 in prior-year FICA wages must make their catch-up contributions as Roth contributions. This means high earners can no longer make these extra contributions before taxes. Now, the catch-up money goes into a Roth account, so employees will pay more taxes than before SECURE 2.0. This rule applies to catch-up contributions for 401(k), 403(b), and certain 457(b) plans, but not to IRAs, including SIMPLE IRAs.

The mandatory Roth catch-up rule does not apply to retirement savers with no FICA wages. This means partners and other self-employed people do not have to follow the Roth catch-up rule, no matter how much they earned last year.

To see if a participant's wages went over $145,000 in the previous year, only look at the wages from each employer separately. The IRS explains it this way: "If an eligible participant's wages for a calendar year were: $100,000 from one participating employer; and $125,000 from another participating employer, then the participant's catch-up contributions under the plan for the next year would not be subject to [the mandatory Roth catch-up] even if the participant's aggregate wages from the participating employers for the prior calendar year exceed $145,000, as adjusted."

The $145,000 FICA wage limit goes up with inflation in $5,000 increments. In November 2025, the IRS raised the limit to $150,000. So, employees who earned more than $150,000 in FICA wages from their employer in 2025 must make all catch-up contributions as Roth contributions starting January 1, 2026.

Example. Darrel is a high-earning employee working for just one employer. In 2025, his FICA wages were $160,000, exceeding the $150,000 limit. He is 51 and participates in a 401(k) plan. In 2026, Darrel makes a regular contribution of $24,500 and an extra catch-up contribution of $8,000, for a total of $32,500. If all $32,500 were pretax, his taxable wages on his W-2 would drop by that amount. But under the new SECURE 2.0 rule, only the $24,500 regular contribution is excluded from taxable income. The $8,000 catch-up must go into a Roth account after taxes, so that $8,000 is counted as taxable income.

Implementation timeline. The mandatory Roth catch-up was originally set to begin on January 1, 2024. However, on August 25, 2023, the IRS issued Notice 2023-62, granting employers and plan sponsors a two-year delay in implementing the new rule. This transition period gave plans until December 31, 2025, to update their systems before the rule started on January 1, 2026.

On September 16, 2025, the IRS and Treasury issued Treasury Decision 10033, the final regulations implementing the Roth mandate.

Although the mandatory Roth catch-up requirement became operational on January 1, 2026, the final regulations themselves do not apply until 2027. Plans must still apply the Roth catch-up to affected participants in 2026, but during that gap year they may do so under a "reasonable, good-faith" interpretation of the statute rather than the detailed regulatory rules. The IRS will consider whether the employer made a reasonable, good-faith effort to follow the rules when evaluating administrative or operational errors during this transition year.

THE IMPLEMENTATION TIMELINE HAS BEEN UNUSUALLY COMPLEX	
Year	***Development***
2022	SECURE 2.0 enacted; Roth catch-up rule scheduled for 2024.
2023	IRS issues transition relief (Notice 2023-62), delaying implementation until 2026.
2024–2025	Administrative transition relief; pre-SECURE operations generally continue.
2025	Final regulations issued; effective for tax years beginning after December 31, 2026.
1/1/2026	Mandatory Roth catch-up requirement becomes operational.
2026	Good-faith compliance year; limited relief for reasonable implementation errors.
1/1/2027	Final regulations become fully effective; strict compliance expected.

The 2025 regulations confirm many of the rules outlined in Notice 2023-62:
● The threshold is based on FICA wages paid by the plan-sponsoring employer — not total compensation and not FICA wages from other employers. An employee who earns $160,000 across two unrelated jobs, each paying $80,000, is not subject to the Roth catch-up mandate under either plan.
● Employees who had no FICA wages from the plan sponsor in the prior year are not subject to the rule, regardless of their compensation level.
● For employees who worked only part of the prior year, only the FICA wages earned during employment with that plan sponsor count toward the threshold.
● The rule applies to 401(k), 403(b), and governmental 457(b) plans. It does not apply to IRAs.

The Plan-Design Trap. If a workplace retirement plan allows catch-up contributions but does not offer a Roth account option, employees who earned more than the inflation-adjusted limit ($150,000) in FICA wages the previous year cannot make any catch-up contributions at all. Plan sponsors need to add a Roth option to keep catch-up contributions available for high-earning employees.

Super catch-up contributions for ages 60-63. Starting in 2025, participants who turn 60, 61, 62, or 63 during the year can contribute a larger catch-up amount instead of the standard age-50 catch-up. For 2026, the standard catch-up increases from $7,500 to $8,000, while the age 60 to 63 limit remains at $11,250. Plans must choose to offer the super catch-up; it is not automatic.

Beginning in 2026, participants whose prior-year FICA wages from the sponsoring employer exceeded the Roth catch-up wage threshold must designate all catch-up contributions as Roth contributions. The Roth rule applies equally to both the standard and larger catch-up amounts. Someone who earned over $150,000 in 2025 must put the full $11,250 enhanced catch-up into a Roth account after taxes in 2026. If the plan

does not offer Roth contributions, high earners cannot make any catch-up contributions, whether standard or enhanced.

Example. Mallorie, age 61, participates in her employer's 401(k) plan, which has adopted the super catch-up provision and offers a designated Roth account. In 2025, Mallorie's FICA wages from this employer were $165,000. Because Mallorie is between the ages of 60 and 63 in 2026, she is eligible to make the enhanced catch-up contribution of $11,250 (rather than the standard $8,000 catch-up).

However, her 2025 FICA wages from the sponsoring employer exceeded the $150,000 Roth catch-up wage threshold. As a result, Mallorie is subject to the Roth mandate for 2026. The mandate does not distinguish between the standard and enhanced catch-up amounts. Mallorie can still contribute the full $11,250 enhanced catch-up, but she must put the entire amount into a Roth (after-tax) account. She cannot make any part of it a pretax contribution.

If Mallorie's plan did not offer a designated Roth account, the result would be more severe. Since the law requires her catch-up contributions to be Roth and the plan has no Roth option, she would not be able to make any catch-up contributions for 2026, neither the $11,250 enhanced amount nor the standard $8,000.

QUESTION	IF YES	IF NO
Is the participant age 50 or older?	Catch-up contribution may be available	No catch-up contribution
Is the participant aged 60–63 and has the plan adopted the super catch-up?	Up to $11,250 catch-up	Standard $8,000 catch-up
Did prior-year FICA wages from the sponsoring employer exceed $150,000?	Catch-up must be Roth	Catch-up may be pretax or Roth (subject to plan design)
Does the plan offer a designated Roth account?	Catch-up permitted	High earners subject to the Roth mandate cannot make catch-up contributions

OTHER SECURE 2.0 RULES REQUIRING ATTENTION IN 2026

LONG-TERM CARE DISTRIBUTIONS FROM RETIREMENT PLANS

SECURE 2.0 added IRC Section 401(a)(39) and Section 72(t)(2)(N) to allow defined contribution plans to permit participants to take penalty-free distributions to pay premiums for certified long-term care insurance contracts. These distributions are called qualified long-term care distributions (QLTCDs). The provision became effective for distributions made after December 29, 2025 — meaning the first full plan year of operation is 2026.

QLTCDs are exempt from the 10% early distribution penalty under IRC Section 72(t), but they remain subject to ordinary income tax. The distribution limit is the lesser of:
● The actual premium cost;
● 10% of the participant's vested account balance; or
● The indexed dollar limit.

The 2026 indexed limit, confirmed in Notice 2026-33, is $2,600. This amount will be adjusted for inflation in future years.

Example. Percy is 58 years old and participates in his employer's 401(k) plan. Percy's vested account balance is $120,000, and his qualified long-term care insurance premium for 2026 is $2,200. Because the premium is below both the 10% account-balance limit ($12,000) and the indexed dollar limit ($2,600), Percy may receive a penalty-free qualified long-term care distribution of $2,200 if his employer's plan has adopted the feature. Although the distribution escapes the 10% early-withdrawal penalty, the $2,200 remains taxable as ordinary income.

A common misconception is that participants can automatically claim this exception. However, they cannot claim the penalty exception on their own unless the plan has adopted the feature. Employers must update their plan documents to allow QLTCDs, and the distribution must be verified with a signed long-term care premium statement from the insurer before the withdrawal. If an employer does not update the plan to allow QLTCDs, a participant cannot self-certify a distribution on their tax return to avoid the 10% penalty.

Practitioners should be aware of these additional limitations on qualified long-term care distributions:
● The provision covers defined contribution plans including 401(k), 403(a), 403(b), and governmental 457(b) plans. Notice 2026-33 states that an IRA is not a plan eligible to make qualified long-term care distributions.
● QLTCDs are not eligible for the extended three-year repayment period that applies to certain other SECURE 2.0 distributions such as disaster distributions.
● The insurance contract must be a certified long-term care insurance policy meeting federal tax-qualification standards. Participants must furnish the plan administrator with a long-term care premium statement from the insurer to verify the policy's eligibility and the amount of premiums eligible for distribution.

The new Form 1099-LPS. While the retirement plan payor reports the actual withdrawal to the participant on Form 1099-R, insurance companies providing the certified long-term care coverage face an independent filing requirement. Specifically, any insurer that submits a long-term care premium statement to a defined contribution plan must file the newly created Form 1099-LPS (Long-Term Care Premiums Paid Statement) with the IRS. This annual information return tracks the total premium amounts paid via retirement plan distributions.

The issuer must file Form 1099-LPS with the IRS no later than February 1 of the calendar year following the calendar year in which the long-term care premium statement was filed with the plan, and must furnish the recipient copy to the covered individual by January 31.

QUICK REFERENCE: QUALIFIED LONG-TERM CARE DISTRIBUTIONS	
Topic	***Key Points***
What is it?	Penalty-free distribution from a defined contribution plan to pay premiums for certified long-term care insurance.
Statutory basis?	SECURE 2.0 added IRC §401(a)(39) and §72(t)(2)(N).
Effective date?	Distributions made after December 29, 2025; first full plan year is 2026.
Tax treatment?	Exempt from the 10% early-distribution penalty under §72(t); still taxable as ordinary income.
Distribution limit?	Lesser of: actual premium; 10% of vested balance; indexed limit
2026 indexed limit?	$2,600 (confirmed in Notice 2026-33); inflation-adjusted in future years.
Eligible plans?	401(k), profit-sharing, 403(a), 403(b), governmental 457(b).
Ineligible plans?	IRAs are not eligible to make QLTCDs (Notice 2026-33).
Plan adoption required?	Yes. The employer's plan must specifically adopt the QLTCD feature.
Self-certification allowed?	No. Participants cannot simply claim the exception on their tax return if the plan has not adopted the feature.
Verification of insurance?	Participant must provide a long-term care premium statement from the insurer.
Type of insurance required?	Policy must be a federally qualified long-term care insurance contract.
Repayment rules?	No repayment allowed. They do not qualify for the 3-year repayment extension seen in disaster distributions.
Reporting form?	Form 1099-LPS for insurer reporting.

IMPROVING COVERAGE FOR PART-TIME WORKERS

In the past, employers could require employees to work at least 1,000 hours a year before joining the workplace 401(k) plan. Because of this rule, many employees worked part-time for years but never reached the 1,000-hour minimum in a year to qualify for employer-sponsored retirement benefits.

SECURE 1.0 expanded coverage to long-term part-time (LTPT) workers. Under this law, most 401(k) plans could offer a dual-path eligibility requirement under which an LTPT employee completed either:

- One year of service where the employee works at least 1,000 hours; or

● Three consecutive years of service where the employee works at least 500 hours per year and has met the minimum age requirement (age 21) by the end of the three-consecutive-year period.

SECURE 2.0 shortens the service period to two years instead of three for the second requirement above. Employees must be eligible to participate in plan years starting in 2025. For the two-year rule, the first group qualified on January 1, 2025 (based on 2023 and 2024 hours), so 2026 will bring the next group, the second wave.

Extended example. Marcela, age 29, works part-time for a company that sponsors a calendar-year 401(k) plan. She works 620 hours in 2024 and 575 hours in 2025. Under the pre-SECURE rules, Marcela would not have become eligible to participate in the plan because she failed to satisfy the traditional one-year, 1,000-hour eligibility requirement.

Under SECURE 2.0, however, Marcela qualifies as an LTPT employee because she completed at least 500 hours of service in two consecutive years (2024 and 2025) and has attained age 21. As a result, Marcela must be permitted to begin making elective deferrals to the 401(k) plan as of January 1, 2026, even though she has never worked 1,000 hours in a year.

The employer is not required to provide Marcela with employer matching or nonelective contributions solely because she enters the plan under the LTPT rules. However, the employer must properly track Marcela's eligibility, enroll her in salary deferrals, and ensure that its plan document is amended by December 31, 2026, to reflect the SECURE 2.0 LTPT provisions.

A key deadline is approaching. Although the two-year eligibility rule took effect for plan years beginning after December 31, 2024, the LTPT rules remain an active compliance item in 2026 for at least two reasons.

First, LTPT eligibility is ongoing. The two-year lookback applies every year. For example, if an employee worked 500 hours in both 2024 and 2025, they must be allowed to make elective deferrals starting in 2026. Each new plan year brings a new group of LTPT employees, so employers need to track hours and manage LTPT entries annually.

Second, even though plans have had to follow LTPT rules since their official start dates, formal plan amendments to include these rules were not required until December 31, 2026, for calendar-year plans. For many employers, 2026 is the year the paperwork finally aligns with operations.

CHANGES SCHEDULED FOR 2027

SAVER'S CREDIT ENDING FOR RETIREMENT CONTRIBUTIONS

The Saver's Credit is designed to help people with lower incomes save for retirement. Savers can get this credit for money they put into a 401(k), 403(b), 457(b), a Roth, SIMPLE, or traditional IRA account. Even an ABLE account is eligible if the money comes from the designated beneficiary.

The Saver's Credit is a percentage of the taxpayer's contributions; that percentage can be 10%, 20%, or 50%, depending on the taxpayer's filing status and MAGI. The maximum credit amount is $1,000 (or $2,000 for couples who file jointly). The $2,000 MFJ maximum requires each spouse to make their own contributions; if one spouse contributes $4,000, the match is only $1,000, since the match is computed per individual on up to $2,000 of that individual's contributions.

Even if a saver's income is below the applicable limit, they won't qualify for the credit if they're under 18 years of age, a full-time student, or can be claimed as a dependent on someone else's income tax return.

Credit Rate	Married Filing Jointly	Head of Household	All Other Filers
50% of contribution	MAGI not more than $48,500	MAGI not more than $36,375	MAGI not more than $24,250
20% of contribution	$48,501 – $52,500	$36,376 – $39,375	$24,251 – $26,250
10% of contribution	$52,501 – $80,500	$39,376 – $60,375	$26,251 – $40,250
0% of contribution	more than $80,500	more than $60,375	more than $40,250

Example 1. Reyna and Dale earned $40,000 in wages in 2026 and will file a joint return. Reyna contributed $2,000 to a traditional IRA, and Dale also contributed $2,000 to a traditional IRA. After factoring in the above-the-line deduction for their IRA contributions, Reyna and Dale will report an AGI of $36,000. This AGI is below the $48,500 threshold for joint filers, qualifying the couple for the Saver's Credit at the 50% rate, and their tentative credit is $2,000 [($2,000 × 50%) + ($2,000 × 50%)].

The couple's allowable credit, however, is a different matter. The Saver's Credit is nonrefundable and cannot exceed the taxpayer's income tax liability, as computed on the Form 8880 Credit Limit Worksheet. After claiming the $32,200 standard deduction for 2026, Reyna and Dale have taxable income of $3,800 and a pre-credit tax liability of just $380. Their Saver's Credit is therefore limited to $380 — the remaining $1,620 of tentative credit disappears. It cannot be refunded, and no carryforward is permitted.

This example shows a key problem with the credit — the lower a household's income, the more likely they are to qualify for the 50% rate, but they also have less tax liability to use the credit.

SAVER'S MATCH COMING IN 2027

SECURE 2.0 will retire the Saver's Credit in 2027 in favor of a new benefit called the "Saver's Match." Unlike the Saver's Credit, which comes as a credit on the claimant's tax return, the Saver's Match goes directly toward retirement savings.

The measure allowing a federal matching contribution is being sought because the current Saver's Credit is nonrefundable, meaning savers don't get the credit if they owe no federal income tax. If the saver is eligible for a match, they get the whole amount even if they owe less than that on their taxes.

The Saver's Credit could be worth 50%, 20%, or 10% of retirement account contributions, with higher earners receiving lower credits. The Saver's Match, however, offers a 50% match that doesn't change based on income for those who qualify.

Instead of taking money off their tax bill, the Saver's Match puts even more money into an eligible individual's retirement plan account. The government will match up to 50% of up to $2,000 in qualified retirement savings contributions. Single filers can get up to $1,000, and married couples filing jointly can get up to $2,000 if both make qualifying contributions. Like the Saver's Credit, each spouse must contribute up to $2,000 to get the full match — one spouse contributing $4,000 only gets a $1,000 match.

An individual must have income within a modified adjusted gross income range tied to their tax filing status. The federal match is a flat 50% on the first $2,000 of retirement contributions (a maximum $1,000 match) for lower-income tiers, which then phases out linearly until it reaches $0 at the upper limit.

FILING STATUS	FULL 50% MATCH LIMIT	PHASE-OUT RANGE	NO MATCH AVAILABLE OVER
Married filing jointly / surviving spouse	$41,000 or less	$41,001 – $71,000	$71,000
Head of Household	$30,750 or less	$30,751 – $53,250	$53,250
Single / married filing separately	$20,500 or less	$20,501 – $35,500	$35,500

Example 2. Reyna and Dale (from Example 1) will earn $40,000 in wages in 2027 and will file a joint return. Reyna will contribute $2,000 to her traditional IRA, and Dale will also contribute $2,000 to his traditional IRA. After factoring in the above-the-line deduction for their IRA contributions, Reyna and Dale will report an AGI of $36,000. This AGI is below the $41,000 full-match threshold for joint filers, so they qualify for the 50% Saver's Match. Their match is $2,000 [($2,000 × 50%) + ($2,000 × 50%)].

Unlike the Saver's Credit, the match is not limited by the couple's tax liability. Even though their pre-credit tax would be only a few hundred dollars — the same constraint that capped their benefit under the old credit — Treasury deposits the full $2,000 directly into their designated retirement accounts in early 2028, matching their 2027 contributions. Because both spouses contributed, they receive the full per-couple maximum; had Dale contributed $4,000 and Reyna nothing, the match would have been only $1,000.

Eligible participants can choose which retirement account (excluding Roth accounts) will receive the contribution. An individual may have a Saver's Match deposited into a 401(k), 403(b), governmental 457(b) plan, or an IRA — if the employer or IRA custodian agrees to accept it. This money will not count against the saver's annual retirement plan contribution limits. Early withdrawal penalties will apply to the matching contribution when withdrawn from a retirement account before age 59½.

Taxpayers under 18 years of age, full-time students, and anyone claimed as a dependent on someone else's tax return will not be eligible for the Saver's Match. Nonresident aliens will not qualify unless treated as US residents for the tax year.

Frequently Asked Questions. Practitioners should expect a steady stream of client questions regarding the Saver's Match, especially from eligible taxpayers who are new to retirement-savings benefits. The following FAQs address the issues most likely to arise in practice.

● How does the taxpayer claim the match? The taxpayer claims the Saver's Match on their federal income tax return (a new form or schedule is expected to be released before 2027). Once the IRS processes the return and verifies eligibility, the Treasury deposits the match amount directly into the taxpayer's designated qualifying retirement account. The taxpayer must designate a qualifying account to receive the deposit when filing. If no account is designated or the account information is invalid, the IRS will work with the taxpayer to identify an appropriate account.

● When is the deposit actually made? The Treasury plans to make the first Saver's Match deposits in early 2028, matching contributions from the 2027 tax year. Unlike employer-matching contributions, which are deposited at the same time as employee contributions, there is a lengthy delay between the contribution date and when the Saver's Match deposit is made.

● How is it taxed? The Saver's Match itself is not taxed when received by the retirement account. Instead, it is treated the same as other pretax contributions to the account — meaning it will be subject to ordinary income tax upon withdrawal, to the extent it is distributed from a pretax account.

● What if the taxpayer takes an early withdrawal of the matched funds? SECURE 2.0 imposes a "recovery tax" (sometimes called a clawback) if a taxpayer receives a Saver's Match and then takes an early distribution from the account within a specified

period. The recovery tax is designed to recapture the match if the recipient does not actually leave the funds invested for retirement. Treasury guidance is expected to clarify the operation of the recovery-tax rules, including reporting procedures, exceptions, and administrative details. Tax professionals should let clients know that the match is not extra money they can access immediately.

● What about low-income workers who don't file tax returns? This is one of the most important implementation questions. A significant portion of the population that would qualify for the Saver's Match on income grounds does not file federal income tax returns because they have no filing obligation. Under the current statutory framework, a non-filer would need to file a return to claim the match.

● Are employer-sponsored plans required to accept the Saver's Match deposit? No. Employer-sponsored plans are not required to accept Saver's Match deposits. The participant may need to designate an IRA as the receiving account if their employer's plan declines to participate.

● How does the Saver's Match interact with the employer match? The Saver's Match is separate from the employer's matching contribution and is added on top of it. It does not lower or replace the employer's match. For an eligible participant who contributes to a 401(k) with an employer match, their retirement benefits could consist of three parts: their own savings, their employer's match, and the federal Saver's Match paid by the Treasury.

Topic	***Saver's Credit (through 2026)***	***Saver's Match (begins 2027)***
Where benefit appears	Form 1040	Treasury deposits match into designated retirement account after IRS processes return
Tax-liability limit	Limited to tax liability; excess is lost (no refund, no carryforward)	Not limited by tax liability; received in full even if no tax is owed
Timing of Benefit	Realized immediately upon filing of tax return.	Delayed. 2027 contributions are deposited by the Treasury in early 2028.
Eligibility factors	Must meet MAGI limits; cannot be <18, full-time student, or a dependent	Same exclusions; must meet MAGI limits; nonresident aliens excluded unless treated as US residents
Eligible accounts	401(k), traditional/Roth IRA, 403(b), gov't 457(b), SIMPLE, ABLE	401(k), 403(b), governmental 457(b), or Traditional IRAs. Excludes Roth accounts.
Match / Credit Rate	10%, 20%, or 50% — depends on filing status and MAGI	Single 50% match for all eligible taxpayers; amount phases out by MAGI
Contribution basis	Credit applies to up to $2,000 of contributions per person	Match applies to up to $2,000 of contributions per person
Maximum benefit	$1,000 single / $2,000 MFJ (each spouse must contribute)	$1,000 single / $2,000 MFJ (each spouse must contribute)
Phase-out ranges	Multiple tiers by filing status	MFJ: $41,001–$71,000; HOH: $30,751–$53,250; Single: $20,501–$35,500
Early withdrawal consequences	N/A	Early-withdrawal penalty applies before 59½; plus a "recovery tax" (clawback)
How claimed	Claimed on Form 8880	Claimed on new IRS form; Treasury deposits match in following year (e.g., 2027 contributions → 2028 deposit)
Special issues	Low-income filers often have insufficient tax liability to benefit	Non-filers must file a return to receive the match; plan participation optional for employers

TAX RELIEF FOR RETIRED, DISABLED FIRST RESPONDERS

Current Law (2026). Police officers, firefighters, paramedics, and emergency medical technicians routinely place themselves in dangerous situations while protecting the public. Some suffer severe injuries that permanently end their careers. Federal tax law has long provided favorable treatment for many disability payments received by these individuals. However, that favorable treatment often ended when the injured worker reached normal retirement age, creating a surprising tax consequence for many disabled first responders.

Under existing rules, disability pensions paid because of service-related injuries may be excluded from income in certain circumstances. As long as the payments are treated as disability benefits, they generally are not subject to federal income tax. The payments are intended to compensate individuals for injuries sustained while performing their duties rather than to provide ordinary retirement income.

For many first responders, this favorable tax treatment continues for years or even decades. A firefighter injured while battling a structure fire, a police officer permanently disabled during an arrest, or a paramedic seriously injured while responding to an emergency may receive disability payments throughout the remainder of their working life.

The tax treatment often changes, however, once the individual reaches normal retirement age under the applicable pension plan. At that point, disability payments commonly convert into ordinary retirement benefits. Although the payment amount may remain unchanged, the former disability benefit is reclassified as a retirement pension, and the exclusion from income generally disappears.

As a result, two individuals receiving identical monthly payments from the same pension system may face dramatically different tax consequences. A disabled firefighter who has not yet reached retirement age may exclude the payments from income. In contrast, another firefighter with the same disability who has reached retirement age may be required to include the payments in taxable income.

Many viewed this result as inequitable. The underlying disability does not disappear when retirement age is reached. Yet federal tax law effectively treated the payments differently solely because of the recipient's age.

SECURE 2.0 change for 2027. SECURE 2.0 addresses this issue by creating a new Internal Revenue Code Section 139C. Beginning in 2027, qualified first responders may exclude certain service-related disability and retirement payments from gross income even after reaching retirement age.

The provision effectively preserves the tax treatment that existed before retirement age. Rather than forcing disabled first responders to transition from tax-free disability payments to taxable retirement benefits, the new rule allows qualifying payments to continue receiving favorable tax treatment.

Congress included this provision in recognition of the unique risks faced by first responders and the financial burdens often associated with career-ending injuries. The change is intended to ensure that tax consequences do not worsen simply because a disabled first responder reaches an age specified in a pension plan.

Who Qualifies? The exclusion is limited to qualified first responders who must have been government employees. SECURE 2.0 identifies several categories of public safety personnel, including:

- Firefighters;
- Law enforcement officers;
- Paramedics;
- Emergency medical technicians (EMTs).

These individuals must be receiving payments attributable to service-connected disabilities or injuries arising from their duties as first responders.

The law focuses on disability-related payments that transition into retirement benefits upon attainment of retirement age. Consequently, the exclusion is not a general exemption for all retirement pensions received by former first responders. Instead, it applies to benefits connected to a qualifying service-related disability.

Moreover, the exclusion is capped at the "annualized excludable disability amount" — the portion of post-retirement payments corresponding to what was excludable as disability income before retirement age — so a pension with a cost of living adjustment is not fully excludable.

Example 1. Randal is a 68-year-old former paramedic who was severely injured and permanently disabled in the line of duty nearly 20 years ago. For the majority of his post-injury life, Randal received $60,000 annually in disability payments. Under IRC Section 104(a)(1), these payments were completely excluded from his gross income, allowing him to cover his specialized medical expenses and mortgage.

When Randal reached age 65, his municipal pension plan hit its "normal retirement" trigger. His disability benefit ceased, and he was transitioned to a standard retirement pension of $60,000 per year. Instantly, his tax-free income became fully taxable. Assuming an effective federal and state tax rate of 20%, Randal's take-home income plummeted from $60,000 to $48,000 — a devastating $1,000 per month loss.

Because of SECURE 2.0, Randal's financial strain will ease. Beginning with the 2027 tax year, Section 139C allows Randal to exclude once again that $60,000 in annual retirement payments from his gross income. His take-home pay returns to its full, tax-free amount.

Example 2. Sarah is a 52-year-old former police officer who retired on a line-of-duty disability five years ago and receives $75,000 annually. Under her department's rules,

“normal retirement age” is reached after 25 years of nominal service, a milestone Sarah will hit in 2028 when she turns 54.

Under the old law, Sarah would have had to prepare for a steep drop in net income in 2028. However, because her retirement transition occurs after January 1, 2027, the effective date of Section 139C, Sarah will experience no tax cliff. When her pension flips from disability to standard retirement in 2028, the $75,000 will remain entirely excludable from her gross income. She will experience a seamless, uninterrupted tax-free income stream.

REVIEW QUESTIONS

38. Your client believes SECURE 2.0 took effect all at once and is asking whether the higher RMD age, 529 Plan-to-Roth IRA rollovers, Roth catch-up contributions, and other retirement rules all started in 2023. Which statement best explains how SECURE 2.0 actually became effective?
{A}. SECURE 2.0 became effective for all retirement-plan provisions in 2023.
{B}. SECURE 2.0 provisions became effective on January 1, 2024, but IRS guidance delayed enforcement of some provisions.
{C}. SECURE 2.0 generally became effective on January 1, 2025, although taxpayers could elect to apply selected provisions earlier.
{D}. SECURE 2.0 implemented numerous retirement provisions over several years, with effective dates ranging from 2023 through 2027.

39. A small-business client adopts a 401(k) feature allowing employees to elect designated Roth employer matching contributions. The client believes these contributions are tax-free to employees and exempt from withholding. Under SECURE 2.0 and Notice 2024-2, how are designated Roth employer contributions treated for the employee?
{A}. They are exempt from tax and withholding.
{B}. They are taxable W-2 wages subject to FICA withholding.
{C}. They are taxable W-2 wages subject to income tax withholding.
{D}. They are taxable and reported on Form 1099-R, but not subject to withholding (for FICA or income taxes).

Part E reveals the correct answers to all end-of-chapter review questions while providing feedback on both correct and incorrect responses.

Part C. Ethical Guidelines for Professional Conduct (2 CE Hours)

Chapter 14. CIRCULAR 230 ESSENTIALS

Learning objectives: Upon completing this chapter, you will understand ethical rules governing the tax profession and the application of these rules in the operation of your business. This chapter will review Circular 230, highlighting the most relevant ethical issues to federally authorized tax practitioners.

Chapter Topics

- Circular 230 standards for tax practitioners
- Proposed regs would update Circular 230 rules
- Subpart A: Authority to practice
  - » § 10.1 Office of Professional Responsibility
  - » § 10.2 What is "practice before the IRS"?
  - » § 10.3 Who may practice before the IRS?
- Subpart B: Duties relating to practice
  - » § 10.21 Knowledge of client's omission
  - » § 10.22 Diligence as to accuracy
  - » § 10.27 Fees
  - » § 10.28 Return of client's records
  - » § 10.31 Negotiation of taxpayer checks
  - » § 10.33 Best practices for tax advisors
  - » § 10.34 Standards with respect to tax returns
  - » § 10.35 Competence
- Subpart C: Sanctions for violating regulations
  - » § 10.50 Sanctions
  - » § 10.51 Incompetence and disreputable conduct
- Protecting client data in the Age of the Internet
  - » Government compels most tax preparers to e-file
  - » Ethics and laws about disclosure of client data
  - » IRS tips on safeguarding taxpayer information
  - » Written Information Security Plan (WISP)

Ethics is the field of knowledge that involves defining, recommending, and defending concepts of right and wrong behavior.

Professional ethics are principles that govern the behavior of an individual or group in a particular business environment. A professional code of ethics is a set of rules that help professionals distinguish right from wrong when performing their work. Many professions formalize their ethical standards through a written code of ethics that members must adhere to.

CIRCULAR 230 STANDARDS FOR TAX PRACTITIONERS

Whereas the IRS requires a tax practitioner to conduct a thorough accounting of all client taxes owed by a given deadline, the client will urge the practitioner to minimize their tax liabilities. Complicating matters for the practitioner in the middle of this tug-of-war is the fact that some tax laws may be interpreted in more than one way. Ethical guidelines are intended to help the tax professional achieve a proper balance between the client's interests and the federal government's legal requirements.

There is more than one code of conduct for those who represent taxpayers:

- CTEC-Registered Tax Preparers (CRTPs) must comply with the CTEC Code of Conduct (https://www.caltaxschool.org/6801CCC.pdf);
- Enrolled Agents (EAs) are bound by the Code of Ethics and Rules of Professional Conduct issued by the National Association of Enrolled Agents (NAEA);
- Certified Public Accountants (CPAs) should abide by the Statements on Standards for Tax Services (SSTS); and
- Tax attorneys are subject to the American Bar Association's Model Rules of Professional Conduct.

However, one code of conduct impacts all tax practitioners, regardless of title or state jurisdiction — namely, Treasury Department Circular No. 230. Circular 230 is the shortened name given to the group of regulations promulgated by the enabling statute

in the United States Code, Title 31 (Money and Finance), Section 330 (Practice before the Treasury Department) — abbreviated as 31 USC §330.

Circular 230 is the definitive code of conduct governing all professionals who practice before the IRS. It is divided into five subparts.

Subpart	Subject Matter
A	Authority to Practice
B	Duties and Restrictions Relating to Practice
C	Sanctions for Violations
D	Disciplinary Proceedings
E	General Provisions

This chapter focuses mainly on Subpart B, while briefly addressing Subparts A and C. Subparts D and E will not be discussed here.

PROPOSED REGS WOULD UPDATE CIRCULAR 230 RULES

Circular 230 has been a cornerstone of tax practice since 1921. Over the years, Circular 230 has undergone numerous revisions. The last major update to Circular 230 occurred in 2014.

Now, more than a decade later, the Treasury Department and IRS are proposing another round of updates to address evolving issues in tax practice and align the regulations with new court decisions and changes in the law. The proposed regulations (REG-116610-20) seek to modernize Circular 230 for the digital age while removing a few obsolete provisions. The proposed regulations were published in the Federal Register on December 26, 2024, and can be found here: https://www.govinfo.gov/content/pkg/FR-2024-12-26/pdf/2024-29371.pdf.

The proposed regulations impacting tax preparers will be summarized throughout this chapter (in the Circular 230 sections they seek to change).

SUBPART A: AUTHORITY TO PRACTICE

§ 10.1 OFFICE OF PROFESSIONAL RESPONSIBILITY

The Office of Professional Responsibility (OPR) is a department within the Internal Revenue Service that interprets and enforces the Circular 230 regulations governing practice before the IRS.

Section 10.1 states that the OPR has “exclusive responsibility” for practitioner conduct, including the authority to institute disciplinary proceedings and pursue sanctions against those who violate Circular 230.

§ 10.2 WHAT IS "PRACTICE BEFORE THE IRS"?

Circular 230 is officially titled "Regulations Governing Practice before the Internal Revenue Service." Hence, it's fitting that the phrase "practice before the IRS" receives some attention near the beginning of the publication.

The current version of Circular 230, in Section 10.2(a)(4), defines "practice before the IRS" in the same way as IRS Publication 947 and the Internal Revenue Manual, Part 1, Chapter 25 ("Practice Before the Service"). In all three documents, IRS practice includes all matters relating to a submission or presentation to the Internal Revenue Service concerning a taxpayer's rights, privileges, or liabilities under laws or regulations administered by the IRS. Such submissions or presentations include, but are not limited to:

- Preparing and filing documents with the IRS on behalf of a taxpayer.
- Corresponding and communicating with the IRS.
- Representing a taxpayer at meetings, hearings, or conferences with the IRS.

This expansive definition of "practice before the IRS" — especially the first bullet point listed above — was challenged in federal court around the time the current Circular 230 was published.

Loving v. IRS (2014). In Loving v. IRS, tax preparers challenged an IRS regulation requiring paid tax preparers to meet certification and continuing education requirements. The IRS issued the provision under 31 USC §330(a)(1), which purportedly enables the government to "regulate the practice of representatives of persons before the Department of Treasury." However, the US Court of Appeals for the District of Columbia Circuit ruled that the tax preparer regulation was invalid because the mere preparation and signing of tax returns do not constitute "practice" before the IRS. The court went on to say that "practice" and "representation" only materialize after a taxpayer's "return is selected for audit or the taxpayer appeals the IRS's proposed liability adjustments." In other words, "practice" before the IRS requires representing a client in an adversarial setting (e.g., audit or appeal).

Sexton v. Hawkins (2017). James Sexton had been suspended from practicing before the IRS. Despite being suspended, the plaintiff continued to offer tax services. In court, Mr. Sexton argued that the OPR lacked jurisdiction over him because he was no longer in "practice," as that term is used in 31 USC §330 and Circular 230. Mr. Sexton complied with the suspension by not representing his clients at conferences, hearings, and meetings before the IRS. He could not file a power of attorney for his clients. He could not advocate, dispute, argue, or otherwise negotiate on behalf of his client's rights, privileges, or liabilities under the law or regulations. However, Mr. Sexton could prepare tax returns for his clients and sign the returns as a preparer because, according to Loving, preparing tax returns doesn't constitute practice before the IRS.

In Sexton, the Nevada District Court agreed with the plaintiff and the decision in Loving v. IRS that "practice before the IRS" does not include tax return preparation. Moreover, Mr. Sexton was not representing any clients before the IRS "during an investigation,

adversarial hearing, or other adjudicative proceeding." Therefore, Mr. Sexton was not subject to an OPR investigation.

After Loving and Sexton, "practice before the IRS" is roughly equivalent to acting as a taxpayer's representative in dealings with the IRS — typically involving a power of attorney — especially in post-filing proceedings such as audits, appeals, collections, or other adversarial matters. It did not include preparing and signing original tax returns or giving general tax advice.

Proposed changes to Circular 230. The Loving case held that the IRS exceeded its authority in applying Circular 230 to the general task of return preparation. The definition of "practice before the IRS" under Section 10.2(a)(4) will be amended to clarify that practice before the IRS includes preparing and submitting tax returns only when directly connected to representing a client in an IRS matter.

The IRS explicitly disagrees with the court decision in Sexton. The proposed rules ensure that a practitioner cannot avoid discipline simply by shifting their business model to "preparation only" while suspended. Even after suspension, practitioners will remain subject to IRS jurisdiction. Any violation committed while suspended would trigger further sanctions, including permanent disbarment.

The proposed amendments to Circular 230 would directly codify the limitations established in Loving v. IRS while simultaneously closing the jurisdictional loophole exposed by Sexton v. Hawkins.

§ 10.3 WHO MAY PRACTICE BEFORE THE IRS?
In the current version of Circular 230, eligibility to practice before the Internal Revenue Service is limited to the following:
- Attorneys [Section 10.3(a)];
- Certified Public Accountants [Section 10.3(b)];
- Enrolled Agents [Section 10.3(c)];
- Enrolled Actuaries [Section 10.3(d)];
- Enrolled Retirement Plan Agents [Section 10.3(e)]; and
- Registered tax return preparers [Section 10.3(f)].

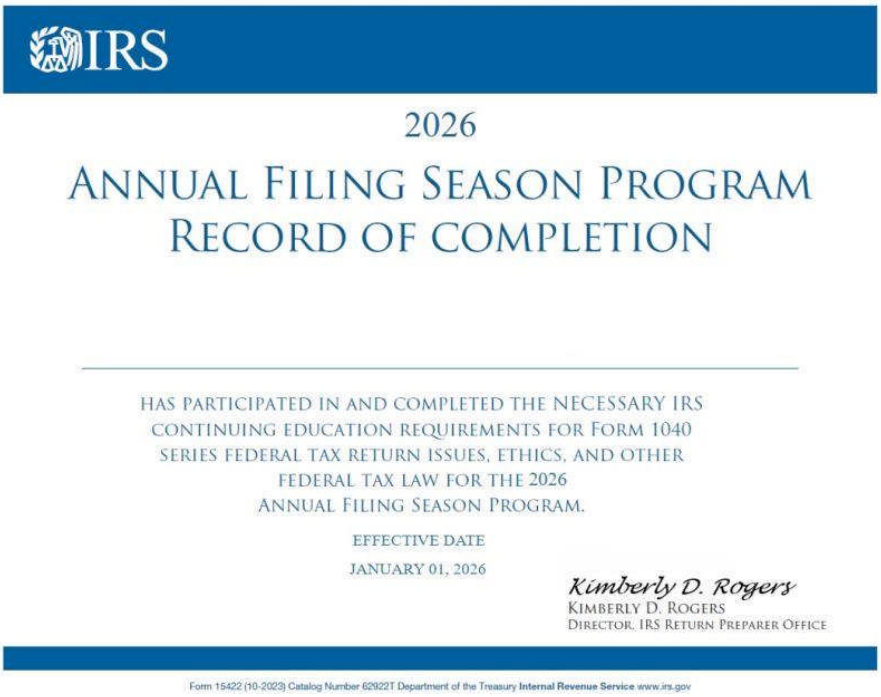
Historically, Section 10.3 defined the categories of individuals authorized to represent taxpayers before the IRS in matters involving examinations, appeals, collections, and other administrative proceedings.

A significant change to the upcoming Circular 230 involves eliminating provisions related to registered tax return preparers (RTRPs). Accordingly, Section 10.3(f) will be deleted from Circular 230. The IRS is expected to replace the RTRP designation with "Annual Filing Season Program Participants," and this relatively new category of federally authorized tax practitioners will be described in proposed Section 10.7(c)(1)(viii).

AFSP participants are federally authorized tax practitioners. Only unlicensed or unenrolled return preparers who have participated in the IRS Annual Filing Season Program (AFSP) may represent a taxpayer regarding tax returns prepared and signed by the preparer. The AFSP is a voluntary program that rewards paid preparers — who are not attorneys, CPAs, or EAs — with three benefits if they choose to expand their knowledge of federal tax matters through continuing education (CE).

Those who choose to participate in the program can meet the requirements by completing continuing education by December 31 (the IRS does not provide any extensions to this deadline).

In exchange for their participation in the AFSP, the IRS would reward unenrolled tax preparers with the following benefits:
● Representation rights (discussed later).
● Inclusion in an IRS directory. This online database (https://irs.treasury.gov/rpo/rpo.jsf) allows the public to search for qualified tax professionals in their area.
● Record of Completion. This printable certificate will be available in the PTIN holder's online IRS account.



IRS

2026

ANNUAL FILING SEASON PROGRAM
RECORD OF COMPLETION

HAS PARTICIPATED IN AND COMPLETED THE NECESSARY IRS CONTINUING EDUCATION REQUIREMENTS FOR FORM 1040 SERIES FEDERAL TAX RETURN ISSUES, ETHICS, AND OTHER FEDERAL TAX LAW FOR THE 2026 ANNUAL FILING SEASON PROGRAM.

EFFECTIVE DATE
JANUARY 01, 2026

Kimberly D. Rogers
KIMBERLY D. ROGERS
DIRECTOR, IRS RETURN PREPARER OFFICE

Form 15422 (10-2023) Catalog Number 62922T Department of the Treasury Internal Revenue Service www.irs.gov

PTIN is needed for AFSP participation. Although the AFSP is voluntary, the IRS still requires all tax return preparers to have a Preparer Tax Identification Number (PTIN). According to Section 10.8(a) of Circular 230: "Any individual who for compensation prepares or assists with the preparation of all or substantially all of a tax return or claim for refund must have a preparer tax identification number." Failure to have a current PTIN could result in penalties or sanctions by the OPR.

NOTABLE IRS DATES & DEADLINES FOR TAX PROFESSIONALS	
October 15 – December 31	**December 31**
PTIN renewal period	AFSP completion deadline
PTINs renewed in the last 2½ months of 2026 will be valid until 12/31/2027.	All CE must be completed by this date. The IRS never grants extensions.

DO YOU NEED 15, 18, OR 20 CE HOURS FOR AFSP BENEFITS?

Attorneys and CPAs are "licensed" by states, while EAs are "enrolled" by the federal government. Attorneys, CPAs, and EAs are not required to participate in the AFSP because they already meet rigorous professional standards.

Unenrolled preparers without a license or credential must obtain 18 hours of continuing education to qualify for AFSP benefits. In addition to 10 hours of federal tax laws and 2 hours of ethics, non-credentialed tax preparers must complete a 6-hour Annual Federal Tax Refresher (AFTR) course.

6-hour AFTR course. The AFTR course is a Form 1040 "refresher" course focusing on current tax law and recent updates. It is a 6-hour course accompanied by a 3-hour exam with 100 randomly selected questions.

CRTPs are exempt from the AFTR Course. CTEC-Registered Tax Professionals (CRTPs) can qualify for AFSP benefits without taking the 6-hour AFTR course (plus the 3-hour exam) because the IRS has exempted state-regulated tax preparers from the AFTR course. However, CRTPs must still complete 10 hours of federal tax laws and 2 hours of ethics. Instead of the 6-hour AFTR course, CRTPs will be expected to complete a 3-hour course on federal updates. These 15 hours of continuing education must be completed by December 31 of a given year to qualify for AFSP benefits during the following year. The IRS never grants extensions to the December 31 AFSP deadline.

CTEC and the IRS have different educational requirements. It is a common misconception among CRTPs that the IRS requires the same number of credit hours as CTEC (20). It turns out that the IRS does not have a state tax law requirement. Unlike CTEC (a state agency), the IRS (a federal agency) does not require you to take a 5-hour course on California tax laws. To qualify for AFSP benefits, CRTPs must complete 10 hours of federal law, 3 hours of federal update, and 2 hours of federal ethics — the sum of which is 15 hours. The 15 federal hours taken for CTEC will automatically satisfy the IRS requirement.

Annual Filing Season Program Participants Continuing Education Requirements

All IRS Continuing Education requirements, including Annual Federal Tax Refresher (AFTR) course and test, must be completed annually by December 31.

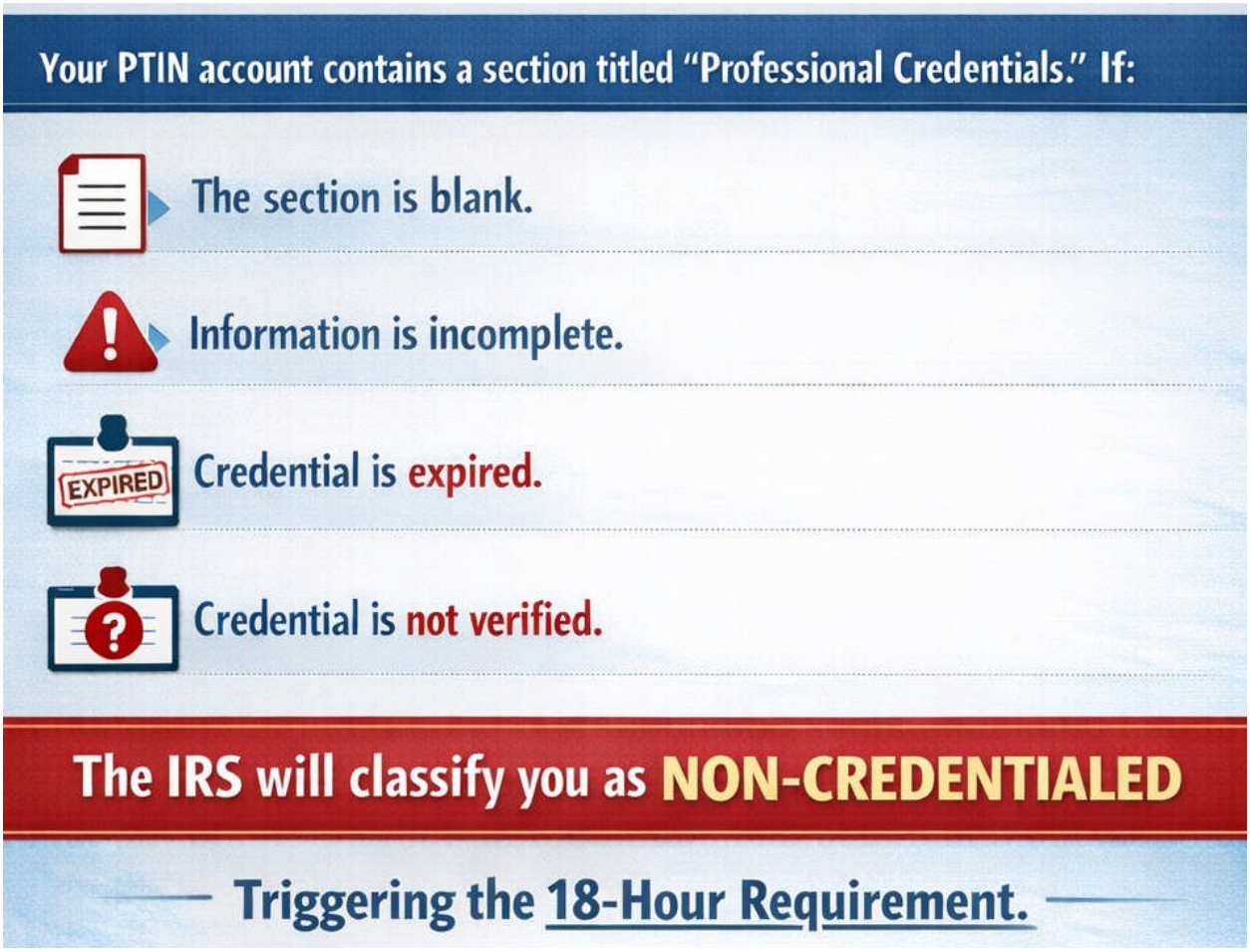
Preparers exempt from the AFTR course and test must have valid applicable credentials or qualifying designations on December 31.

Return Preparer Categories	Description of preparer category	Annual Federal Tax Refresher (AFTR) Course & Test	Tax Law Update CE Credits	Federal Tax Law CE Credits	Ethics CE Credits	Total CE Credits
AFTR Course Exempt Preparers						
State-Based Return Preparer Program Participants						
Oregon Board of Tax Practitioners	Return preparers who are registered with Oregon					
California Tax Education Council (CTEC)	Return preparers who are registered with CTEC	Exempt from AFTR Course & Test	3	10	2	15
Maryland State Board of Individual Tax Preparers	Return preparers who are registered with Maryland					

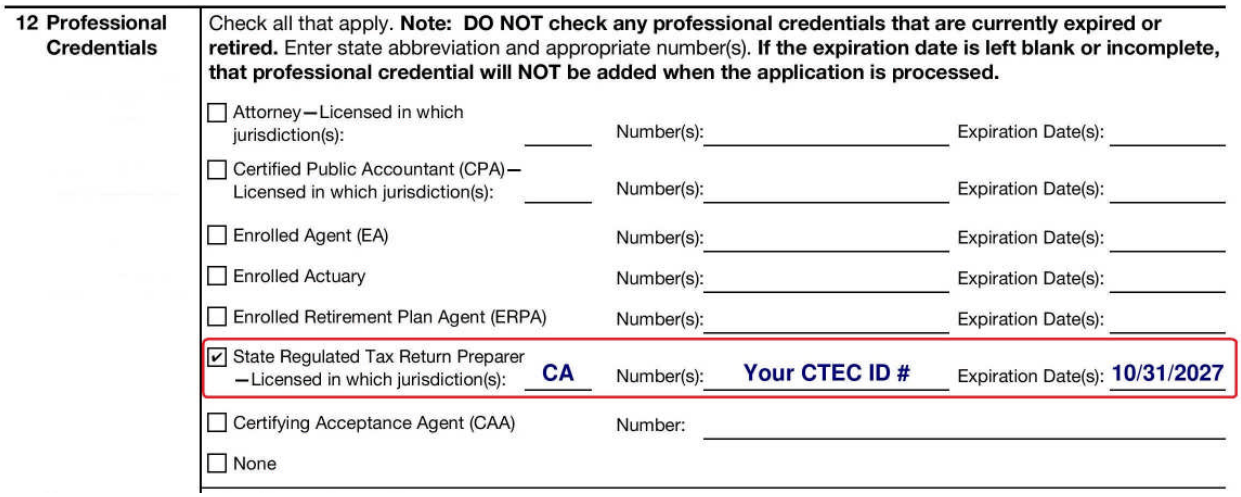
	PTIN-holder without a tax credential	**CTEC-registered tax professional (CRTP)**
Needs 10-hour Federal Tax Law course?	Yes (+10)	Yes (+10)
Needs 2-hour Ethics course?	Yes (+2)	Yes (+2)
Needs 3-hour Federal Update course?	No	Yes (+3)
Needs 6-hour AFTR course?	**Yes (+6)**	**No**
Needs 5-hour State Tax Law course?	**Not applicable to federal AFSP**	**Not applicable to federal AFSP (but CTEC does require a 5-hour California course)**
Total CE hours needed for IRS AFSP benefits	**= 18 CE hours**	**= 15 CE hours**

The CE program you complete with us will award 15 credit hours toward the AFSP, which is the appropriate amount for CRTPs. If the IRS asks you to complete the AFTR course and 18 hours of AFSP training, it is very likely that the PTIN system is not recognizing your CTEC credential.

How does the IRS know that an AFSP participant is a CRTP? PTIN accounts and applications contain a section where the IRS asks for "Professional Credentials." When the entries in this section are incomplete, out-of-date, or not verified by the relevant licensing body, the IRS will assume the PTIN-holder is a NON-CREDENTIALED tax preparer who needs to complete the AFTR course and 18 hours for the AFSP.



To add or update a credential, log in to your PTIN account at https://www.IRS.gov/ptin. After logging in, you will be on the main menu of your PTIN account. Click on the "Edit Account Information" link. In the "Edit Account Information" section, click "Edit" next to "Professional Credentials." Your CTEC credential should be listed in the row for state-regulated tax return preparer. On that row, enter "California," your CTEC ID number, and the credential expiration date. If you have already renewed your CTEC credential, the expiration date should be 10/31/2027. Save the new or updated credential.



Representation rights. Attorneys, CPAs, and EAs have unlimited representation rights; they can represent their clients in any matter — including audits, payment or collection issues, and appeals — before any IRS employee. On the other hand, unenrolled preparers without an AFSP Record of Completion can prepare tax returns, but they will not be permitted to represent clients before the IRS.

AFSP participants who obtain a Record of Completion will be awarded limited representation rights. The next edition of Circular 230 [in proposed Section 10.7(c)(1)(viii)] will incorporate language from Revenue Procedure 2014-42, which introduced the AFSP. Section 6 of Revenue Procedure 2014-42 states: "This section permits unenrolled tax return preparers who obtain a Record of Completion to represent taxpayers before the IRS during an examination of a tax return or claim for refund that they prepared and signed (or prepared if there is no signature space on the form), provided the individual had a valid Annual Filing Season Program Record of Completion for the calendar year in which the tax return or claim for refund was prepared and signed; and has a valid Annual Filing Season Program Record of Completion for the year or years in which the representation occurs."

AFSP participants earn the right to represent clients whose tax returns they have prepared and signed, but cannot represent clients whose tax returns were prepared and signed by someone else. Also, AFSP participants may only represent clients "before revenue agents, customer service matters, and before the Taxpayer Advocate Service." AFSP participants may not represent their clients before appeals officers, revenue officers, or IRS counsel.

REPRESENTATION TIERS COMPARED			
	Unlimited Rights	**Limited Rights**	**No Rights**
Who	Attorneys, CPAs, Enrolled Agents	AFSP Record of Completion Holders	PTIN Holders without AFSP
Scope	Any matter	Initial audits only (for returns they prepared)	None (Preparation only)
Before Whom	Any IRS employee	Revenue Agents, Customer Service, Taxpayer Advocate	N/A

What's the difference between revenue agents and revenue officers? An IRS revenue agent conducts tax audits of individuals, businesses, trusts, and non-profit organizations. Revenue agents determine tax liability through audits but do not collect taxes.

Revenue officers are not examiners who handle tax audits. Instead, they are professional debt collectors who focus on collecting delinquent taxes. IRS revenue officers are agents with broad power to collect taxes through levy, garnishment, and asset seizure. They are sometimes referred to as ROs or IRS collection agents.

AFSP participants may represent their clients before revenue agents (during an audit) but not before revenue officers (in a tax collection case).

AFSP participants who represent their clients before the IRS are not allowed to do the following during their representation:
● Execute closing agreements (a closing agreement is a binding agreement between the IRS and a taxpayer that, if properly implemented, finally and conclusively settles a tax issue between the IRS and a taxpayer);
● Execute waivers (a waiver is a voluntary relinquishment of a right, such as the right to appeal a settlement on a tax issue); or
● Extend the statute of limitations for assessing or collecting a tax.

Extended example. Kathryn is a CRTP who has participated in the Annual Filing Season Program since its inception. In 2025, Kathryn completed 15 hours of continuing education, renewed her PTIN, and consented to Circular 230. As a result of her efforts in 2025, she received an AFSP Record of Completion for 2026.

In 2026, Kathryn again participated in the AFSP by completing 15 hours of continuing education. At the end of 2026, she plans to renew her PTIN, consent to Circular 230, and receive an AFSP Record of Completion for 2027.

During the 2026 filing season, she prepared a tax return for her client, Caesar. If Caesar is audited in 2027, Kathryn would be eligible to represent him before the IRS during the initial audit because she will hold an AFSP Record of Completion for both the year of Caesar's return preparation (2026) and the year of his representation (2027).

In the event that the revenue agent issues an unfavorable decision after the initial audit, Caesar may appeal to the local appeals office, which is separate and independent of the IRS office that conducted the initial examination. CRTPs participating in the AFSP may represent their clients before "revenue agents" but not before "appeals officers," so Kathryn would not be eligible to serve as Caesar's representative during the appeal.

If Caesar does not wish to appeal within the IRS or does not reach an agreement with the IRS appeals officer, he may take his case to court. CRTPs who participate in the AFSP, such as Kathryn, may not represent their clients before IRS counsel.

SUBPART B: DUTIES RELATING TO PRACTICE

Subpart B prescribes the dos and don'ts when practicing before the IRS. This vital subpart lays the ethical foundations for federally authorized tax practitioners.

§ 10.21 KNOWLEDGE OF CLIENT'S OMISSION

A practitioner discovers that a new client's former preparer claimed the QBI deduction under Section 199A and miscalculated the 20% deduction amount. The error resulted in a significant understatement of taxable income. The practitioner is not eager to tell a brand-new client that she owes additional federal tax for the prior year. Can the practitioner just leave things as they are, avoid opening a can of worms, or not rock the boat since he did not prepare the erroneous return?

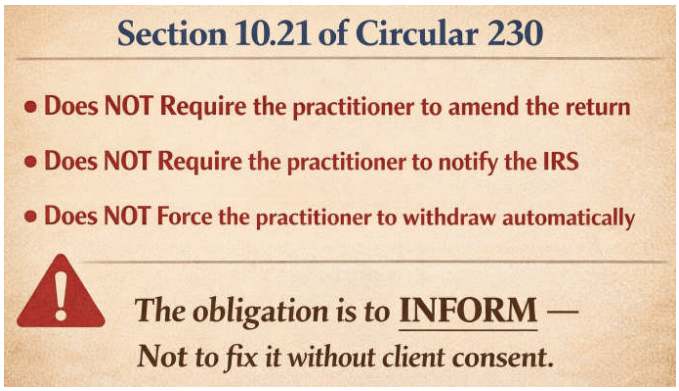
Section 10.21 requires a practitioner who knows that the client has made an error or omission on any return or other federal tax document to inform the client of the mistake. This duty exists whether the mistake concerns work done by the practitioner or by another tax preparer. The practitioner must also inform the client of the possible consequences of the error or omission. The practitioner has this obligation regardless of whether the mistake resulted in an underpayment or an overpayment of tax. Moreover, Section 10.21 does not explicitly exclude small or insignificant mistakes.

While Circular 230 calls upon a practitioner to inform the client of a problem and its potential consequences, Section 10.21 does not compel the practitioner to correct it. However, if the tax professional cannot prepare the current and subsequent years' tax returns without perpetuating the error, they should recommend that the client take corrective action.

Assuming that the practitioner has found an error in a previously filed tax return, has alerted the client of the mistake, warned the client of its consequences, and recommended corrective measures, what should the practitioner do if the client refuses to follow their recommendations?

In Badaracco v. Commissioner (1984), the US Supreme Court acknowledged that a taxpayer is under no legal obligation to submit an amended return after an error or omission is discovered. The taxpayer, not the practitioner, must decide whether to correct a mistake.

Circular 230 does not direct a practitioner to inform the IRS of an error or omission on a client's return. The tax professional can only volunteer information to the IRS regarding a mistake on a return with the client's permission (unless otherwise required by law). The practitioner is not the client's shield for noncompliance, but they are not the IRS's informant either.



Example. While Barbara is preparing Flynn's tax return, she reviews his tax return from the previous year. During this review, Barbara found that Flynn deducted real estate taxes on Schedule A, which he was not eligible to claim. What is Barbara's responsibility to Flynn concerning this discovered error? Barbara must inform Flynn of the findings and recommendations, along with the consequences the taxpayer would face should he choose not to amend the erroneous return. However, Barbara is under no explicit obligation to inform the IRS if Flynn decides not to correct the error.

Once the practitioner informs the client and recommends corrective action, what happens next depends on the client. If the client agrees to fix the error, then the solution is simple: Amend the return. Problem solved.

The Carryover Trap. If the prior error affects the current year (e.g., a capital loss carryover, depreciation basis, or an NOL carryforward), the practitioner must correct the carryover before signing the new return. When a client declines to amend an error found on a prior tax return and the mistake carries forward to the current year, continuing to represent the client might place the practitioner in a situation where the practitioner's ethical duties directly conflict with the client's interests. A rift in the practitioner-client relationship could result because, while Section 10.21 requires practitioners to inform the client of a tax-related mistake, the practitioner is ultimately prohibited by other sections of Circular 230 (discussed later) from signing a current return known to include such an error.

Section 10.21 does not order the practitioner to withdraw from further representation of a client who declines to correct prior-year mistakes that carry over to the current return. Still, the practitioner should seriously consider canceling the engagement since the uncorrected error could come back to haunt them.

§ 10.22 DILIGENCE AS TO ACCURACY

The purpose of conducting due diligence is to investigate facts, circumstances, and actors sufficiently to enable oneself, or those being advised, to make informed decisions about actions to be taken. From another angle, due diligence means taking reasonable steps to ensure that the actions and information provided are correct.

Section 10.22 requires practitioners to exercise due diligence when preparing or submitting all returns and documents relating to IRS matters. Due diligence includes reviewing the applicable tax law to establish the relevance and reasonableness of income, expenses, credits, and deductions on a return.

Section 10.22 also requires practitioners to exercise due diligence when communicating with a client about a federal tax matter. The practitioner may generally rely in good faith, without verification, on information provided by the taxpayer. However, adequate due diligence will not be carried out by a practitioner who accepts all representations made by a client without question. If a client's information appears incorrect, incomplete, or inconsistent with another fact, the practitioner must make additional inquiries to confirm its accuracy.

Example. Marcel hired a practitioner to prepare his individual income tax return. When Marcel delivered his records, he told the practitioner he needed to deduct an above-average amount of rental property expenses this year due to "expensive repairs." The practitioner did not inquire into the nature of those expenses. Instead, without questioning Marcel's numbers, the practitioner entered $51,432 on the "Repairs" line on Schedule E. When the IRS audited the return, Marcel explained to the revenue agent that his rental property's kitchen had to be renovated, which is why he had the practitioner list the expense amount on Schedule E. Had the practitioner exercised due diligence, he would have found that Marcel's "repairs" were actually property improvements that should have been depreciated over several years. A kitchen renovation is typically a capital improvement, not a repair (the renovation cost exceeded the "safe harbor" limits that may have allowed Marcel to bypass the repair vs. improvement dilemma and immediately deduct 100% of his expenses). In this instance, the practitioner failed to comply with Section 10.22.

Using Artificial Intelligence (AI) in a tax practice. AI can help tax professionals streamline workflows and enhance reporting accuracy. For instance, AI-powered document processing can scan unstructured data from receipts, invoices, W-2s, and 1099s, extracting and importing it directly into tax software, reducing manual entry by up to 90%. AI tools can also identify tax optimization opportunities, such as eligible deductions or credits, and simulate different financial scenarios to forecast future liabilities.

AI outputs can be wrong. Section 10.22 requires exercising due diligence in determining the correctness of representations made to the IRS. While a practitioner can rely on the work of others (including AI tools), they must use "reasonable care" in overseeing and evaluating that work. Circular 230 still requires practitioners to exercise

due diligence and verify client returns. Practitioners can use AI to enhance due diligence, not bypass it.

Paid Preparer's Due Diligence Checklist. Since 2016, Congress has gradually expanded the due diligence requirements under IRC Section 6695(g). Before 2016, Section 6695(g) was limited to the earned income tax credit. Section 6695(g) now imposes a penalty on a practitioner who fails to perform due diligence for determining the eligibility for any of the following tax benefits:

- Earned income tax credit (EITC);
- American opportunity tax credit (AOTC);
- Child tax credit or additional child tax credit or other dependents credit (CTC/ACTC/ODC); and
- Head of household (HOH) filing status.

A practitioner who prepares a Form 1040 for a client claiming any of these credits or HOH filing status must ask and answer several questions on Form 8867, *Paid Preparer's Due Diligence Checklist*, to verify that the client qualifies for the claimed benefits. Additional inquiries should be made when the client's information seems incorrect, inconsistent, or incomplete.

Practitioners must meet knowledge requirements concerning the basis for the benefits claimed on returns. They should also contemporaneously document inquiries and responses to satisfy these knowledge requirements.

Example. Client Clark engages practitioner Presley to prepare his 2026 federal income tax return. During Presley's standard intake interview, Clark stated that he had never been married and that his nephew lived with him for most of the 2026 tax year. Presley believes Clark may be eligible to file as head of household while claiming his nephew as a qualifying child for the earned income tax credit and the CTC. To meet the knowledge requirement, Presley must make reasonable inquiries to determine whether her client is eligible for the HOH filing status, the EITC, and the CTC. Thus, she should inquire about the sources of support for the child, the details of the child's residence, and Clark's payment of household operating costs. Presley must contemporaneously document these inquiries and the responses.

Form 8867 must be attached to any tax return that claims any of the credits or filing status mentioned above. Practitioners who fail to perform due diligence with the EITC, AOTC, CTC/ACTC/ODC, or the HOH filing status could be assessed a $650 penalty for each failure. The penalty is indexed for inflation, so it is expected to increase in future years.

Section 6695(g) states that more than one $650 penalty could apply to a single return. Let's imagine a practitioner prepares one federal tax return claiming the EITC, the CTC, the AOTC, and the HOH filing status. Now assume that the due diligence requirements for these benefits are not met. In this case, the practitioner could be subject to a penalty of $2,600 ($650 × 4) for the errors on that federal tax return.

§ 10.27 FEES

The current version of Circular 230 discusses appropriate and inappropriate fees for services rendered. Section 10.27 regulates fees charged by tax practitioners concerning matters before the IRS and restricts the use of "unconscionable" or "contingent" fees in tax-related representations.

What is a contingent fee? The rules on fees in Section 10.27 focus heavily on contingent fees. Generally speaking, a contingent fee is any payment for services that depends on (is contingent upon) a favorable outcome. In the tax world, a contingent fee could be a payment amount linked to a percentage of the client's tax refund or a portion of the taxes saved as a result of the prepared return. A contingent fee arrangement

also arises when the practitioner's fee depends on whether an audit results from the prepared tax return.

A practitioner is permitted to charge different fees depending on the complexity of a tax return. However, they are generally prohibited from charging fees depending on the results of a tax return (especially for preparing an original tax return).

Under the current version of Circular 230, contingent fee arrangements are permitted only in limited circumstances. For example, contingent fees are permitted when the government starts a fight against a client. In other words, a contingent fee may be charged and collected when an audit or other government challenge is involved. Moreover, a contingent fee is permitted when it relates to preparing an amended return (or a claim for refund) filed no later than 120 days after receiving an IRS examination notice challenging the original return.

Example. In February 2025, Riley prepared an original return for her client, Adalynn. Per Section 10.27, Riley could not charge a contingent fee for preparing Adalynn's original return. On July 1, 2026, Adalynn received an examination notice from the IRS challenging the original return. Adalynn presents the IRS letter to Riley, who decides an amended return is the best course of action. If Adalynn files an amended return in July with Riley's professional assistance, Riley could charge Adalynn a contingent fee without violating Section 10.27 (because Riley would comply with the 120-day rule).

There is one situation in which contingent fees are permitted even though the government has not yet initiated a "fight" against the client. A contingent fee is allowed for services rendered in a claim for refund solely related to statutory interest or penalties imposed by the IRS.

Had the refund claim been related to the overpayment of tax rather than interest or penalties, practitioners would be prohibited from charging a contingent fee for preparing and filing this unchallenged "ordinary refund claim." Filing an ordinary refund claim — before any back-and-forth with the IRS — is similar to submitting an original tax return. Both take place before any adversarial assessment of the taxpayer's liability.

Ridgely v. Lew (2014). Plaintiff Gerald Lee Ridgely, a practicing CPA, brought suit against the Secretary of the Treasury (Jacob "Jack" Lew), arguing that the IRS exceeded the scope of its statutory authority in regulating the preparation and filing of ordinary refund claims.

What is an ordinary refund claim? It is a claim for a refund of a tax overpayment submitted to the IRS after the client has filed their original income tax return but before the IRS has started an examination or challenge of that return. For example, a taxpayer hastily files their return on April 15, 2026. In their haste, they forgot to include a $5,500 deduction. When the taxpayer realizes the error in May, they employ the help of a tax professional to file an amended return, this time including the $5,500 deduction.

Assuming the IRS has not yet initiated audit proceedings on the return filed in April, this corrective action in May is an ordinary refund claim.

Ridgely prepared and filed a client's ordinary refund claim. He charged the client a contingent fee based on the refund amount. Ridgely argued that his fee arrangement regarding the ordinary refund claim was not subject to Circular 230. He would only be subject to Circular 230 when he "practiced before the IRS," but such practice would only occur when presenting his client's case before the IRS. Until the IRS challenged the refund claim, there would be no adversarial dispute and, thus, no "practice before the IRS."

The federal district court agreed with Ridgely that the IRS had overstepped its authority when it attempted to regulate fee arrangements regarding ordinary refund claims filed before the commencement of any adversarial proceedings with the IRS. The Ridgely court found that a practitioner who prepares and submits an ordinary refund claim is not vested with legal authority to act on behalf of the client (if they hold no power of attorney). Under these circumstances, the practitioner is not a formal representative, so preparing the refund claim is not "practice before the IRS." Ultimately, the district court found Section 10.27(b) invalid and permanently enjoined the IRS from enforcing the regulation concerning fees for preparing refund claims.

The IRS's proposed workaround to Ridgely. The IRS could have acquiesced to the court's decisions in Ridgely v. Lew by removing Section 10.27 from Circular 230 and doing nothing else. However, according to the IRS, charging a contingent fee for the preparation of an original return, amended return, or claim for refund prepared before the examination of a tax return is disreputable conduct because these circumstances encourage evasion or abuse of federal tax laws by incentivizing practitioners to take aggressive or abusive tax positions to inflate their own compensation. Therefore, the IRS states that these contingent-fee arrangements reflect conduct incompatible with the ethical practices prescribed in Circular 230.

The preamble to the proposed regulations reflects on Ridgely v. Lew. It concludes that the scope of that case is relatively narrow, standing only for the proposition that the IRS cannot ban contingency fees for refund claims whenever these services are rendered "before the IRS." The preamble reveals that the IRS will revise the current ban on contingency fees and adopt a different legal position that does not violate the Ridgely court ruling.

As explained in the proposed regs, the IRS will delete the current version of Section 10.27 and then expand the definition of disreputable conduct under another provision, Section 10.51, to cover contingency fees. Section 10.27 (related to fees) applies only in situations involving a "matter before the IRS," which the district court in Ridgely v. Lew determined does not include preparing some returns and claims for refund. On the other hand, Section 10.51 (related to incompetence or disreputable conduct) allows the IRS to regulate and punish "practitioners who engage in disreputable conduct, whether or not the conduct constitutes representation of a client."

The IRS now takes the position that "charging a contingent fee for the preparation of an original return, amended return, or claim for refund" will constitute disreputable conduct, whether or not the matter is presented "before the IRS" or the IRS initiates an audit of such documents.

If adopted, this revised definition of "disreputable conduct" would give the IRS authority to "disbar any practitioner" who charges a contingent fee. However, it remains to be seen whether this workaround is permissible if or when it is challenged in a federal court. The courts will likely examine whether the IRS exceeded its statutory authority, whether the rule is arbitrary and capricious, and whether it conflicts with Ridgely's reasoning.

§ 10.28 RETURN OF CLIENT'S RECORDS

According to Section 10.28(a), a "practitioner must, at the request of a client, promptly return any and all records of the client that are necessary for the client to comply with his or her Federal tax obligations." If the client chooses to go elsewhere, arrangements should be made for the prompt and orderly transfer of all the client's files. Practitioners can retain copies of said records.

In most cases, this Circular 230 provision is noncontroversial. However, the potential to violate Section 10.28 increases significantly when a practitioner encounters a non-paying client. Let's say a client refuses or fails to pay their tax preparation fee before the practitioner delivers the work product or returns the client's documents. Can the practitioner induce the client to pay by withholding the finished work product or withholding the client's records?

Documents not prepared by the practitioner. Returnable client records include all documents provided to — or obtained by — the practitioner while representing the client. These documents usually predate the client's retention of the tax practitioner. The practitioner should return all written or electronic documents generated by parties other than the practitioner — such as receipts, W-2 forms, 1098 forms, 1099 forms, and other "records that must be attached to the taxpayer's return." It would be unethical for the practitioner to coerce the client by saying, "I'll only return your receipts, W-2s, 1098s, and 1099s after you pay me."

Documents prepared in prior representation. Generally speaking, the practitioner should return documents prepared during a previous engagement to the client. Returnable client records include a return, schedule, appraisal, or any other document prepared by the practitioner that was presented to the client in a prior engagement if that document is necessary for them to comply with current federal tax obligations.

Documents prepared in current representation. The last sentence of Section 10.28 permits certain documents to be withheld from non-paying clients. Such materials include "any return, claim for refund, schedule, affidavit, appraisal or any other document prepared by the practitioner . . . if the practitioner is withholding such document pending the client's performance of its contractual obligation to pay fees with respect to such document."

The practitioner must give back any document the client handed over during the engagement. On the other hand, the practitioner doesn't have to turn over any of their current work product (e.g., Form 1040) if there is a fee dispute. Circular 230 directs practitioners to "return" client records, so workpapers originating in the practitioner's office (during the current engagement) generally fall outside the purview of Section 10.28.

Extended example. Client Lannette has engaged practitioner Jaylen near the April 15 deadline. Lannette provides most of her tax records by April 15. However, the lack of certain critical documents prevents Jaylen from preparing an accurate return by the original filing deadline, so both the practitioner and the client agree to apply for an extension. Jaylen completes the extension form, but just before he files it, Lannette informs him that she is going to another tax preparer to finalize her 2026 tax returns. Jaylen then submits an invoice for the time spent rendering services. Lannette fails to pay the invoice, but she still demands the following documents:

- Lannette's W-2 form, 1098 forms, and 1099 forms;
- Lannette's tax depreciation schedules prepared by Jaylen in a prior representation;
- Jaylen's extension calculation and other working papers (Lannette believes these documents will help the next tax preparer do her returns);
- Form 4868, *Application for Automatic Extension of Time to File US Individual Income Tax Return*.

Can Jaylen withhold any of these documents until he receives payment from Lannette? Section 10.28 requires Jaylen to return forms W-2, 1098, and 1099 that Lannette provided to him to prepare her return (and extension).

Jaylen should return the tax depreciation schedule he prepared for Lannette during a previous engagement if the client needs it to comply with her current federal tax obligations.

Section 10.28(b) excludes the practitioner's working papers from the definition of "records of the client," so Jaylen could withhold the extension calculation until he receives Lannette's payment.

Section 10.28 also allows Jaylen to withhold a copy of Form 4868 because the term "records of the client" includes an exception for any document prepared by the practitioner in the current engagement. The delivery of such a document (in this case, Form 4868) may depend on the client's fulfillment of their contractual obligation to pay any fees incurred in preparing the document.

Document	Must return under §10.28?	Why?
W-2, 1098, 1099	Yes	Client-provided records
Receipts	Yes	Client-provided records
Prior depreciation schedules	Yes	Prior engagement + necessary for compliance
Current-year Form 1040 (unfinished or finished)	No	Current work product may be withheld pending payment
Form 4868 (extension form)	No	Current work product may be withheld pending payment
Extension calculations	No	Practitioner workpapers
Internal workpapers	No	Practitioner workpapers

§ 10.31 NEGOTIATION OF TAXPAYER CHECKS

Section 10.31 reads as follows: "A practitioner may not endorse or otherwise negotiate any check (including directing or accepting payment by any means, electronic or otherwise, into an account owned or controlled by the practitioner or any firm or other entity with whom the practitioner is associated) issued to a client by the government in respect of a Federal tax liability."

Even if a practitioner is designated as the client's representative on Form 2848, *Power of Attorney*, the practitioner is still forbidden from endorsing or negotiating a client's refund check. A client may authorize a representative to "receive" refund checks at their office, but even a POA cannot allow tax practitioners to "endorse" refund checks.

A practitioner who enters their bank account number on the client's Form 1040 direct deposit line or the client's Form 8888 would violate Circular 230 Section 10.31 and IRC Section 6695(f). Under Section 6695(f), the penalty is $665 for a practitioner who endorses or negotiates any check issued to a taxpayer.

Example. A client will get a tax refund of $3,120. The client suggested the following plan to the practitioner who prepared his return. First, the client asked the practitioner to pay him $2,747 today. This amount reflects the tax refund minus the practitioner's fee of $273 and $100 for the costs (including interest) of advancing the client's refund amount. Second, the client will direct the $3,120 refund check to the practitioner's bank account (through the direct deposit line on Form 1040). That way, the client gets their refund today (minus the practitioner's fee of $273 and the $100 accelerated refund service fee), and the practitioner will be fully reimbursed later via direct deposit. Section 10.31 of Circular 230 and IRC Section 6695(f) forbid this type of transaction.

Tax refund delivery method for US taxpayers abroad. Most taxpayers are US residents who can have their refunds deposited directly into a US bank account. But what happens if a US taxpayer qualifies for a tax refund but does not have a US bank account because they live overseas?

The IRS will not directly deposit an individual income tax refund into a foreign bank account. The IRS cannot deposit income tax refunds into foreign bank accounts because their electronic system is designed exclusively for US-based financial institutions that are members of the Federal Reserve System. Foreign accounts lack the required US bank routing numbers needed for ACH transfers.

Before September 30, 2025, the IRS protocol was to mail a paper check to the address on the tax return for filers without a US bank account.

IRS paper tax refund changes for 2026. On September 30, 2025, the federal government stopped issuing paper checks for most federal payments. The move away from paper checks aligns with President Donald Trump's Executive Order (EO) 14247, *Modernizing Payments to and From America's Bank Account*, which orders the Treasury to transition to electronic disbursements. Not only does EO 14247 affect the IRS, but it also affects all government agencies, including the Social Security Administration.

The IRS no longer issues paper refund checks by default, and it still does not deposit refunds into foreign bank accounts. This combination creates a refund delivery dilemma for millions of Americans living abroad. Since the IRS has stopped mailing paper checks and cannot direct deposit into foreign banks, many expatriates are left without a valid refund delivery method. If an expat files their 2026 return without valid US banking information, the IRS will now freeze their refund and issue a Notice CP53E, requiring them to take additional steps before their money is released.

American expats might ask their California-based tax practitioners for a workaround to the refund delivery dilemma. If such a conversation arises, the practitioner should first remember their duty under Section 10.31. Then, the practitioner may have the client research the following services that provide the routing and account numbers required to receive a US tax refund while living abroad:

- Wise
- Revolut
- Utoppia
- State Department Federal Credit Union

Proposed changes to Circular 230. Section 10.31 is currently titled "Negotiation of taxpayer checks." When considering the changes implemented by EO 14247, the label on Section 10.31 will need to be updated.

Since the last edition of Circular 230 in 2014, the number of direct deposits of federal tax refunds to checking or savings accounts, mobile apps (Venmo or CashApp), virtual wallets (like PayPal), and reloadable prepaid cards (e.g., Green Dot and NetSpend) has increased. During the same period, the share of tax refunds disbursed by paper check has declined significantly.

Proposed Section 10.31 would maintain the prohibition on practitioner negotiation of client refund checks and broaden it to all electronic payments related to a client's federal tax liability. Under the proposed rules, a practitioner is strictly prohibited from directing or accepting a client's tax refund into any account or payment mechanism they own or control — whether that be a bank account, mobile wallet, or prepaid card.

§ 10.33 BEST PRACTICES FOR TAX ADVISORS

Section 10.33 contains recommendations concerning certain aspects of practice, especially those related to advising clients and preparing information submitted to the IRS. This section promotes an aspirational set of behaviors for tax practitioners. A practitioner will not be sanctioned for disregarding any of the best practices mentioned in Section 10.33.

Client communication at the beginning. Client communication is at the top of the list of best practices. On the one hand, the practitioner should listen carefully to understand what the client expects. On the other hand, the practitioner should communicate clearly with the client to establish the terms of the engagement and the goal of the advice or assistance to be rendered. The practitioner should discuss in detail how the services will be delivered and their possible outcomes.

Establishing relevant facts. Next on the list is the level of diligence in preparing the client's tax return and associated documents. Practitioners who provide professional services for clients are expected to apply their evaluative skills during the engagement. Practitioners should evaluate any assumptions, establish the facts, relate the law to the facts, and arrive at a tax return position supported by the law and the relevant facts.

Acting fairly and honestly. The practitioner must act fairly and honestly throughout the engagement and whenever practicing before the IRS. Tax professionals enjoy a position of trust when practicing before the IRS, and one of the pillars of that trust is the practitioner's professional integrity. Integrity promotes qualities such as honesty and fairness above personal gain or advantage.

Client communication at the end. Finally, the practitioner should communicate with the client regarding the conclusions reached during the representation. For example, the practitioner should point out any risks of accuracy-related penalties being imposed on the client for relying upon the practitioner's advice.

Proposed changes to Circular 230. The IRS has proposed three new aspirational best practices to reflect the evolving digital and professional landscape.

● Data security policy. Practitioners should create a data security policy to protect client information and establish a plan for responding to data breaches. This often aligns with existing requirements for a Written Information Security Plan (WISP). The WISP will be described in greater detail at the end of this chapter.

● Mental fitness. Practitioners should identify and address any mental impairments — whether related to age, substance abuse, or health conditions — that could adversely impact their ability to represent clients effectively.

● Business continuity and succession planning. Practitioners should establish plans to handle the cessation of practice or unexpected outside events, such as natural disasters or cyberattacks, to ensure clients are not left without representation.

§ 10.34 STANDARDS WITH RESPECT TO TAX RETURNS

There is a professional responsibility under Section 10.34 only to take positions on a tax return that have a reasonable basis in the law. A position has a "reasonable basis" if it is reasonably based on an authoritative source — such as the Tax Code, Treasury regulations, court cases, revenue rulings, revenue procedures, private letter rulings, or tax treaties.

According to Section 10.34(a)(1), a practitioner may not "sign a tax return or claim for refund that the practitioner knows or reasonably should know contains a position that . . . lacks a reasonable basis." Then, in Section 10.34(c)(1), practitioners are instructed to "inform a client of any penalties that are reasonably likely to apply to the client with respect to . . . a position taken on a tax return." Section 10.34(c)(2) states that practitioners "also must inform the client of any opportunity to avoid any such penalties by disclosure, if relevant, and of the requirements for adequate disclosure."

IRC Section 6694(a). Circular 230 (Section 10.34) explicitly ties to IRC Section 6694, which means costly penalties might be assessed when one prepares and signs a return with an unreasonable position. IRC Section 6694(a) imposes a penalty on a practitioner who:

● Prepares a return that understates the client's tax liability due to an unreasonable position; and
● The practitioner knew (or should have known) that the tax position was unreasonable.

IRC Section 6694(a) authorizes a penalty of at least $1,000 on a practitioner who takes an unreasonable position on a return that results in an understatement of tax.

Adequate disclosure. Federal tax law is more complex than ever, and differences of opinion about certain rules among tax authorities, tax professionals, and taxpayers are not uncommon. To avoid the IRC Section 6694 penalty for taking a position on a client's return that the IRS disagrees with, "adequate disclosure" should be the guiding principle for all tax professionals who prepare returns.

At least once in their career, most tax professionals have faced the dilemma of whether and how to make a disclosure on a tax return. A disclosure is an extra explanation beyond the regular income and expenses shown on a tax return. It's no surprise that most taxpayers don't want to disclose anything more than necessary to the IRS. They might have privacy concerns or would rather keep the IRS from knowing too much about them or their business. Taxpayers may also be concerned that a disclosure will

raise a red flag and increase the chances of an IRS audit. These concerns are legitimate, but disclosures usually protect taxpayers and tax return preparers from penalties.

The IRS and professional standards recognize distinct "levels of confidence" regarding whether a tax position will be upheld if challenged in court. The minimum threshold for a preparer depends on whether the position is disclosed or involves a tax shelter.

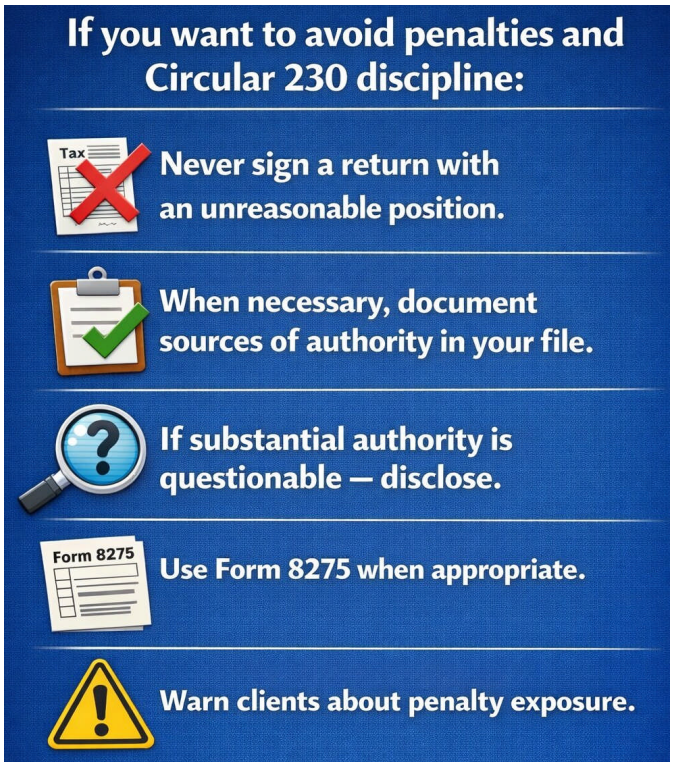
Penalty Standard	Likelihood of Being Upheld	Context & Usage
More Likely Than Not	> 50%	Required for tax shelters to avoid penalties.
Substantial Authority	~ 40%	An objective standard; the weight of authorities in favor must be substantial compared to those against.
Reasonable Basis	20% – 30%	Generally requires adequate disclosure on Form 8275 to avoid penalties
Unreasonable Position	< 20%	Because it falls below the Reasonable Basis standard, disclosure on Form 8275 typically will not protect a taxpayer from accuracy-related penalties.
Frivolous Position	Essentially 0%	Clearly contrary to law, and subject to a $5,000 frivolous return penalty under IRC Section 6702.

In most cases, a preparer must have "**substantial authority**" for any position taken on a tax return. Disclosure is not required when substantial authority (derived from statutes, regulations, and court cases) supports a tax return position. However, to establish substantial authority for a tax position, written documentation of the relevant facts and tax analysis should be prepared and retained in the tax return file.

What if a preparer examines legal sources regarding a nonstandard tax position that could result in significant tax savings for the client and concludes that the "substantial" authority standard is not met? A preparer can still avoid a Section 6694 penalty if there is "sufficient" authority to provide a "**reasonable basis**" to use the nonstandard tax position. A written explanation of that reasonable basis — citing statutes, regulations, and court cases — must be provided to the IRS and the client. A position justified by the reasonable basis standard must be accompanied by adequate disclosure. To disclose a position meeting the reasonable basis standard, use Form 8275, Form 8275-R, or a white paper disclosure statement. The practitioner should advise the client of applicable penalty standards and the possibility of an accuracy-related penalty.

There are higher and stricter standards for tax return positions involving "tax shelters." Suppose a paid preparer finds significant tax savings through a new or novel interpretation of the Tax Code. The IRS may assert that the tax planning involved a "tax shelter" and, consequently, requires a higher level of authority (the "**more likely than not**" standard) to justify a position taken on the tax return.

Adequate disclosure of a debatable position taken on a nonfrivolous return is a good defense to the Section 6694 penalty and Circular 230 sanctions. Thus, preparers should do their best to identify potentially problematic issues, disclose those issues to the IRS, and link the position to authoritative sources (for example, statutes, regulations, and court cases). The relevant disclosure form (in many cases, Form 8275) should be attached to the client's return to disclose the position and lift that position to the minimal standard of reasonable basis.



§ 10.35 COMPETENCE

Tax attorneys, CPAs, EAs, and CRTPs must understand the underlying laws applicable to the client's return. Section 10.35 encapsulates the expectation that practitioners be competent when working for clients. Relying blindly on tax software without understanding the legal basis for a calculation is a violation of Circular 230. Tax software is a tool — not a substitute for understanding the law.

Practitioners should be adequately qualified — that is, have sufficient knowledge and skill — in the tax matter they have been engaged in. Personal research, mentored experience, and regular participation in continuing education appear to be implicit obligations of practitioners, regardless of their broad or narrow field of practice.

Section 10.35 does not impose upon practitioners an unrealistic standard of being competent in everything related to taxes. Instead, it expects practitioners to acknowledge when they lack competence in a particular subject area before giving advice or a requested service to a client. Practitioners who know that they don't know

about a specific federal tax matter should not engage in that matter where they lack adequate competence.

Extended example. Tania is competent in preparing individual tax returns and all related schedules. Months before the start of tax season, she is visited by the owner of a single-member limited liability company who has elected to be treated as a corporation for federal tax purposes. This taxpayer, who happens to be Tania's brother-in-law, expresses interest in using Tania's tax preparation service in the future. Tania informs the prospective client that she does not have the necessary knowledge and skills to prepare a corporate tax return.

What if the same prospective client contacts Tania during the next tax season to ask if she is ready to prepare his corporate tax return? In light of Section 10.35, Tania should decline the engagement if she does not have "the appropriate level of knowledge, skill, thoroughness, and preparation necessary for the matter for which the practitioner is engaged." However, Tania could accept the engagement if she has "become competent" through various methods, such as "studying the relevant law." In other words, she can proceed with the new engagement as a competent practitioner after taking a self-study course, attending a seminar, conducting private research, or consulting experts on corporate taxation.

AI is a tool, not a practitioner. Tax professionals are increasingly adopting AI and this shift introduces significant ethical obligations, primarily centered on maintaining professional judgment.

Practitioners should not outsource professional judgment or competence to a machine, as they remain accountable for all advice provided under their name. AI should never replace professional judgment in critical decision-making, such as making final decisions on complex tax matters.

Proposed changes to Circular 230. A key addition to the upcoming Circular 230 is a technological competency requirement for tax professionals. As the Treasury noted, this proposed amendment recognizes that "competence also includes maintaining familiarity with technological tools used to represent a client."

The landscape of tax practice has shifted significantly toward digital tools. The proposed update to Section 10.35 reflects the growing reliance on digital systems (including AI) in tax preparation and filing. At a minimum, practitioners must understand the tax software they use for e-filing, maintain familiarity with evolving online tools, use them responsibly, and protect client data.

SUBPART C: SANCTIONS FOR VIOLATING REGULATIONS

Circular 230 Subpart C establishes the disciplinary framework for tax practitioners, granting the Office of Professional Responsibility (OPR) the exclusive authority to investigate allegations, prosecute misconduct, and impose sanctions ranging from private reprimands to permanent disbarment.

§ 10.50 SANCTIONS
Section 10.50 gives the OPR the authority to issue appropriate sanctions and describes the elements that could trigger such sanctions under Circular 230.

If disciplinary action isn't warranted, the OPR could downgrade their response to a private reprimand or a cautionary "soft letter." The soft letter typically informs recipients that an allegation has been made against them, but that the OPR decided not to take action. The soft letter is an educational "nudge" rather than a penalty.

A "private reprimand" is a formal determination that a violation did occur. The OPR admonishes the practitioner privately to correct the behavior without publishing the practitioner's name in the Internal Revenue Bulletin.

The OPR can impose both monetary and non-monetary sanctions against practitioners and firms. The non-monetary sanctions that the OPR might assess on a tax practitioner who fails to comply with their duties or who misleads with the intent to defraud are:
- censure (a public reprimand);
- suspension; or
- disbarment.

A monetary penalty might be applied in addition to (or instead of) a non-monetary sanction. According to Section 10.50(c)(2), "The amount of the penalty shall not exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty." The monetary penalty ensures the practitioner does not profit from the violation.

§ 10.51 INCOMPETENCE AND DISREPUTABLE CONDUCT

The OPR can open a case against a practitioner who does not comply with the duties and restrictions described in Subpart B of Circular 230. Other types of bad behavior that may be subject to sanctions are included in Section 10.51(a). As listed, a practitioner can be sanctioned for the following:

(1) Being convicted of any criminal offense under federal tax laws.
(2) Being convicted of any criminal offense involving dishonesty or breach of trust.
(3) Being convicted of any serious crime (i.e., a felony) under federal or state law for which the conduct involved renders the practitioner ineligible or unfit to practice before the IRS.
(4) Giving false or misleading information (including tax returns and financial statements) to the IRS.
(5) Using false or misleading representations to clients or implying that the practitioner can improperly obtain special consideration from the IRS.
(6) Failing to file a federal tax return or attempting to evade payment of federal taxes (due from the practitioner).
(7) Assisting or counseling a client (or prospective client) to violate federal tax law.
(8) Failing to remit funds received from a client for purposes of payment of taxes or other obligations due to the United States.
(9) Attempting to bribe or coerce an IRS officer or employee.
(10) Being disbarred or suspended from practice by a state agency, body, or board (for example, CTEC).
(11) Aiding and abetting another person to practice before the IRS when that person is suspended, disbarred, or ineligible to practice.
(12) Contemptuous conduct before the IRS, including abusive or malicious language and false accusations.
(13) Knowingly, recklessly, or through gross incompetence, giving a false opinion on questions arising under federal tax laws.
(14) Failing to sign a tax return prepared by the practitioner when required by federal tax laws.
(15) Using or disclosing tax return information in a manner not legally authorized.
(16) Failing to file a client's tax return electronically (e-file) when the practitioner is required to do so.
(17) Preparing (substantially) all of a tax return — or signing that tax return — when the practitioner does not possess a current or valid Preparer Tax Identification Number (PTIN).

Failure to adhere to the aforementioned standards could trigger the sanctions outlined in Section 10.50.

Extended example. Zoey is representing a client in an IRS audit. The client had to postpone the initial meeting with the auditor twice because of "family issues." Now, Zoey has all the records and an appointment to meet the auditor on Monday morning.

After spending all weekend compiling and checking the documents, Zoey gets a call from the client on Sunday night. The client wants to know whether the quantity and

quality of the records he gave her will result in a favorable outcome in the morning. In her reply, Zoey mentions that Circular 230 requires her to exercise due diligence in preparing returns and in determining the correctness of all documents filed with the IRS. Accordingly, she came across some information that appears incorrect, and these erroneous records may give rise to new problems during the audit. At this point, Zoey's client confesses that some of the documents he gave her earlier were faked. The client reveals to Zoey why he had to falsify the records and then asks her not to tell the auditor.

With this new information, Zoey cannot submit the falsified records under Section 10.51(a)(4). Telling the client that it's okay to proceed with the falsified documents would violate Section 10.51(a)(13) regarding false opinions on questions arising under federal tax laws. Submitting falsified records could also subject Zoey to sanctions under Section 10.51(a)(6) for helping the client evade taxes and Section 10.51(a)(7) for assisting the client in violating tax laws.

Zoey must inform the client of the noncompliance and the consequences, as required by Section 10.21 (Knowledge of client's error). Now, she cannot rely on the information provided by the client under Section 10.22 (diligence as to accuracy). Nor can Zoey prepare or sign a return with an unreasonable position, as instructed by Section 10.34 of Circular 230 and IRC Section 6694(a). Assuming the client starts producing his true tax data and Zoey is eventually satisfied with the resolution of the erroneous records issue, she may continue representing the client. Of course, Zoey can quit representing the client if she believes this engagement presents more risks than rewards.

Proposed changes to Circular 230. Subpart C would redesignate the current Section 10.51 as proposed Section 10.50. In other words, the current Section 10.50 on "Sanctions" will be replaced by a new Section 10.50 that will define and list examples of disreputable conduct. Other instances of bad behavior will be added to the list currently in Section 10.51. New Section 10.50 will emphasize that a practitioner may be sanctioned for conduct related to the practitioner's overall fitness to practice, and that sanctions are not limited to actions taken while representing clients before the IRS.

Proposed Section 10.51 would focus specifically on fee arrangements that constitute disreputable conduct. With a few exceptions, contingent fees will be explicitly prohibited for tax return preparation.

PROTECTING CLIENT DATA IN THE AGE OF THE INTERNET

GOVERNMENT COMPELS MOST TAX PREPARERS TO E-FILE

IRC Section 6011(e)(3) requires tax return preparers to electronically file (e-file) certain federal income tax returns that they prepare and file for individuals, trusts, or estates. The failure to e-file client tax returns, when required to do so, would also be considered "disreputable conduct" under Circular 230, Section 10.51(a)(16).

Any tax return preparer who anticipates preparing and filing 11 or more Forms 1040, 1040-SR, and 1041 during a calendar year must use IRS e-file. If a preparer is a member of a firm, the threshold is determined by adding together all returns the firm's members expect to file. If the firm's total is 11 or more, all members must e-file, even if an individual preparer handles fewer than 11 returns personally.

Before e-filing tax returns, a practitioner must be an authorized e-file provider with a six-digit Electronic Filing Identification Number (EFIN). Practitioners must use their EFIN when filing client returns electronically.

Tax practitioners who do not have an EFIN will need to apply for one through the IRS website [https://www.irs.gov/e-file-providers/become-an-authorized-e-file-provider]. Obtaining an EFIN from the IRS is free. However, applicants may have to get fingerprinted and pass a "suitability check." Fingerprinting usually costs around $50. Applicants can expect to receive their EFIN in about 45 days. Once it is issued, the EFIN does not expire, and users don't have to renew it.

EFIN vs. PTIN vs. CTEC	
EFIN	An Electronic Filing Identification Number (EFIN) is a number assigned by the IRS to preparers approved for the federal and state e-file programs. It is a six-digit ID number. Obtaining an EFIN from the IRS is free, and there is no need to renew it. The EFIN helps tax professionals comply with IRC Section 6011(e)(3) and Circular 230 Section 10.51(a)(16).
PTIN	Anyone who prepares or assists with preparing federal tax returns for compensation must have a valid Preparer Tax Identification Number (PTIN). The PTIN is an ID number required when submitting US federal tax returns to the IRS. The PTIN is an eight-digit ID number that starts with the letter "P." It expires on December 31 and must be renewed for the following year (the renewal fee is $18.75). The PTIN helps tax professionals comply with Circular 230 sections 10.8(a) and 10.51(a)(17).
CTEC	The California Tax Education Council assigns a CTEC identification number to individuals who have met California's educational, bonding, and registration requirements for paid preparers. It is a six-digit ID number that starts with the letter "A." It expires every October 31 and must be renewed for the following year (fee of $33 between August 1 and October 31 or $88 between November 1 and January 15).

ETHICS AND LAWS ABOUT DISCLOSURE OF CLIENT DATA

The federal and state governments now compel most tax professionals to shift a significant part of their business to the Internet (e.g., through mandatory e-filing). Despite its advantages, the Internet also poses risks of theft, fraud, and abuse. Computer security threats range from data breaches to identity theft to phishing attacks (phishing is a type of cyberattack that uses fraudulent emails, text messages, phone calls, or websites to trick people into sharing sensitive data).

A data breach can bring about Circular 230 sanctions for the practitioner. According to Section 10.51(a)(15), a practitioner can be sanctioned for disclosing tax return information in a manner not legally authorized.

In addition to Circular 230 ethical standards, tax practitioners must consider their legal responsibility to safeguard their clients' information. Some laws impose penalties on practitioners who disclose information to third parties without the taxpayer's consent. One data breach can trigger Circular 230 discipline along with statutory penalties.

IRC Section 6713. This federal statute authorizes a penalty on tax preparers for improperly disclosing information furnished to prepare a client's return. The civil penalty is $250 for each unauthorized disclosure, with a maximum aggregate penalty of $10,000 per calendar year. The Section 6713 penalty is imposed when the preparer discloses client information unknowingly or unintentionally.

Even leaks resulting from accidents or theft can trigger penalties if the preparer failed to implement reasonable safeguards. The IRS does not accept ignorance of cybersecurity as a defense. Practitioners are expected to implement proactive measures to prevent data breaches.

IRC Section 7216. If the IRS can establish that a preparer disclosed client information "knowingly or recklessly," then the penalty for such misconduct could be imprisonment of up to one year. A monetary fine of $1,000 could be imposed by Section 7216 instead of (or in addition to) prison.

Authorized disclosures. There are exceptions to the non-disclosure rule. Under Treasury Regulation 301.7216-2, a tax professional may share a client's tax information without consent in a limited set of circumstances, including:

● Disclosure to an IRS employee (pursuant to Tax Code provisions);
● Disclosure or use in an audit under the law of any state or local taxing authority;
● Disclosure to a client's fiduciary, such as the executor of the client's estate;
● Disclosure or use, if necessary, for a tax return preparer to collect payment for tax preparation services;
● Disclosure instructed by court order, subpoena, or to report the commission of a crime.

IRS TIPS ON SAFEGUARDING TAXPAYER INFORMATION

Tax professionals have a legal and ethical responsibility to protect the confidential information they obtain while serving their clients. To help practitioners meet these responsibilities, the IRS encourages tax professionals to review Publication 4557, *Safeguarding Taxpayer Data*, available at https://www.irs.gov/pub/irs-pdf/p4557.pdf.

Publication 4557 provides tips and guidelines to help tax professionals apply the security controls needed in their businesses. Practitioners should take the following precautions to protect client data from the escalating threats in cyberspace:
● Purchase and install top-notch security software that includes a firewall, anti-malware, and anti-virus protection.
● Be alert for phishing scams, and don't click on links or open attachments in email messages from unknown or suspicious email senders.
● Use strong passwords of at least eight characters that include a combination of letters, numbers, and special characters.
● Change passwords regularly to reduce the risk of credential theft.
● Use separate passwords for accessing the computer system and the specific tax software. That way, if the computer system is breached, a client's tax files might not be exposed.
● Train all employees and associates on security protocols for handling client information both inside the office and during remote work.
● When discarding records, you must ensure data is unrecoverable. Paper documents containing taxpayer information must be cross-cut shredded, not just thrown away.
● Prevent former employees from accessing client information by immediately deactivating their passwords and usernames.

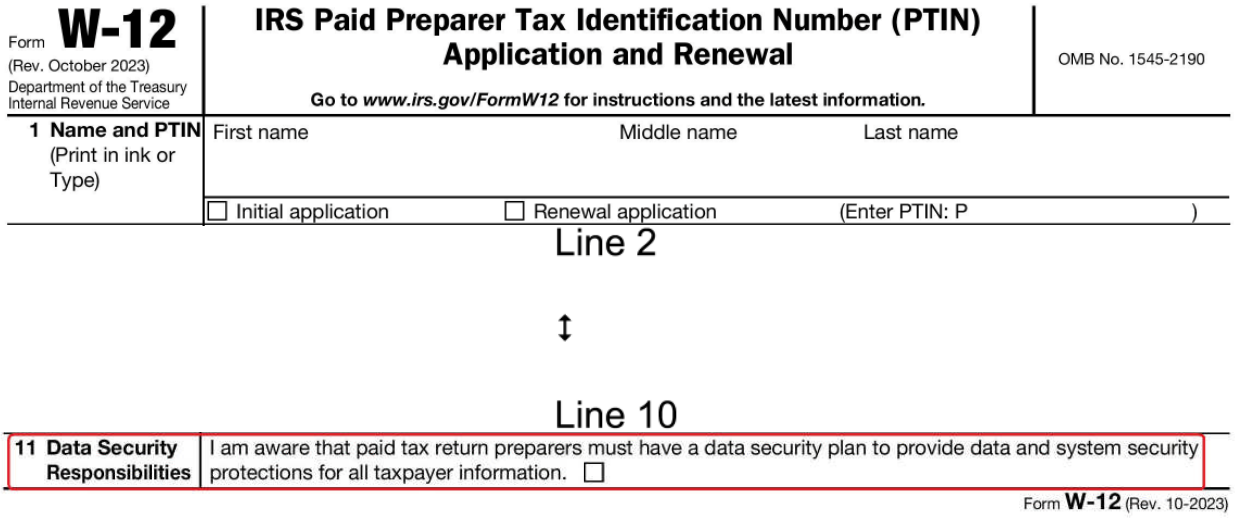
By implementing these measures and following the guidance in IRS Publication 4557, tax professionals can significantly reduce the risk of data breaches and protect both their clients and their businesses.

WRITTEN INFORMATION SECURITY PLAN (WISP)

Tax preparation businesses handle sensitive client information, including financial records and personal data. They are expected to protect their clients' Social Security numbers, bank account numbers, credit card data, telephone numbers, addresses, and other personal information.

The IRS now requires tax preparers to create and maintain a Written Information Security Plan (WISP) as part of their efforts to secure taxpayer data. To obtain or

renew a PTIN, tax professionals must acknowledge their legal obligation to have a WISP.



Form **W-12** (Rev. October 2023) Department of the Treasury Internal Revenue Service

IRS Paid Preparer Tax Identification Number (PTIN) Application and Renewal

Go to *www.irs.gov/FormW12* for instructions and the latest information.

OMB No. 1545-2190

1 Name and PTIN (Print in ink or Type) First name Middle name Last name

☐ Initial application ☐ Renewal application (Enter PTIN: P)

Line 2

↕

Line 10

11 Data Security Responsibilities I am aware that paid tax return preparers must have a data security plan to provide data and system security protections for all taxpayer information. ☐

Form **W-12** (Rev. 10-2023)

Companies that provide tax preparation and related services are required under federal law to develop and maintain WISPs. A WISP is a legal requirement under the Gramm-Leach-Bliley Act and the Federal Trade Commission's Safeguards Rule.

While there isn't a California statute explicitly outlining WISP requirements, the "California Consumer Privacy Act" requires businesses handling personal information of California residents to implement reasonable security practices to protect that data, including the creation and maintenance of a comprehensive security plan outlining their safeguards against unauthorized access or disclosure.

Having robust security measures in place is not just a legal requirement under federal and state laws but a "best practice" for tax professionals. Section 10.33(a)(4) in the next edition of Circular 230 would provide that it is a best practice for tax professionals to create a data security policy to maintain safeguards with respect to client information and establish a plan and procedures for responding to data breaches. The upcoming Circular 230 will acknowledge this duty to have a WISP and will also include an obligation to maintain "technological competence" under proposed Section 10.35.

There is no one-size-fits-all WISP. A WISP can be scaled to fit a company's size and scope of activities. For example, a sole practitioner can use a more abbreviated security plan than a tax prep business with 15 employees.

As a part of the WISP, the federal government requires each tax prep business to designate one or more employees to coordinate its information security program. At a minimum, a WISP will include the core elements described below.

● **Start with an inventory**. Tax prep businesses can only formulate an effective information security program once they know what information they have and where it's

stored. An accurate inventory is the foundation of an effective security program. Discover and disclose all locations where client data is stored. Scan through every computer, device, external hard drive, and file cabinet — then list which contains client data. Email counts, too, as do any software-as-a-service applications and cloud services that might be storing client data.

● **Risk assessment**. After completing the inventory, tax prep businesses should conduct an assessment to identify foreseeable internal and external risks to the security, confidentiality, and integrity of client information. This step is pivotal for understanding the landscape of data vulnerabilities in a tax prep business, and paving the way for targeted risk mitigation strategies.

● **Security policies and procedures**. After conducting an inventory and risk assessment, formulate suitable policies regarding data security, including how to handle and protect personally identifiable information (PII). These policies and procedures should help the tax professional combat risks to the security, confidentiality, and/or integrity of any electronic, paper, or other records containing personal client information.

● **Educating employees**. A WISP should clarify each employee's role in maintaining the security of client information — ideally through annual training sessions. All attendees at such training sessions must certify their familiarity with the requirements for protecting confidential or personal information. Employees with access to a client's PII should read the WISP document and sign a policy acknowledgment form.

● **Access controls**. WISPs should list the technical steps taken to limit and secure who has access to client information. Access to records containing PII should be limited to persons required to know such information to accomplish a legitimate business purpose. Only authorized personnel should have access to sensitive data (using strong passwords and two-factor authentication).

● **Data encryption**. To control electronic access to client data, do not transmit unencrypted PII by email or other electronic transmission. All records and files containing PII transmitted across public networks or wirelessly must be sent using strong encryption methods. Encryption significantly reduces the risk of exposure if data is intercepted.

● **Secure data disposal**. Electronic records containing confidential or personal information should be securely deleted after serving their business needs or after the expiration of the legal retention period. Paper documents containing client information must be shredded once they are no longer needed for business purposes.

● **Incident response plan**. A WISP protects tax prep businesses and clients by providing a blueprint of action in the event of a security incident. An often-overlooked aspect of cybersecurity is having a well-prepared response plan in the event of a breach. This plan should include immediate steps to mitigate damage, methods to investigate and resolve the breach, and strategies for communicating with affected parties. The

immediate response must be swift and effective, involving containment and assessment of the breach.

● **Regular monitoring and compliance**. The IRS emphasizes that a WISP is not a "set it and forget it" exercise but a living document that requires regular updates and reviews to adapt to new threats and changes. Accordingly, tax professionals should implement regular monitoring and testing of WISP-defined protocols, including an annual review of the security plan to keep it up to date.

For help in creating a WISP, visit https://www.irs.gov/pub/irs-pdf/p5708.pdf to read IRS Publication 5708, *Creating a Written Information Security Plan for your Tax & Accounting Practice*. Solo practitioners can use the WISP template in Publication 5708, then scale it down by marking "N/A" for sections related to employee training or multi-office management.

REVIEW QUESTIONS

40. The Annual Filing Season Program (AFSP) is a voluntary program designed to reward participants (who are not attorneys, CPAs, or EAs) with special benefits if they choose to expand their knowledge of federal tax matters. After AFSP participants agree to follow Circular 230 standards (through their online PTIN account), the IRS will:
{A}. issue a Record of Completion to the AFSP participant
{B}. list the AFSP participant's name in a public directory of qualified tax professionals
{C}. allow the AFSP participant to have limited representation rights
{D}. all of the above

41. Adelina holds a valid AFSP Record of Completion for both 2025 and 2026. She prepared and signed a 2025 tax return for her client, Barry. In 2026, Barry's 2025 return is flagged for audit, and he later receives a notice of intent to levy for an unpaid balance from 2024. Under the proposed Section 10.7(c)(1)(viii) of Circular 230, which of the following is true regarding Adelina's representation rights?
{A}. Adelina may represent Barry before a Revenue Agent regarding the 2025 audit AND before a Revenue Officer regarding the 2024 levy.
{B}. Adelina may represent Barry before a Revenue Agent regarding the 2025 audit, BUT she cannot represent him before a Revenue Officer regarding the levy.
{C}. Adelina cannot represent Barry before a Revenue Agent regarding the 2025 audit, BUT she can represent him before a Revenue Officer regarding the levy.
{D}. Adelina cannot represent Barry before any IRS employee (AFSP participants have no representation rights).

42. Greg prepares a federal tax return package for Beatrice. Beatrice refuses to pay the invoiced amount for the service and demands the return of all records. What documents may Greg **withhold** until he receives payment from Beatrice?
{A}. The Form 1040 prepared by Greg for Beatrice during the current representation.
{B}. Beatrice's W-2 form and receipts.
{C]. Beatrice's 1098 and 1099 forms.
{D}. According to Circular 230 Section 10.28, Greg could withhold all of the above from Beatrice.

43. A CRTP participating in the Annual Filing Season Program directs several clients' refunds into a single bank account controlled by the preparer. The preparer then issues cashier's checks to the clients after deducting preparation fees. Which potential consequences could apply?
{A}. A penalty under IRC Section 6695(f) only.
{B}. Discipline under Circular 230 only.
{C}. Both IRC Section 6695(f) penalties and Circular 230 discipline.
{D}. No consequences if clients provided written consent.

44. Camille retired last year and then moved to Mexico. She no longer has a US bank account. Camille and her California-based tax preparer, Damion, conducted their meetings online via Zoom. It turns out that Camille will receive a tax refund this year. Which of the following is true regarding the issuance of Camille's refund?
{A}. The IRS does not allow a direct deposit of a tax refund into a foreign bank account.
{B}. As a result of Executive Order 14247, the IRS has largely ceased issuing paper checks for federal payments, requiring a move toward electronic disbursements.
{C}. Under a new rule, Camille cannot receive her refund by paper check, and Damion is prohibited by Circular 230 from receiving the refund as a direct deposit on her behalf.
{D}. All of the statements above are true.

45. A sole practitioner without employees prepares 150 individual returns annually and stores all client data electronically. Which statement is correct?
{A}. A WISP is only required if the practitioner stores paper records.
{B}. A WISP is optional if the practitioner uses commercial tax software.
{C}. The practitioner must maintain a WISP that is appropriately scaled to the practice.
{D}. The practitioner is exempt from maintaining a WISP due to firm size.

Part E reveals the correct answers to all end-of-chapter review questions while providing feedback on both correct and incorrect responses.

Part D. California Tax Laws (5 CE Hours)

Chapter 15. EXCLUSIONS FROM CALIFORNIA GROSS INCOME

Learning objectives: By the end of this chapter, you will understand California's new conformity date and how the state's tax rules can differ from federal rules. You will also learn how to apply important California exclusions and report differences from federal law on Schedule CA.

Chapter Topics

- CA updates IRC conformity but differences remain
  - » Background
  - » The Conformity Act of 2025 (Senate Bill 711)
- State tax incentives for education
  - » IRC Section 529 plans
  - » Employer-provided educational assistance
  - » Excluding income from forgiven student debt
- ABLE savings accounts
  - » Federal
  - » California
- Trump Accounts
  - » Earnings and employer contributions are taxable
  - » $1,000 federal seed contribution is not taxable
- Wildfire-related payments
  - » Wildfire settlement payments
  - » Wildfire relief payments
  - » Wildfire mitigation payments
- Exclusion for qualified transportation benefits
  - » Federal
  - » California
- Other tax exclusions in California
  - » Native American income exemptions
  - » Military retirement exclusion

CA UPDATES IRC CONFORMITY BUT DIFFERENCES REMAIN

BACKGROUND

In 1939, the Legislature adopted the Revenue and Taxation Code, often abbreviated as "R&TC," which officially codified California tax law. California's income tax laws usually follow federal tax laws, so the R&TC generally matches the Internal Revenue Code (IRC).

"Conformity" is the degree to which state tax codes conform to the federal IRC. Most states have enacted legislation to conform to the IRC in some respect. States either follow federal tax law on a "rolling" or "static" basis. Rolling conformity means the state

automatically adopts changes to the IRC without requiring legislative action. Other states conform legislatively every year and are functionally identical to states with rolling conformity.

Static or fixed conformity means the state follows the IRC as it existed on a specific date. The state does not automatically adopt changes made after that date. In essence, static conformity "freezes" the state's tax code to a particular version of the IRC until the state actively chooses to update it.

California conforms to the IRC on a static or fixed-date basis. One exception to California's fixed-date conformity is that the R&TC automatically conforms to federal tax laws in a few sections of the IRC that address retirement and accounting methods.

When there are differences between federal and state treatment of a given tax policy, California's FTB may require the taxpayer and their tax professional to complete Schedule CA.

Basic outline of Schedule CA

		A Federal Amounts	**B** California Subtractions	**C** California Additions
Part I: Income Adjustment Schedule				
Section A	List of income items from federal Form 1040			
Section B	Additional income items from federal Schedule 1			
Section C	Above-the-line deductions from federal Schedule 1			
Part II: Adjustments to federal itemized deductions				

THE CONFORMITY ACT OF 2025 (SENATE BILL 711)

The Conformity Act of 2025 (Senate Bill 711), signed by Governor Gavin Newsom on October 1, 2025, updates California's tax code by moving the state's official date for matching the federal IRC from January 1, 2015, to January 1, 2025. Before this law, California followed the IRC as of 2015, which caused many differences between federal and state tax rules over those 10 years.

The legislation brings California into line with many federal tax changes made over the past decade. The state now follows federal rules for alimony, like-kind exchanges, and the research and development (R&D) credit.

The Conformity Act of 2025 doesn't automatically adopt every federal change since 2015. Despite general alignment, California continues to diverge from most tax provisions in federal laws enacted between January 1, 2015, and January 1, 2025, such as:

- The Tax Cuts And Jobs Act (TCJA) of 2017;
- The CARES Act of 2020;
- The Consolidated Appropriations Act, 2021;
- The American Rescue Plan Act of 2021 (ARPA);
- The Inflation Reduction Act of 2022; and
- The Federal Disaster Tax Relief Act of 2023.

Senate Bill 711 does not adopt changes from the One Big Beautiful Bill Act (OBBBA) because that federal law was passed after January 1, 2025 (on July 4, 2025).

As we will see in the following chapters, California does not adopt all of the changes made at the federal level; the state remains decoupled from several significant federal provisions, such as AMT rules, bonus depreciation, Section 179 expensing limits, and net operating loss rules.

Federal Tax Provision	CA Conforms?
Repeal of Deduction for Alimony Payments	**Yes**
Like-kind exchanges under IRC Section 1031	**Yes**
Indexing IRA Catch-Up Limit	**Yes**
Higher Catch-Up Limit to Apply at Age 60, 61, 62, and 63	**Yes**
Contribution Limit for SIMPLE Plans	**Yes**
Exclusion of Certain Disability-Related First Responder Retirement Payments	**Yes**
Exclusion of 100% of Gain on Certain Small Business Stock	**No**
Availability of Bonus Depreciation	**No**
Deduction for Qualified Business Income of Pass-Thru Entities	**No**
Increased Limitation for Certain Charitable Contributions	**No**
Limitation on Deduction for State and Local Taxes (SALT)	**No**
Limitation on Deduction for Qualified Residence Interest	**No**
Modification of Deduction for Personal Casualty Losses	**No**
TCJA suspension (OBBBA termination) of Miscellaneous Itemized Deductions	**No**
TCJA suspension (OBBBA termination) of Exclusion for Qualified Bicycle Commuting Reimbursement	**No**
Modification of Exclusion and Deduction for Moving Expenses	**No**
Limitation on Wagering Losses	**No**
Modification of Net Operating Loss Deduction	**No**
Opportunity Zones	**No**
Special Rules for Certain Distributions from 529 Plans to Roth IRAs	**No**

STATE TAX INCENTIVES FOR EDUCATION

IRC SECTION 529 PLANS

Federal. There is no deduction on the federal tax return for contributing to a 529 plan, but the money invested in a 529 account grows tax-deferred. As long as 529 plan distributions are used to pay for qualified education expenses, distributions are 100% tax-free. So, for example, if a taxpayer contributes $5,000 to a 529 plan and it grows to $30,000 by the time their child goes to college, the entire $30,000 can be distributed tax-free and penalty-free (provided it's used to pay for qualifying expenses).

Withdrawals from a 529 plan not used for eligible educational expenses will be subject to taxes and an additional 10% federal tax penalty on any earnings (but not the basis or contribution amount).

Because of the TCJA, federal law allows 529 plans to pay up to $10,000 per year for K-12 school expenses at public, private, or religious schools. The OBBBA has raised this limit to $20,000 per year starting in 2026.

The TCJA changed federal law to allow tax-free transfers from 529 plans to ABLE accounts until December 31, 2025. The OBBBA made this rule permanent.

Before the SECURE Act of 2019 (SECURE 1.0), student debt was not a qualified expense. Now, because of SECURE 1.0, 529 plan money can be used to pay student loans for the account owner or their siblings (such as a brother, sister, stepbrother, or stepsister). The account owner can pay a sibling's student loan without changing the account's beneficiary. There is a lifetime limit of $10,000 per person for using 529 funds on student loans.

Because of SECURE 1.0, 529 plan beneficiaries can also use the money to pay for qualified costs in apprenticeship programs approved by the US Department of Labor. These programs usually combine on-the-job training with classroom learning, often at community colleges.

Under the OBBBA, federal law now allows tax-exempt distributions from 529 plans for qualified postsecondary credentialing expenses. This change, in new IRC Section 529(f), expands 529 plans from just "college savings plans" to broader "career savings plans" by including professional certificates and job training.

SECURE 2.0 allows people who opened a 529 plan at least 15 years ago to move unused money into a Roth IRA. Account owners can transfer up to $35,000 in their lifetime from a 529 plan to a Roth IRA. The amount rolled over cannot be more than what was contributed in the last five years. The money must go directly to a Roth IRA for the same person who was the 529 plan beneficiary.

California. "ScholarShare" is California's official 529 plan. Qualified withdrawals and earnings from ScholarShare or other state 529 plans can be excluded from California gross income [R&TC Section 17140.3]. To qualify, withdrawals must pay for the beneficiary's higher education expenses (not just in California). California and federal law both consider tuition, books, and supplies as qualified expenses. In California, 529 plan money used for room and board is also tax-free if the student is enrolled at least half-time.

A distribution not used for qualified higher education expenses would be subject to California state income tax plus a California state penalty on the earnings. For Californians, the earnings portion of any distribution from a 529 plan used to pay for tuition at an elementary, middle, or high school will be subject to California income tax

and a penalty, as reported on FTB 3805P. R&TC sections 17140.3(d)(2)(C) and 17140.3(f)(2)(C) affirm that distributions for K-12 expenses will "be includable in the gross income of the distributee."

Example. Viviana has been contributing to a California ScholarShare 529 plan since her son was born. Viviana's 16-year-old son now attends 11th grade at a private school that costs $13,553 per academic year. If a $10,000 withdrawal is made from the ScholarShare plan to help pay for the son's private school tuition in 2026, California will tax and penalize part of that distribution. Although federal law allows 529 plans to pay for K-12 expenses, California does not follow this TCJA change, so a 2.5% penalty applies, calculated on FTB 3805P. The penalty amount will be reported on the "Other Taxes" section of Form 540.

California law aligns with recent federal changes to 529 plans. For instance, earnings on qualified withdrawals for apprenticeship programs and the repayment of student loans (with a lifetime limit of $10,000) will not be subject to California tax. The state also allows tax-free transfers from 529 plans to ABLE accounts, up to the annual federal gift tax exclusion amount (as incorporated into the ABLE contribution limit).

On July 4, 2025, the OBBBA changed federal law and allowed 529 funds to be used for postsecondary credentialing expenses (e.g., occupational licenses, professional certifications, and continuing education required to maintain a credential). California law conforms to IRC Section 529 as of the specified date of January 1, 2025, with modifications, and does not follow the rules about postsecondary credentialing expenses.

Where does California stand on the federal provision that allows nontaxable transfers from 529 plans to Roth IRAs? California has not adopted the federal rule allowing tax-advantaged rollovers from 529 plans to Roth IRAs. On the state level, 529-to-IRA rollovers are treated as nonqualified withdrawals. California residents who do this rollover will be subject to state income tax and an additional 2.5% penalty on earnings.

Purpose of Withdrawal from 529 Plan	Federal Treatment	California Treatment	Conformity?
Up to $20,000 (per calendar year) for K-12 expenses	**Nontaxable**	**Taxable**	**No**
Expenses for qualified apprenticeship program expenses	**Nontaxable**	**Nontaxable**	**Yes**
Up to $10,000 (lifetime limit) used for student loan payments	**Nontaxable**	**Nontaxable**	**Yes**
Rollover to an ABLE account (up to the annual gift tax exclusion)	**Nontaxable**	**Nontaxable**	**Yes**
Expenses for postsecondary credentialing	**Nontaxable**	**Taxable**	**No**
Up to $35,000 (lifetime limit) rolled over to a Roth IRA	**Nontaxable**	**Taxable**	**No**

EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE

Federal. IRC Section 127 lets employees exclude up to $5,250 of "employer-provided education assistance" from their income. This usually includes tuition reimbursement and continuing education costs. Educational assistance programs must be written plans that meet the specific rules in Section 127.

In 2020, the CARES Act temporarily expanded tax-free employer education assistance to include student loan payments made by employers. Employers who update their Section 127 plan can pay principal and interest on an employee's qualified student loan. Payments can be made directly to lenders or reimbursed to employees.

A federal law passed in late 2020 extended the CARES Act rule for 5 years. Employers could keep paying up to $5,250 per employee each year for eligible education costs, like student loans, without adding to the employee's federal taxable income through December 31, 2025.

This benefit was supposed to end on December 31, 2025, but the OBBBA made permanent the rule allowing employers to provide up to $5,250 per year in tax-free help with employee student loan payments. Starting in 2027, the $5,250 limit will adjust for inflation.

California. R&TC Section 17151 lets employees exclude from income up to $5,250 paid by their employer for education assistance under a program like IRC Section 127. However, California does not follow the federal rule that excludes employer help with student loan payments or the future inflation adjustments to the $5,250 limit.

Student loan payments are not excluded from the employee's California income. Any student loan payments made by an employer must be added back to the employee's California income on Schedule CA.

Example. Latanya works for a company with a Section 127 education assistance program. The employer amended the program to include student loan payments. Latanya asked the employer to make her monthly student loan payments for the last six months of the year. Since each monthly payment is $300, the annual total reached $1,800 (well below the $5,250 limit). While the federal government would allow Latanya to exclude the $1,800 from her gross income, California would require her to include this amount on her state tax return. She would enter $1,800 on Schedule CA, line 1a, column C. Ultimately, the extra income will flow over to her Form 540.

SCHEDULE

California Adjustments — Residents **CA (540)**

Important: Attach this schedule behind Form 540, Side 5 as a supporting California schedule.

Name(s) as shown on tax return	SSN or ITIN
Latanya Jackson	123-45-6789

Part I Income Adjustment Schedule **Section A – Income** from federal Form 1040 or 1040-SR	**A** Federal Amounts (taxable amounts from your federal tax return)	**B** Subtractions See instructions	**C** Additions See instructions
1 a Total amount from federal Form(s) W-2, box 1. See instructions 1a	52,729		1,800
b Household employee wages not reported on federal Form(s) W-2 . . . . . 1b			

EXCLUDING INCOME FROM FORGIVEN STUDENT DEBT

Federal. Before the TCJA, forgiven student loan debt could be excluded from income if the borrower had to work in a certain field for a set time. For example, one popular repayment program that has provided tax exclusion for decades is the Public Service Loan Forgiveness (PSLF) program. Under this program, if a student works for 10 years in a qualifying job, any remaining loans after the 10th year of repayment are forgiven without being taxed as income.

The TCJA added a new paragraph (5) to IRC Section 108(f) that excludes from gross income any student loan debt forgiven due to the student's disability or death. The TCJA provision covers eligible loans discharged from January 1, 2018, to December 31, 2025.

One common type of student loan involves an income-driven repayment (IDR) plan. IDR plans are those in which monthly payments are based on the borrower's monthly income, allowing borrowers with lower incomes to make lower monthly payments. Section 1098e of Title 20 governs the Education Department's IDR plans, which cancel a borrower's remaining debt after up to 25 years of monthly payments. Federal student loan forgiveness under IDR plans was typically treated as taxable income until 2021.

The American Rescue Plan Act (ARPA) of 2021 amended IRC Section 108(f)(5) to exclude student loan discharges from gross income for the period between December

31, 2020, and January 1, 2026. In other words, forgiven student loan debt during this time period was not subject to federal taxation. Because of ARPA, virtually all student loan debt forgiven by December 31, 2025, could be excluded from the borrower's gross income.

The OBBBA permanently preserved the death-and-disability discharge exclusion. However, it allowed the broad ARPA tax exclusion for forgiveness to expire. Beginning in 2026, most forgiven student loan debt (including under IDR plans) is once again treated as taxable income at the federal level.

California. California generally conforms to the federal income tax rules governing the cancellation of student loan debt under IRC Section 108 as of the specified date of January 1, 2025, with modifications explained below.

The following types of student loan forgiveness generally remain excluded from California taxable income in 2026 because they are protected under permanent IRC Section 108(f) provisions to which California conforms:
- Public Service Loan Forgiveness (PSLF);
- Certain profession-based repayment assistance programs; and
- Death or total-and-permanent-disability discharges.

In California, borrowers may escape the tax hit if the student loan is forgiven under a provision specifying that the debt is discharged because the borrower worked in a particular field for a period of time. For example, teachers, nurses, doctors, and attorneys agreeing to serve in rural or low-income areas in exchange for the cancellation of their student loans should not have California gross income from the debt cancellation.

Example. A California physician working for a nonprofit hospital receives PSLF forgiveness in 2026 after making 120 qualifying payments. The forgiven balance is excluded from both federal and California gross income.

R&TC Section 17144.8 conforms to the TCJA change (which the OBBBA made permanent) regarding the exclusion from a borrower's gross income of the amount of student loan indebtedness discharged due to the student's death or disability. California conforms to this provision for the gross income exclusion for student loan discharges due to the death or disability of the debtor for discharges after December 31, 2025. However, it does not conform to the OBBBA change requiring the borrower to have a valid SSN on the return for the tax year.

AB 111 (2023) expressly conformed California to the ARPA exclusion for forgiven student loans, but only for a limited time. From January 1, 2021, through December 31, 2025, California followed the federal rule that allowed borrowers to exclude forgiven student loan amounts from their gross income if the loans were used for postsecondary educational expenses.

In 2026, most forgiven student loan debt is taxable in California because the federal ARPA exclusion expired after 2025, and California has not adopted a permanent exclusion for 2026.

Example. A California taxpayer has $85,000 forgiven under an IDR plan in 2026 after 25 years of payments. Unless another exclusion applies (such as insolvency or bankruptcy), the $85,000 generally constitutes gross income from discharge of indebtedness for both federal and California income tax purposes. The taxpayer may receive a federal Form 1099-C reporting the discharged debt.

Forgiveness Type	Federal 2026	California 2026
IDR forgiveness	Taxable	Taxable
PSLF	Not taxable	Not taxable
Death/disability discharge	Not taxable	Not taxable

ABLE SAVINGS ACCOUNTS

FEDERAL

The Achieving a Better Life Experience (ABLE) Act of 2014 added Section 529A of the Internal Revenue Code, which authorized a tax-advantaged savings account for individuals with disabilities. One of the most significant benefits of the ABLE account is that the savings held in the plan, up to a current limit of $100,000, do not count toward the $2,000 personal asset limit for individuals to qualify for public benefits. Before the federal ABLE Act, an individual receiving government assistance could not save more than $2,000 without their benefits being suspended.

TCJA improvements in 2017. Under the TCJA, a family could move unused 529 plan funds into an ABLE account for the same beneficiary (or a qualifying sibling) without triggering tax or penalty, as long as the rollover — combined with all other contributions — did not exceed that beneficiary's annual ABLE contribution limit.

The TCJA also enabled eligible individuals with disabilities to qualify for the saver's credit. Contributions to an ABLE account could count toward the saver's credit if they're made by the designated beneficiary, who must be working and not saving for retirement. ABLE account beneficiaries may claim the saver's credit for a percentage of their contributions.

The "ABLE to Work" provision in the TCJA allows ABLE account owners who work and earn income to contribute more than the standard annual limit. The general rule is that ABLE account beneficiaries can contribute up to $20,000 in 2026. However, eligible working individuals living in California can contribute an additional amount equal to their current year's gross income, up to $15,650. In other words, a working beneficiary can contribute up to $35,650 ($20,000 + $15,650) in 2026.

OBBBA improvements in 2025. The OBBBA significantly expanded and enhanced ABLE accounts beginning in 2026. The law made several previously temporary ABLE provisions permanent, including the "ABLE to Work" rule permitting employed beneficiaries to contribute above the normal annual contribution limit, the ability for beneficiaries to qualify for the saver's credit based on ABLE contributions, and tax-free rollovers from Section 529 education plans into ABLE accounts. Together, these changes greatly expand the usefulness of ABLE accounts as tax-advantaged savings vehicles that help disabled individuals save for qualified disability expenses without jeopardizing eligibility for means-tested government benefits.

ABLE Age Adjustment Act improvement in 2026. Under prior law, ABLE accounts could be opened only for individuals who became disabled before age 26. However, effective in 2026, ABLE accounts can be set up for individuals who become disabled before age 46.

Individuals will not need to be under 46 in 2026 to be eligible for this account. Instead, they must have only been under 46 when they became disabled. In other words, someone who is 56 years old in 2026 can open an ABLE account if they became disabled at the age of 36.

CALIFORNIA

A CalABLE account is a state-administered, tax-advantaged savings and investment account designed specifically for individuals living with disabilities. It allows contributions up to the annual federal ABLE limit, with earnings excluded from federal and California income tax when used for qualified disability expenses.

Account owners who are employed can contribute above the $20,000 annual contribution limit, provided they do not participate in an employer-sponsored retirement plan. If the account owner earns $15,650 or more, they could have up to $35,650 deposited into their CalABLE account in a year. If the account owner earns less than $15,650, their contribution would be lower.

Federal law permits a designated beneficiary of an ABLE account to claim the saver's credit for contributions made to their ABLE account. California does not conform to the saver's credit under IRC Section 25B and has no comparable credit. While there is no state tax credit for contributing to a CalABLE account, beneficiaries may still claim the saver's credit on their federal tax returns if they meet the requirements.

In 2019, California Assembly Bill 91 conformed to the TCJA provision allowing tax-free rollovers from Section 529 plans into ABLE accounts, but only for contributions made before January 1, 2026. The OBBBA permanently extended the federal tax-free rollover rule; however, California has not conformed to that federal change. As a result, rollovers from a 529 plan into a CalABLE account occurring on or after January 1, 2026, are no longer tax-free for California income tax purposes.

California has conformed to the ABLE Age Adjustment Act through Assembly Bill 339 (passed in 2023). AB 339 increases the age limit for individuals eligible for the CalABLE Program from 26 to 46, effective January 1, 2026.

ABLE PROVISION	FEDERAL	CALIFORNIA
Standard contribution limit	$20,000 in 2026	Conforms
Eligibility age	Disability must have occurred before age 46 beginning in 2026	Conforms through AB 339
"ABLE to Work" Add-on	$20,000 base + earned income (max $15,650), total up to $35,650	Conforms
Saver's credit for ABLE contributions	Eligible if working beneficiary meets requirements	Does not conform; no state credit available
529-to-ABLE Rollovers	Permanently tax-free under OBBBA	Tax-free before 2026; taxable after 2025

TRUMP ACCOUNTS

EARNINGS AND EMPLOYER CONTRIBUTIONS ARE TAXABLE

Because Trump Accounts were established by federal law on July 4, 2025 — after California's January 1, 2025, conformity cutoff — the state does not recognize these accounts as tax-deferred vehicles. Accordingly, earnings within a Trump Account will be subject to California tax on an annual basis rather than being deferred until distribution.

California also does not conform to the exclusion for employer contributions to Trump Accounts, meaning such contributions would be taxable income to the employee for California purposes.

$1,000 FEDERAL SEED CONTRIBUTION IS NOT TAXABLE

Under IRC Section 6434, created by the OBBBA, the federal government makes a $1,000 pilot contribution for children born from 2025 to 2028. The statute treats the amount as a payment against federal tax that is refunded directly into the eligible child's Trump Account.

California does not conform to IRC Section 6434. Nevertheless, because the federal provision characterizes the payment as a tax refund rather than gross income, the FTB has indicated that the initial $1,000 pilot contribution itself generally would not be treated as taxable income for California purposes.

WILDFIRE-RELATED PAYMENTS

California residents must include wildfire-related payments in gross income unless a specific exclusion applies. That said, most common wildfire-related payments — such as legal settlements, relief payments, and mitigation payments — do qualify for an

exclusion under California law.

WILDFIRE SETTLEMENT PAYMENTS

Under Senate Bill 132 (June 2025) and SB 159 (September 2025), California provides a broad exclusion for wildfire settlement payments. Under R&TC sections 17138.7 and 24309.2, qualified taxpayers may exclude qualified amounts received from a settlement entity in connection with a qualified wildfire disaster in California for tax years beginning on or after January 1, 2021, and before January 1, 2030.

The Legislature broadened the exclusion so it is no longer confined to only a few named wildfire settlement programs (e.g., Kincade, Zogg, Thomas and Woolsey). These exclusions broadly apply to qualified settlement payments received in connection with a qualified California wildfire disaster, including many payments relating to property losses, evacuation impacts, business losses, or other wildfire-related damages.

If the wildfire-related payment is a "qualified wildfire disaster settlement" (e.g., from a court-supervised settlement program or trust tied to a California wildfire), residents should generally exclude it from California gross income.

Example. Bernadette receives $425,000 in 2026 from a utility-sponsored settlement program relating to a California wildfire for which the Governor declared a state of emergency. Because the payment qualifies under R&TC Section 17138.7, she excludes the payment from California gross income and does not report it on Form 540.

If a qualified taxpayer included income for a qualified amount received from a settlement entity in a prior year, the taxpayer can file an amended return for that year within the normal statute of limitations.

If the payment does not meet the statutory definition of a "qualified wildfire disaster settlement" (for example, some undocumented private payments or non-settlement-type compensation), it may still be treated as includible in California gross income unless another exclusion applies.

WILDFIRE RELIEF PAYMENTS

Wildfire relief payments provide immediate financial assistance to individuals and families who have lost homes, belongings, or experienced other damages due to a wildfire. Relief payments are typically distributed by agencies like FEMA after a wildfire event, following a disaster declaration. These payments address immediate needs arising from a wildfire, such as temporary housing, food, and other essentials.

California generally conforms to IRC Section 139, which excludes many qualified disaster relief payments — including many FEMA and emergency assistance payments — from gross income.

WILDFIRE MITIGATION PAYMENTS

Wildfire mitigation payments provide financial assistance for projects that reduce wildfire

risk and protect homes and communities from future wildfire damage. Mitigation payments are provided before a wildfire occurs, focusing on prevention and preparedness. These payments help California homeowners pay for home hardening, defensible space creation, or community-wide wildfire resilience initiatives. Homeowners can receive up to $40,000 for home hardening and defensible space projects.

California Senate Bill 946, enacted in 2024, provides an exclusion from gross income for payments received by property owners for wildfire loss mitigation through the California Wildfire Mitigation Financial Assistance Program. This exclusion applies to tax years beginning on or after January 1, 2024, and before January 1, 2029. The exclusion covers specific payments allocated for reducing wildfire risks to residential structures and their contents [R&TC Section 17138.8].

Federal law primarily addresses relief payments and settlements, not mitigation payments. There is no federal tax exclusion for payments received by Californians for wildfire loss mitigation. If any qualified amount was included as income for federal purposes, enter the amount on Schedule CA, Part I, Section B, line 8z, column B.

Example. A homeowner receives a $15,000 grant in 2026 from the California Wildfire Mitigation Financial Assistance Program for home hardening. While this is included in federal gross income, the homeowner will subtract it on their California Schedule CA as it is specifically excluded under state law.

Payment type	California treatment	Tax years covered
Wildfire settlement payments	Generally excluded under R&TC Section 17138.7	Tax years 2021 through 2029
Wildfire relief payments	Generally excluded under IRC Section 139 conformity	Permanent
Wildfire mitigation payments	Generally excluded under R&TC Section 17138.8	Tax years 2024 through 2028

EXCLUSION FOR QUALIFIED TRANSPORTATION BENEFITS

FEDERAL

Federal law no longer offers an employer deduction for qualified mass transit and parking benefits, except when necessary to ensure employee safety. Congress repealed the employer deduction for mass transit and parking benefits by amending IRC Section 274, but did not change Section 132. With Section 132 unchanged, employees can still exclude mass transit and parking benefits, which they can continue to purchase with elective salary deferrals. For 2026, the monthly exclusion is:

- Up to $340 for the combined value of commuter highway vehicle transportation and transit passes; and
- Up to an additional $340 for qualified parking.

Example. Marilen elects salary reductions of $400 per month for transit passes and $400 per month for qualified parking. For federal purposes, up to $340 of transit benefits and up to $340 of parking benefits may be excluded from income. Therefore, $60 of transit benefits and $60 of parking benefits are taxable wages and must be included in Marilen's federal gross income.

The OBBBA permanently repealed the federal exclusion for qualified bicycle commuting reimbursements, effective for tax years beginning after December 31, 2025. IRC Section 132(f)(8), which had previously provided for this exclusion (and which was temporarily suspended by the TCJA from 2018 through 2025), has been eliminated. Any employer-provided bicycle commuting reimbursements are now taxable wages to the employee and subject to withholding and payroll taxes.

CALIFORNIA

California does not conform to the federal limits on qualified transportation expenses. California decoupled from federal Section 132(f) limits in the early 1990s. The state now provides its own independent exclusion for qualifying ridesharing and alternative transportation benefits under R&TC Section 17149.

California does not apply the federal monthly exclusion limits under IRC Section 132(f) to qualifying transportation benefits covered by R&TC Section 17149.

California's special commuter provisions have historically been more taxpayer-friendly than the federal rules. For instance, R&TC Section 17149 allows exclusion of the fair market value of transportation benefits, not just salary-reduction amounts. Also, California has a broader list of qualifying benefits:

- Commuting in a vanpool, subscription taxi pool, carpool, bus pool, private commuter bus, or ferry;
- Transit passes to be used by employees or their dependents (other than transit passes to be used by students who are in elementary or secondary school);
- Free or subsidized parking for employees who participate in ridesharing arrangements;
- Travel to or from a telecommuting facility; or
- Use of any other alternative transportation method that reduces the use of a motor vehicle by a single occupant for trips to or from that individual's place of employment.

California's R&TC Section 17149 still includes bicycling to or from work as an excludable transportation benefit with no monthly cap. Since the federal exclusion is now permanently gone, an employee receiving bicycle commuting benefits will have a Schedule CA adjustment every year.

Example. If Marilen contributes $400 to parking and/or $400 to transit expenses in any month, she has exceeded the federal limit of $340. Therefore, the qualified transportation benefits above $340 are included in Marilen's wages as taxable income on her federal return. Since California does not impose any monthly limit on eligible transportation benefits, Marilen should adjust her wage income (as reported on her federal 1040) downward on her state return. Because the excess transportation

benefits are included in federal wages but excluded for California purposes, Marilen would claim a subtraction adjustment on Schedule CA, Part I, Section A, line 1h, column B.

Feature	Federal (2026)	California (2026)
Qualified Parking	Excludable up to $340/month	Fully excluded (R&TC §17149)
Transit Pass / Vanpooling	Excludable up to $340/month	Fully excluded (R&TC §17149)
Bicycle Commuting Reimbursement	Taxable	Excluded (R&TC §17149)
Scope of qualifying benefits	Narrow (transit, vanpool, parking)	Broad (vanpool, subscription taxi, ferry, telecommute travel, bicycling, etc.)

OTHER TAX EXCLUSIONS IN CALIFORNIA

NATIVE AMERICAN INCOME EXEMPTIONS

Federal law does not provide a general exemption for income earned by Native Americans. The controlling federal rule is the source of the income, not the taxpayer's identity. Unless a specific treaty or statute provides an exemption, federal income tax applies even to income earned in Indian country.

In California, enrolled members of federally recognized tribes do not have to pay state income tax if they live in Indian country and earn their income from reservation sources. There are two sets of exemption rules: one for income from work, such as wages, and another for per capita payments. To qualify for the earned income exemption, a tribal member must meet these requirements:

- Be enrolled in a federally recognized California Indian tribe;
- Reside within any California Indian country; and
- Earn reservation source income from within California Indian country.

The requirements for per capita income are stricter. To qualify, a tribal member must meet all of the following:

- Be enrolled in a federally recognized California Indian tribe;
- Reside in their own tribe's California Indian country; and
- Receive reservation source income from the same California Indian country in which they live and are enrolled.

California treats active-duty military compensation of an enrolled member domiciled in and living in Indian country as reservation-sourced earned income. Because military pay is treated as earned income, the earned-income framework applies — not the per-capita framework. For active-duty military pay, the enrolled member may live in any federally recognized California Indian country, and the income remains reservation-sourced and exempt from California taxation. They do not have to live specifically on their own tribe's land.

Taxpayers may use the optional FTB 3504, *Enrolled Tribal Member Certification*, to declare reservation residency and tax-exempt status.

Wage income exempt from California taxation is generally adjusted on Schedule CA, Part I, Section A, line 1a through line 1h, column B. Other federally taxable income exempt for California purposes is generally adjusted on Schedule CA, Part I, Section B, line 8z, column B.

Example. Erika is an enrolled member of the Pechanga Band of Indians in southern California. She lives on a different tribe's Indian country — the Torres-Martinez Desert Cahuilla Indian (TMDCI) Reservation in the Coachella Valley. Erika works for a clinic on the TMDCI Reservation. Her wages are exempt from California tax because she is an enrolled member of a California tribe living and working in California Indian country. However, if Erika receives a per capita payment from her own tribe (Pechanga), that payment is taxable because she does not reside on the Pechanga Reservation.

This type of income...	Is TAX-EXEMPT in CA if recipient is a member of a...	Residing in...	That is sourced from...
Earned Income (Wages)	Federally recognized CA tribe	Any California Indian country	Any California Indian country
Per Capita Payments	Federally recognized CA tribe	Own tribe's California Indian country	Own tribe's California Indian country

MILITARY RETIREMENT EXCLUSION

California generally taxes military retirement income. However, beginning in 2025, California enacted (via SB 132) a temporary partial exclusion for certain military retirement and survivor benefit payments. California was previously the only state to fully tax military retirement income, making this a landmark shift that affects roughly 145,000 military retirees in the state.

For tax years beginning on or after January 1, 2025, and before January 1, 2030, California law allows a qualified taxpayer to exclude up to $20,000 of:

- Retirement pay received from the federal government for service in the uniformed services (as defined under federal law), or
- Annuity payments received pursuant to a United States Department of Defense Survivor Benefit Plan (SBP).

The qualified taxpayer's federal AGI must not exceed $250,000 if a joint filer or qualifying surviving spouse; a $125,000 threshold applies to all other filing statuses — including single, married filing separately, and head of household.

There is no parallel federal exclusion (military retirement pay is fully taxable under federal law), so an adjustment on the California tax return is always required if the taxpayer qualifies. Taxpayers claim this exclusion on Schedule CA, Part I, Section A, line 5.

Example. A retired Army colonel living in California receives $36,000 in annual military retirement pay. His federal AGI is $110,000. He may exclude $20,000 from California gross income (the cap) and report only $16,000 as taxable to California. He claims the exclusion on Schedule CA, Part I, Section A, line 5, column B. If his federal AGI had been $130,000, he would not have qualified and would have had to include the full $36,000 in California gross income.

REVIEW QUESTIONS

46. California updated its IRC conformity date to January 1, 2025, under the Conformity Act of 2025 (Senate Bill 711). Which federal law listed below was enacted after that date and therefore falls outside the state's updated fixed-date conformity window?
{A}. The Tax Cuts and Jobs Act
{B}. The American Rescue Plan Act
{C}. The Inflation Reduction Act
{D}. The One Big Beautiful Bill Act (OBBBA)

47. Amari is a California resident who became disabled at age 36. He is now 56, is employed, earns $18,000 in 2026, and does not participate in an employer retirement plan. What is the maximum amount Amari may contribute to a CalABLE account in 2026?
{A}. $18,000; CalABLE contributions cannot exceed annual earned income.
{B}. $20,000; CalABLE contributions are strictly capped at the standard 2026 annual limit.
{C}. $35,650; CalABLE contributions may consist of the $20,000 annual limit plus an additional $15,650 "ABLE to Work" contribution.
{D}. $0; eligibility for CalABLE accounts is limited to individuals who became disabled before age 26.

48. A California homeowner receives a $30,000 grant in 2026 from the California Wildfire Mitigation Financial Assistance Program for home-hardening improvements. How is the wildfire mitigation payment reported for federal and California income tax purposes?
{A}. The grant is excluded from both federal and California gross income.
{B}. The grant is included in federal gross income, but is excluded from California gross income under R&TC Section 17138.8.
{C}. The grant is excluded from federal gross income only; California has no mitigation payment exclusion.
{D}. The grant is fully taxable at both the federal and California levels because it was received before any wildfire occurred.

Part E reveals the correct answers to all end-of-chapter review questions while providing feedback on both correct and incorrect responses.

Chapter 16. NON-ITEMIZED DEDUCTIONS IN CALIFORNIA

Learning objectives: After reading this chapter, you should be able to tell the difference between federal and California rules for non-itemized deductions, identify which deductions reduce AGI versus taxable income, understand when California does or does not follow federal tax laws, and know when Schedule CA adjustments are needed.

Chapter Topics

- Above-the-line deductions
  - » Deduction for K-12 educators
  - » Health Savings Accounts
  - » Deduction (and exclusion) for moving expenses
  - » Student loan interest deduction
- Tax treatment of divorce-related income
  - » Federal
  - » California
- Standard deduction
  - » Federal
  - » California
- New federal Schedule 1-A deductions (2025–2028)
  - » Enhanced deduction for seniors
  - » No tax on tips
  - » No tax on overtime
  - » No tax on car loan interest
- Permanent charitable deduction for non-itemizers
  - » Federal
  - » California

ABOVE-THE-LINE DEDUCTIONS

DEDUCTION FOR K-12 EDUCATORS

Federal. The federal educator expense deduction allows eligible K-12 teachers, instructors, counselors, principals, and classroom aides who work at least 900 hours in a school year to deduct unreimbursed classroom and professional development expenses. For 2026, the IRS set the above-the-line limit at $350 per educator, or $700 for married couples when both spouses qualify. Qualifying expenses include books, supplies, technology, supplemental materials, and professional-development costs tied to student instruction.

In 2026, the OBBBA improves the educator deduction. The standard above-the-line deduction remains, but the OBBBA adds a new itemized deduction for qualified educator expenses above that limit. Further, the OBBBA broadens eligibility to include interscholastic sports administrators and coaches. The law also expands eligible expenses to include athletic supplies for health and physical education. These changes

allow educators to deduct significantly higher out-of-pocket costs than previously permitted.

California. California generally conforms selectively to the Internal Revenue Code, but it historically has not conformed to the federal educator-expense deduction under IRC Section 62(a)(2)(D). Because of this, California taxpayers who claim the federal deduction must add it back on their California return, which raises their California AGI and taxable income. In simple terms, a California teacher might get a federal tax break for unreimbursed classroom expenses but get no similar deduction on their California return.

California also does not follow the OBBBA's new itemized educator deduction, which starts in 2026. Since California's conformity date is January 1, 2025, any federal changes made after that — including the OBBBA's expanded eligible expenses, broadened educator categories, and a new uncapped Schedule A deduction — are not incorporated into California law. Educators must cancel out the federal deduction on Schedule CA by adding those expenses back into their California taxable income.

Example. Celia is a California resident and a high-school physical education teacher in 2026. She spends $2,400 of her own funds on classroom athletic equipment, instructional supplies, and qualifying professional development seminars. For federal purposes, Celia may claim the $350 above-the-line educator deduction. Under the OBBBA, she may also claim an additional $2,050 itemized deduction for qualified educator expenses exceeding the $350 cap. Her total federal deduction, therefore, equals $2,400. California does not conform to either deduction. Celia must add back the $350 federal adjustment on Schedule CA (Part I, line 11, column B). California also disallows the additional $2,050 OBBBA educator itemized deduction. Consequently, Celia's unreimbursed educator expenses do not reduce her California taxable income.

HEALTH SAVINGS ACCOUNTS

Federal. IRC Section 223 allows eligible taxpayers to deduct contributions to a Health Savings Account (HSA). A person must be covered by a high-deductible health plan (HDHP) to be eligible to contribute to an HSA. For 2026, the contribution limits are $4,400 for individual coverage and $8,750 for family coverage, with an extra $1,000 allowed for people age 55 and older.

The HSA deduction provides a "triple-tax advantage." First, contributions made by the taxpayer are deductible above the line, meaning the deduction is allowed regardless of whether the taxpayer itemizes deductions. Second, earnings in the account grow tax-free. Third, distributions used for qualified medical expenses are also excluded from income.

Employer contributions are generally excluded from wages rather than deducted by the employee.

The OBBBA greatly expanded who can use HSAs starting in 2025 and 2026. The law now lets HDHPs cover telehealth and remote care services before the deductible is met without losing HSA eligibility. Starting in 2026, people with Bronze or catastrophic plans from the ACA Marketplace can usually contribute to HSAs, even if their plans do not meet the usual HDHP rules. The OBBBA also allows some direct primary care plans to work with HSAs and lets HSA money pay for certain direct primary care fees tax-free, up to $150 per month for individuals.

California. California does not conform to federal HSA rules, either before or after the OBBBA changes. The state does not offer any special tax treatment for HSAs. There is no deduction or exclusion for HSA contributions, so California taxpayers must add the contribution amount to their income on Schedule CA (Part I, Section C, line 13).

In California, employer contributions to HSAs are taxable. Employees need to adjust their income on Schedule CA (Part I, Section A, line 1h, column C) to include these amounts.

Any interest or dividends earned in an HSA must be reported as taxable income on the California return each year. Taxpayers should enter these earnings as an adjustment on Schedule CA.

Since California follows federal law only up to January 1, 2025, none of the OBBBA changes affect California taxes.

RULE	FEDERAL (2026)	CALIFORNIA (2026)
Deduction for HSA contributions	Allowed above the line for eligible individuals	Not allowed
Employer HSA contributions	Excluded from wages	Generally taxable
Account Earnings	Tax-free	Taxable annually
OBBBA expansions	Adopted	Not adopted
Qualified withdrawals	Tax-free	No special treatment

DEDUCTION (AND EXCLUSION) FOR MOVING EXPENSES

Federal. Before 2018, IRC Section 217 allowed workers to deduct "qualified moving expenses" from adjusted gross income. To qualify, the new job had to be at least 50 miles farther from the taxpayer's old home than the previous job was.

Employer reimbursements for qualified moving expenses also could be excluded from gross income under IRC Section 132.

The TCJA temporarily suspended both the Section 217 deduction and the Section 132(g) income exclusion through 2025, except for active-duty military members moving because of permanent orders.

The OBBBA removed the TCJA's end date, making the suspension permanent for civilians starting in 2026. Important exceptions still apply. Active-duty military members can still deduct unreimbursed moving expenses if the move is due to military orders and a permanent change of station. The OBBBA also expanded benefits to certain employees and new appointees of the Intelligence Community beginning in 2026.

The TCJA and OBBBA did not change the definition of "qualified moving expenses," which include transporting household goods, storage, as well as travel and lodging costs (meals are nondeductible). Eligible taxpayers do not have to meet any distance or time test if moving on permanent change of station orders, and would claim the deduction on Form 3903 and Schedule 1 of Form 1040.

California. California does not conform to the TCJA suspension or the OBBBA's permanent removal of the civilian moving expense deduction. California does not limit eligibility to military and Intelligence Community workers like the federal rules do. California also lets taxpayers exclude employer-paid moving reimbursements that are taxable on the federal return. Thus, California partially decouples from the federal suspension of moving-expense deductions for civilians while generally conforming to the military exception.

R&TC sections 17072 and 17076 allow Californians to deduct work-related moving expenses, subject to distance and timing rules. The move must be closely linked to starting a full-time, long-term job. Also, the new job must be at least 50 miles farther from the old home than the previous job was. For example, if the old commute was five miles each way, the new job must be at least 55 miles from the old home.

Qualifying California expenses include transporting household goods, travel costs (at the federal standard mileage rate or actual gas), and lodging en route, but not meals.

California still allows a moving-expense deduction on Form FTB 3913 for qualifying job-related civilian moves, and it preserves special treatment for active-duty military moves. Nonmilitary taxpayers transfer the California deduction to Schedule CA, while active-duty military taxpayers generally do not make a California adjustment.

Example. D'Anna moved from Sacramento to San Diego in 2026 for a new civilian job. She incurred $1,000 in qualified moving expenses that her employer did not reimburse. On D'Anna's federal return, the moving expenses are not deductible because the federal deduction for civilians is permanently repealed. On the Form 540, California allows the deduction for D'Anna's moving expenses, reducing her California taxable income.

CALIFORNIA FORM

Moving Expense Deduction 3913

Attach to your California Form 540 or Form 540NR.

Name(s) as shown on tax return	Your SSN or ITIN
D'Anna Valencia	987654321

Before you begin: Are you a military member?

☐ **Yes**. See **Members of the Armed Forces** section in the instructions before you continue on to line 1 below.

☑ **No**. See the **Distance Test** and **Time Test** in the instructions **under Non-military Members section** to find out if you can deduct your moving expenses.

1	Transportation and storage of household goods and personal effects. See instructions.	1	$500
2	Travel (including lodging) from your old home to your new home. **Do not** include the cost of meals. See instructions.	2	$500
3	Add line 1 and line 2.	3	$1,000
4	Enter the total amount your employer or the government paid you for the expenses listed on line 1 and line 2 that is **not** included in box 1 of your federal Form W-2 (wages).	4	0
5	Is line 3 **more than** line 4?		

☐ **No**. You cannot deduct your moving expenses. If line 3 is less than line 4, subtract line 3 from line 4 and include the result on Schedule CA (540), Part I, Section A, line 1, column C or Schedule CA (540NR), Part II, Section A, line 1, column C.
If you checked the Yes box above for **military member**, you have no CA adjustment. Do not enter the result on Schedule CA. See instructions.

☑ **Yes**. Subtract line 4 from line 3. Enter the result here and on Schedule CA (540), Part I, line 14, column C or Schedule CA (540NR), Part II, line 14, column C. This is your **moving expense deduction.**
If you checked the Yes box above for **military member**, you have no CA adjustment. Do not enter the result on Schedule CA. See instructions. 5 $1,000

Schedule CA, Part I, line 14

Section C – Adjustments to Income from federal Schedule 1 (Form 1040)	A. Federal Amounts	B. Subtractions	C. Additions
11 Educator expenses 11	◉	◉	
12 Certain business expenses of reservists, performing artists, and fee-basis government officials. 12	◉	◉	◉
13 Health savings account deduction 13	◉	◉	
14 Moving expenses. Attach form FTB 3913. See instructions 14	◉ $0		◉ $1,000
15 Deductible part of self-employment tax. See instructions. 15	◉	◉	
16 Self-employed SEP, SIMPLE, and qualified plans. 16	◉		
17 Self-employed health insurance deduction. See instructions. 17	◉	◉	

STUDENT LOAN INTEREST DEDUCTION

Federal. IRC Section 221 lets taxpayers deduct interest paid on a qualified student loan before calculating adjusted gross income. The loan must have been taken out only to pay qualified higher education costs for the taxpayer, their spouse, or a dependent. The taxpayer must be legally obligated to pay the interest, cannot file married filing separately (MFS), and cannot be claimed as a dependent.

The deduction is $2,500 or the actual qualifying interest paid, whichever is less. Most borrowers get Form 1098-E from their lender showing deductible interest. The deduction is claimed on Schedule 1 of Form 1040.

The deduction phases out at higher MAGI levels, with thresholds adjusted annually. For 2026, the phaseout range for single filers shifts to MAGI between $85,000 and $100,000, and for joint filers between $175,000 and $205,000. Taxpayers above those thresholds receive no deduction.

The OBBBA makes permanent the rule allowing employers to provide up to $5,250 per year in tax-free student loan repayment assistance. This benefit allows employers to pay an employee's loan principal or interest without it being treated as taxable income. However, employees cannot claim a student loan interest deduction for any interest paid by their employer under this tax-free program.

California. California incorporates the federal student loan interest deduction through R&TC Section 17201(b), which matches IRC Section 221. This means California residents can deduct up to $2,500 of student loan interest paid during the year on their state tax returns. Usually, the federal and California deduction amounts are the same.

Federal and state deductions differ mainly when the taxpayer is a California nonresident, a part-year resident, or in special military-spouse community property situations where federal and California MAGI differ. In these cases, the California taxpayer uses the Student Loan Interest Deduction Worksheet in the Schedule CA instructions to figure the California deduction.

FEATURE	FEDERAL	CALIFORNIA
Deduction available?	Yes [IRC §221]	Yes [R&TC §17201(b)]
Maximum Deduction	$2,500	$2,500 (same)
Income limits	Phaseout based on MAGI, set annually	Generally conforms to federal structure
MFS filers allowed?	No	No

TAX TREATMENT OF DIVORCE-RELATED INCOME

FEDERAL
Federal tax treatment of divorce-related payments and transfers depends on whether the payment constitutes alimony, child support, or a property settlement.

Alimony (spousal support). Under current federal law, the tax treatment of alimony depends on when the divorce or separation agreement was executed.

● Agreements executed before January 1, 2019: Agreements finalized before 2019 generally maintain the "old" rules in which the payer may deduct alimony payments as an adjustment to income, and the recipient must include them in gross income. This regime still governs agreements executed on or before December 31, 2018, unless later modified with an express election to adopt the newer rules.

● Agreements executed after December 31, 2018: The TCJA eliminated the deduction for alimony paid and the income inclusion for alimony received for any divorce or separation instrument executed on or after January 1, 2019.

Unlike other TCJA provisions, this change was permanent, meaning there was never going to be a reversion to pre-TCJA deductibility even if the TCJA's other provisions had expired. The OBBBA left the existing federal alimony rules untouched, maintaining the tax treatment established under the TCJA. Alimony remains nondeductible and nontaxable for all post-2018 agreements.

Child support. Payments designated for the necessities of the payor's children are not treated as alimony but rather as child support. Child support is not a reportable event for income taxes. It is nondeductible by the payer and not includible in the recipient's gross income under federal law. This rule applies regardless of when the agreement was executed and is unchanged by the TCJA or OBBBA.

Property transfers incident to divorce. Under IRC Section 1041, most transfers of property between spouses (or former spouses if incident to a divorce) are nontaxable. No gain or loss is recognized on the transfer; the receiving spouse takes the transferor's basis (carryover basis). A taxable gain may arise later when the recipient sells the property. Neither the TCJA nor the OBBBA modified these rules.

CALIFORNIA

Following the enactment of SB 711, California conforms to the TCJA treatment of alimony for any divorce or separation instrument executed after December 31, 2025, or for any divorce or separation instrument executed on or before December 31, 2025, and modified after that date.

Alimony (spousal support). California's alimony history unfolds in three chronological tiers, determined by when the divorce or separation agreement was executed.

● Tier 1 covers agreements made on or before December 31, 2018. Under these rules, both federal and California law allowed the person paying alimony to deduct it from their taxes, while the person receiving alimony had to report it as income. This treatment

continues to apply to pre-2019 agreements that have not been modified to adopt the newer rules. Taxpayers in Tier 1 do not need to make a Schedule CA adjustment.

● Tier 2 covers agreements made from January 1, 2019, to December 31, 2025. The TCJA removed the federal deduction and income inclusion for alimony starting in 2019, but California kept its Tier 1 rules unchanged. This created a difference between federal and California tax returns. The paying spouse could not claim a federal deduction but could claim a California deduction. The receiving spouse did not pay federal tax but did pay California tax. Schedule CA adjustments were needed to show these differences.

● Tier 3 covers agreements made on or after January 1, 2026. With the passage of SB 711 on October 1, 2025, California now conforms to the federal TCJA treatment of spousal support. Alimony is no longer deductible by the payor for state or federal taxes, and the recipient will not pay taxes on spousal support income.

For alimony paid under agreements entered into after December 31, 2025, California law aligns with federal law, so no Schedule CA adjustment is needed. This new rule also applies to pre-2026 agreements that are changed after December 31, 2025, but only if the change clearly states that SB 711 applies. A modification to a previous agreement without that express language leaves the old treatment in place.

Child support. Both California and federal law consider child support as a nondeductible obligation of the paying spouse and tax-free income to the receiving spouse, regardless of when the divorce was finalized.

Property transfers incident to divorce. Both federal and California laws provide that a transfer of property between spouses, or former spouses, is not taxable if the transfer is "incident to a divorce." According to IRC Section 1041(c) — which R&TC Section 18031 conforms to — a property transfer is incident to a divorce when it "(1) occurs within one year after the date on which the marriage ceases, or (2) is related to the cessation of the marriage." Accordingly, the giving spouse will recognize neither gain nor loss on the transfer. The receiving spouse does not pay income tax on the value of the property received.

PAYMENT TYPE	FEDERAL	CALIFORNIA
Old Alimony (Pre-2019)	Deductible to payer; taxable to recipient	Same as federal
TCJA Alimony (2019–2025)	Not deductible; not taxable	Deductible to payer; taxable to recipient
New Alimony (Post-2025)	Not deductible; not taxable	Same as federal (SB 711)
Child support	Not deductible; not taxable	Same as federal
Property transfers	Tax-Free [IRC §1041]	Same as federal

STANDARD DEDUCTION

FEDERAL

The TCJA roughly doubled the standard deduction, which dramatically reduced the number of taxpayers who benefited from itemizing. The elevated TCJA amounts were originally scheduled to sunset after 2025 and revert to pre-2018 levels.

The OBBBA permanently extended the higher TCJA standard deduction amounts and further increased them. For tax year 2026, the standard deduction amounts are:

- $16,100 for single filers and MFS;
- $24,150 for heads of household; and
- $32,200 for married couples filing jointly.

CALIFORNIA

California does not use the federal standard deduction amounts — the state has its own standard deduction provision. The state version of the standard deduction is computed annually by adding an inflation factor based on the California Consumer Price Index.

The state has not yet released the standard deduction amounts for 2026. The updated numbers will be published in the last quarter of 2026 and should be slightly higher than the 2025 amounts (displayed in the table below).

STANDARD DEDUCTIONS	
Taxpayers with this filing status:	**May get a standard deduction amount for:**
Single or MFS	$5,706
Married filing jointly, head of household, or surviving spouse	$11,412

California does not increase the standard deduction for senior citizens or legally blind taxpayers. However, these taxpayers can add an extra amount to their state exemption credits.

California does not conform to federal provisions prohibiting most nonresident aliens from claiming the standard deduction. Therefore, nonresident aliens may claim the standard deduction for California tax purposes.

California conforms to the federal rule requiring both spouses filing separately to either itemize or claim the standard deduction. In other words, married taxpayers who file separately cannot mix deductions — where one spouse itemizes and the other takes the standard deduction. If one spouse itemizes and the other does not, the non-itemizing spouse's standard deduction amount will be zero.

Example. Cecil and Naomi are married California residents who will file separately for the 2026 tax year. Cecil has $18,000 of itemized deductions, while Naomi has only $3,000. Cecil elects to itemize on both his federal and California returns because his $18,000 in deductions exceeds the $16,100 federal MFS standard deduction (and the lower California base). Because Cecil itemizes, Naomi's standard deduction is reduced to zero on both returns. She is forced to itemize her $3,000 in expenses, losing the benefit of the larger standard deduction.

FEDERAL AND CALIFORNIA RULES FOR STANDARD DEDUCTION (SD)	
Federal	***California***
SD amounts are higher	**California's SD amounts are lower**
MFS filers must both claim the SD or neither may claim the SD	**California agrees**
Add an extra amount to the SD claimed by seniors and the blind	**California does not conform**
Most nonresident aliens cannot claim the SD	**California does not conform; nonresidents may claim the SD**

NEW FEDERAL SCHEDULE 1-A DEDUCTIONS (2025–2028)

The new Schedule 1-A benefits are below-the-line deductions created by the OBBBA. They do not reduce federal AGI, but they do reduce federal taxable income. These deductions are available to both itemizing and non-itemizing taxpayers.

All of these new federal deductions share three important eligibility limitations. First, each deduction is subject to income-based phaseouts, meaning the allowable deduction is reduced or eliminated once the taxpayer's modified adjusted gross income exceeds specified thresholds.

Second, the taxpayer generally must possess a valid Social Security number issued on or before the due date of the return (including extensions). Individual Taxpayer Identification Numbers (ITINs) do not qualify.

Third, taxpayers using the MFS filing status are categorically ineligible to claim these deductions, regardless of income level or other qualifying factors. Eligible taxpayers must file as single, head of household, qualifying surviving spouse, or married filing jointly.

Because California Form 540 begins with federal AGI rather than federal taxable income, Schedule 1-A deductions generally do not flow through to the California

return. Thus, despite California's nonconformity to the OBBBA, no California add-back is required because the federal deduction was never incorporated into California taxable income in the first place.

ENHANCED DEDUCTION FOR SENIORS

Federal. Federal law has long provided an additional standard deduction for taxpayers who are age 65 or older or blind under IRC Section 63(f). For 2026, this additional amount is $2,050 for single filers and $1,650 per qualifying spouse for married couples filing jointly. This existing benefit is separate from the OBBBA's new provision.

The OBBBA created a new temporary "enhanced deduction for seniors." Beginning in 2025 and continuing through 2028, taxpayers age 65 or older may claim an additional deduction of up to $6,000 per qualifying individual. Married taxpayers filing jointly may receive up to $12,000 if both spouses qualify. Unlike the traditional IRC Section 63(f) age-based standard deduction increase, the OBBBA deduction is separate from the standard deduction. Generally, it may be claimed by both standard deduction taxpayers and itemizers.

The deduction phases out for higher-income taxpayers. For single and head-of-household filers, the phaseout begins at $75,000 of MAGI. For married taxpayers filing jointly, the phaseout begins at $150,000 MAGI.

California. California does not conform to the OBBBA enhanced deduction for seniors. Instead of an additional deduction, California provides a Senior Exemption Credit to taxpayers who are age 65 or older. This is a tax credit that directly reduces tax liability rather than taxable income.

Because the senior deduction is a below-the-line federal deduction claimed on Schedule 1-A — not a federal AGI adjustment — it does not flow into California's starting point at all.

Example. Esperanza is a single 66-year-old California resident with MAGI of $70,000. In 2026, she will claim a federal standard deduction of $18,150 ($16,100 base + $2,050 senior amount) plus the new $6,000 OBBBA deduction, for a total of $24,150 in federal deductions. On her state return, Esperanza will itemize her deductions and claim the senior exemption credit. California does not allow the additional $6,000 OBBBA deduction.

SENIOR TAX BENEFITS	FEDERAL (2026)	CALIFORNIA (2026)
New OBBBA Deduction?	Up to $6,000 per person	Does not conform
Additional Standard Deduction?	$2,050 (single filers); $1,650 (joint filers)	Does not conform
Senior Exemption Credit?	No	Yes

NO TAX ON TIPS

Federal. The OBBBA established a new federal income tax deduction for qualified tips under IRC Section 224. This "No Tax on Tips" provision is effective for tax years 2025 through 2028.

Employees and self-employed individuals may deduct up to $25,000 of qualified tips received in occupations that the IRS has listed as customarily and regularly receiving tips on or before December 31, 2024, provided the tips are reported to the employer or the IRS (on a Form W-2, Form 1099, Form 4137, or another specified statement).

"Qualified tips" are voluntary cash or charged tips received from customers (or through tip-sharing arrangements). Mandatory service charges added to the bill are not qualified tips.

The deduction phases out for higher-income taxpayers. The allowable deduction is reduced by $100 for every $1,000 of modified adjusted gross income exceeding $150,000 for single filers or $300,000 for married taxpayers filing jointly.

For 2026 and subsequent tax years, qualifying tips must be reported on Form W-2 in Box 12 using code "TP" and Box 14b with a tipped occupation code.

Despite the label "No Tax on Tips," the law does not completely exempt tips from tax. Importantly, the deduction affects only federal income tax. Tips remain subject to Social Security and Medicare taxes (FICA or SECA taxes), and employers generally continue withholding taxes under normal payroll rules.

California. California does not conform to the federal "No Tax on Tips" deduction. Accordingly, tip income is generally deductible on the federal return but remains fully taxable for California personal income tax purposes.

The tip deduction under IRC Section 224 was created by the OBBBA (on July 4, 2025), after California's conformity cutoff date (January 1, 2025), so it won't affect state taxable income.

Example: Monique is a server at a San Francisco restaurant. She earned $22,000 in qualified tips in 2026 and has a MAGI of $65,000. On Monique's federal return, she deducts the full $22,000 under IRC Section 224, reducing her federal taxable income by that amount. On Monique's California return, no such deduction exists — all $22,000 remains in her California taxable income, subject to California's income tax rates.

NO TAX ON OVERTIME

Federal. The OBBBA added a temporary federal deduction for "qualified overtime compensation" for tax years 2025 through 2028, often described as "no tax on overtime."

Qualified overtime compensation is defined as overtime pay required by the Fair Labor Standards Act (FLSA) that exceeds the employee's regular rate — in other words, only the premium "half" portion of time-and-a-half pay qualifies, not the base rate portion of the overtime hour. For example, if an employee earns $30 per hour and receives $45 for overtime hours, only the additional $15 premium may qualify for the deduction. Overtime required solely by state law or collective bargaining agreements — rather than by the FLSA — is not eligible.

The deduction applies only to overtime that meets the federal FLSA definition and is properly reported on Form W-2, Form 1099, or other required statements. The OBBBA also created new employer information-reporting obligations to identify qualifying overtime amounts. For 2026 and later years, qualified overtime is reported on W-2 Box 12 using Code TT.

The maximum annual deduction is $12,500 for single filers and $25,000 for married taxpayers filing jointly — the deduction phases out for taxpayers with MAGI over $150,000 ($300,000 for joint filers). The deduction is reduced by $100 for every $1,000 of MAGI above those thresholds.

The provision affects only federal income tax. Overtime wages remain subject to Social Security and Medicare taxes.

California. California does not conform to the OBBBA overtime deduction. Although California updated its IRC conformity date to January 1, 2025, the OBBBA was enacted on July 4, 2025, after that date. Consequently, California does not recognize the federal deduction, and no subsequent legislation has adopted it. All overtime — daily, weekly, or double-time — remains fully taxable for California income-tax purposes.

California's overtime rules are significantly broader than the FLSA (e.g., daily overtime after 8 hours). State-mandated premiums do not qualify for the federal deduction unless the same hours also exceed 40 hours under the FLSA in the same week.

Example. Callie works four 10-hour shifts in California during one workweek, for a total of 40 hours. Under California law, Callie earns 2 hours of daily overtime pay each day because she worked more than 8 hours per day. Callie therefore receives 8 hours of overtime wages under California law. However, because she did not exceed 40 total hours for the week, none of those wages qualify as overtime under the FLSA. As a result, Callie cannot claim the federal OBBBA overtime deduction for those amounts, even though California required her employer to pay overtime premiums.

By contrast, if Callie worked 46 hours during the week, the 6 hours exceeding 40 weekly hours would generally qualify as FLSA overtime and could qualify for the federal OBBBA deduction (subject to federal limitations and income thresholds). California, however, would still tax all of the overtime pay because it does not conform to the federal deduction.

NO TAX ON CAR LOAN INTEREST

Federal. The OBBBA created a new federal deduction for interest paid on a loan used to purchase a qualified vehicle, effective for tax years 2025 through 2028.

For nearly 40 years, personal car-loan interest was nondeductible. However, the OBBBA amended IRC Section 163(h) to allow individuals to deduct up to $10,000 per year of interest paid on a qualified passenger-vehicle loan.

The deduction phases out for higher-income taxpayers. The phaseout generally begins at MAGI of $100,000 for single filers and $200,000 for married taxpayers filing jointly, with the deduction eliminated at $150,000 and $250,000, respectively.

To qualify, several requirements must be met. The vehicle must be expected to be used more than 50% for personal use at the time of purchase. Also, it must be new (used vehicles do not qualify) and must have undergone final assembly in the United States. Eligible vehicles include cars, minivans, vans, SUVs, pickup trucks, and motorcycles with a gross vehicle weight rating (GVWR) of 14,000 pounds or less. The loan must have been incurred after December 31, 2024.

Only the interest portion of payments qualifies; principal is never deductible. Lenders must file new information returns under IRC Section 6050AA, reporting interest received and vehicle details, enabling taxpayers to substantiate the deduction. When claiming the deduction, taxpayers must provide the vehicle identification number and maintain lender documentation showing qualifying interest paid.

California. California has not incorporated any provisions of the OBBBA. As a result, California does not conform to the federal deduction for qualified passenger-vehicle loan interest.

The car loan interest deduction is below-the-line on the federal return, so it reduces federal taxable income but not federal AGI. Since California Form 540 starts with federal AGI and Schedule CA does not have a line for Schedule 1-A deductions, the car loan interest deduction does not appear on the California return. No add-back is needed.

	FEDERAL (OBBBA)	CALIFORNIA
Qualified car-loan interest	Deductible (up to statutory limits)	Not deductible
Effect on AGI	No reduction	No reduction
Effect on taxable income	Reduces federal taxable income by up to $10,000	No California benefit

PERMANENT CHARITABLE DEDUCTION FOR NON-ITEMIZERS

FEDERAL

Before the OBBBA, non-itemizers had no mechanism to deduct charitable contributions — they took the standard deduction and forfeited any tax benefit from their giving. Prior law temporarily allowed a small deduction during the COVID-19 years, but that provision expired after 2021.

Under the OBBBA, for tax years beginning after December 31, 2025, a new permanent deduction under IRC Section 170(p) is created for taxpayers who do not elect to itemize. This is a below-the-line deduction that is taken in addition to the standard deduction. Non-itemizers may deduct up to $1,000 (or $2,000 for married taxpayers filing jointly) for cash contributions made during the year.

The new non-itemizer deduction is not indexed for inflation, and excess contributions above the $1,000 or $2,000 cap cannot be carried forward under this special provision.

Eligible gifts generally must be cash contributions to qualifying public charities described in IRC Section 170(b)(1)(A). Donations to donor-advised funds, supporting organizations, and most private foundations do not qualify. Noncash donations — such as clothing, vehicles, or appreciated stock — also do not qualify for this special deduction. The usual substantiation requirements under IRC Section 170 apply.

CALIFORNIA

California does not conform to the new federal charitable deduction for non-itemizers. Under California law, charitable contributions are deductible only as part of itemized deductions on Schedule CA.

Example. A married couple filing jointly in California donates $2,000 cash to a qualifying public charity in 2026 and takes the standard deduction on both returns. Under federal law, they deduct the full $2,000 under IRC Section 170(p), reducing their federal taxable income. On their California return, they receive no deduction for that $2,000 — California's standard deduction is taken instead, and there is no California counterpart to IRC Section 170(p).

California Voluntary Contributions. Any state taxpayer can make a voluntary contribution on Form 540 (Side 4), whether they take the standard deduction or itemize. This voluntary contribution works more like a "checkout donation" on the tax return — similar to being asked at a grocery store if you want to round up for a food bank — rather than as a tax benefit.

Rather than providing an immediate tax benefit, the voluntary contribution is added to the California tax due or subtracted from the state refund. The taxpayer is simply redirecting part of their refund or increasing their payment to support a designated fund. Examples of funds include the Emergency Food for Families Fund and the Rare

and Endangered Species Preservation Program. The list of available funds changes legislatively from year to year.

California voluntary contributions may generally be claimed as charitable deductions on a later federal Schedule A if the taxpayer itemizes deductions in the following year. However, California itself provides no separate deduction or credit merely for making the voluntary contribution unless the taxpayer itemizes.

REVIEW QUESTIONS

49. In 2026, Davon and Tanya are legally married and file separately for federal and California purposes. Davon itemizes on both returns because his itemized deductions exceed the standard deduction. Tanya has only $2,400 of itemized deductions and prefers to claim the standard deduction. Under federal and California rules, what must Tanya do?
{A}. Tanya may claim the standard deduction on both the federal and California returns.
{B}. Tanya must itemize on both the federal and California returns because Davon itemizes.
{C}. Tanya may claim the federal standard deduction, but she must itemize on the California return.
{D}. Tanya must itemize under federal law, but California allows the standard deduction even when the spouse itemizes.

50. Benson is a California employee whose 2026 pay includes $3,000 of daily overtime required only by California law. His weekly hours never exceed 40. Which statement correctly describes the federal deductibility of Benson's California overtime compensation?
{A}. $0, because the California overtime fails to meet the federal FLSA requirement.
{B}. $600, because California daily overtime is worth 1/5 of FLSA weekly overtime.
{C}. $1,500, representing the premium "half" portion of the overtime rate.
{D}. $3,000, because California daily overtime is eligible under the federal FLSA.

Part E reveals the correct answers to all end-of-chapter review questions while providing feedback on both correct and incorrect responses.

Chapter 17. ITEMIZED DEDUCTIONS IN CALIFORNIA

Learning objectives: By the end of this chapter, you should be able to explain the differences between federal and California itemized deduction rules, calculate key California changes on Schedule CA, and identify important California differences for SALT deductions, mortgage interest, charitable donations, casualty losses, miscellaneous deductions, and overall itemized deduction limits.

Chapter Topics

- Select deduction method that maximizes tax savings
  - » Federal
  - » California
- Deduction for medical expenses
  - » Federal
  - » California
- State and local tax (SALT) deduction
  - » Federal
  - » California
- Mortgage interest payments
  - » Interest from acquisition loans
  - » Interest from home equity loans
  - » Mortgage insurance premiums
- Charitable contributions
  - » AGI limits on deductibility
- Casualty and theft losses
  - » Federal
  - » California
- Miscellaneous itemized deductions
  - » Federal
  - » California
- Overall limitation on itemized deductions
  - » Federal
  - » California

SELECT DEDUCTION METHOD THAT MAXIMIZES TAX SAVINGS

FEDERAL

The TCJA nearly doubled the federal standard deduction and limited many itemized deductions, so fewer people now file Schedule A. The OBBBA made the higher standard deduction permanent and further increased it. As a result, most Californians do not file Schedule A with their federal tax returns. The current federal standard deduction ($16,100 for single filers and $32,200 for married couples filing jointly) gives most households a larger federal tax break.

CALIFORNIA

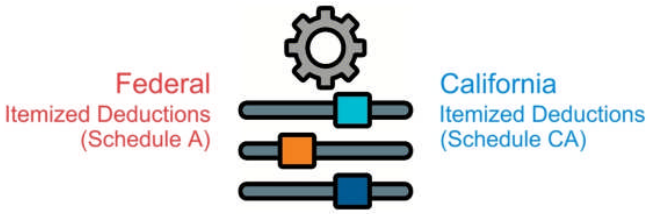
Some states require taxpayers to use the same deduction method on their state tax return as they did on their federal return. In those states, if a taxpayer claims the federal standard deduction, they must also claim the state standard deduction, even if itemizing would have lowered their state taxes.

California does not have this rule. Unlike other states, California does not require residents to take the standard deduction on their state return just because they used it on their federal return. Californians who take the standard deduction on their federal return can choose to itemize on their Form 540 if it lowers their state taxes. Under California law, taxpayers can claim either the standard deduction or itemized deductions for state taxes, no matter what they do on their federal return [R&TC Section 17073(c)].

This flexibility is important because California's standard deduction is quite small, and state law still allows some itemized deductions that federal law has limited or eliminated. Many California homeowners who take the federal standard deduction still itemize on their state return, since even modest mortgage interest or property tax payments can exceed the state's standard deduction. By itemizing on their California return, these taxpayers can lower their state taxable income, even if they do not itemize on their federal return.

Californians who choose to itemize on Form 540 must do the following:

- Complete a federal Schedule A (even though it will not be filed with the IRS);
- Check the box at the top of Schedule CA, Part II;
- Complete lines 1 through 30 on Part II of Schedule CA; and
- Attach a copy of the completed federal Schedule A to Form 540.



Example. Benjamin is a California resident with modest itemized deductions. His allowable itemized deductions exceed the California standard deduction but are less than the federal standard deduction. As a result, Benjamin claims the standard deduction on his federal income tax return and itemizes deductions on his California return. Before claiming itemized deductions for California purposes, Benjamin must complete a federal Schedule A even though he is not itemizing deductions on his federal return. Benjamin then transfers the applicable Schedule A amounts to Schedule CA, Part II.

California has its own rules for itemized deductions, and many differ from federal rules in terms of amounts, limits, or eligibility. As you will see in the next sections, Californians often need to adjust their itemized deductions up or down when filling out Schedule CA.

Fragment of Schedule CA, Part II, Itemized Deductions

Part II Adjustments to Federal Itemized Deductions

Check the box if you did NOT itemize for federal but will itemize for California . . . . . ☐

	A Federal Amounts (from federal Schedule A (Form 1040))	B Subtractions See instructions	C Additions See instructions
Medical and Dental Expenses See instructions.			
1 Medical and dental expenses 1			
2 Enter amount from federal Form 1040 or 1040-SR, line 11.. 2			
3 Multiply line 2 by 7.5% (0.075) 3			
4 Subtract line 3 from line 1. If line 3 is more than line 1, enter 0 4			
Taxes You Paid			
5 a State and local income tax or general sales taxes. 5a			
b State and local real estate taxes 5b			
c State and local personal property taxes 5c			
d Add line 5a through line 5c. 5d			
e Enter the smaller of line 5d or $10,000 ($5,000 if married filing separately) in column A. Enter the amount from line 5a, column B in line 5e, column B. Enter the difference from line 5d and line 5e, column A in line 5e, column C 5e			
6 Other taxes. List type 6			
7 Add line 5e and line 6. 7			
Interest You Paid			
8 a Home mortgage interest and points reported to you on federal Form 1098 . . . . . 8a			
b Home mortgage interest not reported to you on federal Form 1098. . . . . 8b			
Gifts to Charity			
11 Gifts by cash or check. 11			
12 Other than by cash or check. 12			
13 Carryover from prior year. 13			
14 Add line 11 through line 13 14			
Casualty and Theft Losses			
15 Casualty or theft loss(es) (other than net qualified disaster losses). Attach federal Form 4684. See instructions . . 15			
Other Itemized Deductions			
16 Other—from list in federal instructions. 16			

Job Expenses and Certain Miscellaneous Deductions

19 Unreimbursed employee expenses: job travel, union dues, job education, etc. Attach federal Form 2106 if required. See instructions 19

20 Tax preparation fees 20

21 Other expenses: investment, safe deposit box, etc. List type 21

DEDUCTION FOR MEDICAL EXPENSES

FEDERAL

Most private health insurance in the United States is employer-sponsored. When an employer pays all or part of an employee's health insurance premiums, the employee cannot deduct those employer-paid amounts on Schedule A. Likewise, taxpayers cannot deduct medical expenses reimbursed through a health savings account (HSA), flexible spending arrangement (FSA), health reimbursement arrangement (HRA), insurance reimbursement, or similar tax-favored arrangement.

Taxpayers may include unreimbursed medical expenses paid for themselves, their spouse, and their dependents (such as children or elderly parents). Deductible medical expenses include amounts paid for:

- Diagnosis, cure, mitigation, treatment, or prevention of disease;
- Prescription medications and insulin;
- Medical insurance premiums;
- Transportation primarily for medical care; and
- Certain long-term care services and qualified long-term care insurance premiums.

After subtracting upfront payments or reimbursements from other parties, the taxpayer arrives at a preliminary out-of-pocket medical expense amount. The deductible portion is then limited to the amount that exceeds 7.5% of AGI, and the taxpayer must itemize to benefit from the deduction.

After several changes beginning in 2013, Congress permanently set the federal floor at 7.5% in 2021.

CALIFORNIA

California has long applied a 7.5% AGI threshold and did not adopt the temporary federal 10% limit in the 2010s. Now, both California and federal law use the same 7.5% threshold for medical expense deductions.

California amounts can still be different from federal amounts because California recognizes some family relationships differently. For example, California may allow medical expenses paid for a registered domestic partner (RDP) and their dependents, while federal law usually does not treat those expenses the same way.

Extended example. Shaun and Davin are RDPs in California. Shaun has an adjusted gross income of $100,000 and paid the following unreimbursed medical expenses during the year: $4,500 for Shaun's own medical care, $3,000 for Davin's medical care, and $1,500 for Davin's dependent child from a prior relationship.

Federal law does not recognize an RDP as a spouse or qualifying relative solely by virtue of the domestic partnership. Accordingly, the $3,000 paid for Davin's care and the $1,500 paid for Davin's dependent child are not deductible on Shaun's federal return. Only the $4,500 paid for Shaun's own care is eligible. The 7.5% AGI floor is $7,500,

which exceeds $4,500, so Shaun receives no federal medical expense deduction despite having $9,000 of actual out-of-pocket costs.

California recognizes Davin and his dependent child as part of Shaun's family for the medical expense deduction. Shaun's total eligible medical expenses are $9,000. The 7.5% AGI floor is $7,500, so Shaun can claim a $1,500 California deduction.

	FEDERAL	CALIFORNIA
AGI floor	7.5% of AGI	7.5% of AGI
Where claimed	Schedule A (Form 1040)	Schedule CA (540), Part II
Double-Dipping Rule	Prohibited if paid via pretax HSA/FSA accounts	Prohibited if paid via pretax HSA/FSA accounts
Registered Domestic Partners (RDPs)	Excluded (unless they qualify as dependents under IRC §152)	Included (treated identically to spouses)
Definition of dependent	Federal dependent rules	CA recognizes RDPs and their dependents

STATE AND LOCAL TAX (SALT) DEDUCTION

FEDERAL
Taxpayers who itemize deductions may claim a deduction under IRC Section 164 for certain taxes paid to state and local governments — most commonly real estate and personal property taxes, and either state and local income taxes or sales taxes (but not both). This is commonly referred to as the SALT deduction.

Before 2018, there was no dollar limit on the deduction for state and local taxes. The TCJA changed this by capping the total SALT deduction at $10,000 per year for most individual taxpayers, and $5,000 if married filing separately (MFS). That cap was scheduled to expire after 2025, at which point the pre-TCJA uncapped deduction would have been restored.

Congress made changes before the limit was set to expire on December 31, 2025. In July 2025, the OBBBA raised the SALT deduction limit from $10,000 to $40,000 and made this change retroactive to January 1, 2025. For MFS filers, the limit increased from $5,000 to $20,000.

The deduction cap will increase slightly each year while this temporary rule is in effect. The limit was $40,000 for 2025 and will go up by 1% each year through 2029. For 2026, the cap is $40,400. In 2030, the cap returns to $10,000.

The higher cap is reduced for higher-income taxpayers. The phaseout begins at $505,000 of MAGI for 2026 (or $252,500 for MFS), and this threshold increases by 1% each year through 2029. The cap is reduced by 30% of the MAGI above the threshold,

but the deduction cannot go below $10,000. So, taxpayers with very high incomes are still limited to a $10,000 SALT deduction.

CALIFORNIA
California does not conform to IRC Section 164 regarding the deduction for state and local income taxes. R&TC Section 17220 does not allow taxpayers to deduct California income taxes or sales taxes on their state returns, even though these may be partly or fully deductible on federal returns.

California and federal law have long agreed on the deductibility of ad valorem property taxes. An ad valorem tax is one levied as a percentage of assessed value. In the context of California real estate, the classic example is the 1% limit imposed by Proposition 13, which applies in each of California's 58 counties. California allows a full deduction for ad valorem property taxes, with no dollar cap.

California's non-conformity to the federal SALT cap. California has not adopted the SALT deduction limit set by the TCJA, which the OBBBA recently increased.

While federal law now allows up to $40,400 in SALT deductions for eligible taxpayers, California continues to apply its own longstanding rules: a full deduction for ad valorem property taxes and no deduction for California income or sales taxes. As a result, California taxpayers must recompute itemized deductions on Schedule CA using state law rather than relying solely on the federal Schedule A calculation.

Example. In 2026, Hunter's MAGI is $400,000, and his SALT payments consist of $10,000 in property taxes and $35,000 in California income taxes, for a total of $45,000. On his Form 1040, Hunter's SALT deduction is capped at $40,400 under the OBBBA, so he loses $4,600 of potential federal SALT deductions. On his Form 540, California applies different SALT deduction rules. California did not conform to the federal OBBBA SALT limitation, so there is no comparable $40,400 cap on the state return. However, California does not permit a deduction for California income taxes under R&TC Section 17220. As a result, Hunter may deduct the full $10,000 of qualifying property taxes on Schedule CA, but none of the $35,000 of California income taxes. Hunter must make the necessary additions and subtractions on Part II of Schedule CA to reconcile the federal Schedule A amounts to the proper California itemized deductions.

STATE AND LOCAL TAXES (SALT) FOR INDIVIDUALS		
	On California Schedule CA:	***On federal Schedule A:***
California income or sales taxes	**Not deductible**	Combined amount is deductible up to $40,400
California property taxes	**Fully deductible**	

MORTGAGE INTEREST PAYMENTS

Interest paid or owed by an individual falls into five types: qualified student loan interest, qualified residence interest, investment interest, business interest, and personal interest. Only the first four are deductible; personal interest is not. Qualified student loan interest and business interest are above-the-line deductions, while qualified residence and investment interest are itemized deductions.

INTEREST FROM ACQUISITION LOANS

Federal. Acquisition debt includes loans used to buy, build, or significantly improve a main or second home, provided the loan is secured by that property. Loans made on or before December 15, 2017, can deduct interest generated from home loans of up to $1 million ($500,000 for MFS).

The TCJA lowered the acquisition debt limit from $1 million to $750,000 ($375,000 for MFS) for loans taken out after December 15, 2017. This lower limit was set to expire after 2025, which would have brought back the $1 million cap.

The OBBBA permanently blocked that reversion. Loans made after December 15, 2017, still have the $750,000 limit ($375,000 for MFS). For loans made on or before December 15, 2017, the higher $1 million limit ($500,000 for MFS) still applies.

California. California does not follow the changes to IRC Section 163(h) made by the TCJA or OBBBA. California allows a more generous mortgage interest deduction. Californians can still deduct interest on up to $1 million in mortgage debt for one or two homes on their state return.

Example. Caryn and Layne are married and file a joint tax return. In 2026, they bought a home in San Francisco for $1.25 million, paid 20% down, and took out a $1 million mortgage. During the year, they paid $68,677 in mortgage interest. For federal taxes, they can only deduct the interest generated by the first $750,000 of their loan. Accordingly, only $51,508 of interest is deductible under federal law. California still allows deductions on up to $1 million in mortgage debt, so Caryn and Layne can deduct the full $68,677 on their Form 540. The additional California deduction of $17,169 is reported on Schedule CA (Part II, line 8a, column C).

INTEREST FROM HOME EQUITY LOANS

Federal. Under current federal law, interest on a loan secured by a home is deductible only if the borrowed funds are used to buy, build, or significantly improve the home. Interest on loans used for personal reasons is usually not deductible, even if the loan is secured by the home. Examples of personal uses that are not deductible include:

- Paying credit card debt;
- Purchasing automobiles;
- Paying college tuition;
- Financing weddings; and
- Funding vacations.

By contrast, if taxpayers use the money to improve the home (that secures the loan), they may be able to deduct the interest as acquisition debt interest, as long as they stay within the allowed debt limits.

California. California continues to permit a deduction for interest attributable to home equity indebtedness of up to $100,000, even when the borrowed funds are used for personal purposes. This is a significant and enduring advantage California homeowners retain over the federal rules.

The home equity debt limit is reduced to $50,000 if the taxpayer is married and filing separately. The deduction for home equity interest may be further reduced if home equity is less than the applicable dollar limit.

Example. Annette takes out a $250,000 loan (secured by her home) at an 8.41% interest rate and pays $20,695 in interest during the first year. If she spends the full $250,000 on home improvements, she can deduct all the interest as acquisition debt interest. If she uses $150,000 for improvements and $100,000 for her son's college expenses, she can still deduct all the interest because the personal-use portion does not exceed California's $100,000 home equity debt limit. However, if she spends $100,000 on improvements and $150,000 on college costs, only $200,000 of the loan qualifies for a deduction ($100,000 as acquisition debt and $100,000 as allowed home equity debt). In this case, 20% of the loan is not deductible, so 20% of the annual interest ($4,139) is not deductible. That means Annette's allowed California interest deduction is $16,556.

MORTGAGE INSURANCE PREMIUMS

Federal. The deduction for qualified mortgage insurance premiums expired after 2021. However, the OBBBA reinstated the deduction beginning in 2026 and incorporated mortgage insurance premiums into the qualified residence interest rules. The allowable deduction for mortgage insurance premiums is now considered part of the taxpayer's qualified residence interest deduction and is subject to the same $750,000 acquisition debt cap.

The deduction for mortgage insurance premiums begins to phase out once AGI exceeds $100,000 ($50,000 for MFS). The phaseout amount equals 10% of the otherwise allowable deduction for each $1,000 that AGI exceeds the applicable threshold ($500 increments for MFS). For an unmarried individual or a married couple filing jointly, the deduction is completely phased out once AGI reaches $110,000 or higher.

California. California does not conform to the federal deduction for mortgage insurance premiums. R&TC Section 17225 specifically decouples from this federal provision. Accordingly, if mortgage insurance premiums are deductible on the federal return, California taxpayers must strip out the federal deduction on Schedule CA (Part II, line 8a, column B).

Example. Ed and Lakisha are married and file jointly. In 2026, they purchased a home with a 10% down payment and are required to pay $3,600 annually in mortgage insurance premiums. Their AGI is $95,000, which is below the $100,000 phaseout threshold. On their federal return, the couple may deduct the full $3,600 as qualified residence interest on Schedule A. On their California return, however, no deduction is available for those premiums. Ed and Lakisha must enter $3,600 as an addition on Schedule CA (Part II, line 8d, Column B) to remove the benefit from their California taxable income calculation.

	FEDERAL (2026, OBBBA)	CALIFORNIA
Acquisition debt limit	$750,000 ($375,000 MFS) for post-12/15/2017 debt	$1 million ($500,000 MFS)
Grandfathered debt	Pre-12/16/2017 debt retains $1 million limit	Continues to follow pre-TCJA law
Home Equity Loan Interest	Nondeductible (Unless used to buy, build, or improve)	Deductible up to $100,000 of debt for any purpose
Mortgage insurance premiums	Deductible again beginning in 2026 under OBBBA	Not allowed; add back on Schedule CA

CHARITABLE CONTRIBUTIONS

AGI LIMITS ON DEDUCTIBILITY

Federal. The OBBBA made major changes to the federal rules for charitable contribution deductions, affecting both itemizers and non-itemizers. While the maximum deduction limits remain high, the new rules add a minimum threshold for itemizers.

● The 60% AGI ceiling is now permanent. The OBBBA permanently extends the 60% AGI limitation for cash contributions to qualified public charities. Previously, this 60% ceiling had been set only temporarily by the TCJA, with the limit scheduled to revert to 50%. Individual taxpayers may therefore deduct up to 60% of their AGI for substantial cash donations to public charities and other qualified organizations, with a five-year carryover period to the extent that the contribution amount exceeds the 60% ceiling.

Lower limitations apply in other situations. Contributions of appreciated capital gain property to public charities are generally limited to 30% of AGI. Contributions to certain private foundations and other organizations may be limited to 30% or 20% of AGI, depending on the circumstances.

● New 0.5% AGI floor for itemizers. Beginning in 2026, federal law also imposes a new floor on charitable contribution deductions for taxpayers who itemize deductions. Charitable contributions are deductible only to the extent that total annual contributions exceed 0.5% of the taxpayer's AGI. In practical terms, the first 0.5% of AGI in charitable contributions yields no deduction. For example, a taxpayer with $100,000 of AGI loses the first $500 of charitable deductions each year.

Taxpayers should note that amounts disallowed solely because of the 0.5% floor are permanently lost and may not be carried forward — unlike amounts disallowed because they exceed the 60% AGI ceiling, which do carry forward for five years.

● Permanent charitable deduction for non-itemizers. This topic was covered in the previous chapter. Starting in 2026, the permanent charitable deduction for non-itemizers allows taxpayers who take the standard deduction to also deduct a limited amount of charitable cash contributions directly from their taxable income, without needing to itemize their deductions.

California. California does not conform to the three major OBBBA changes mentioned above.

California's rules are as follows. Itemizers can only deduct charitable donations up to 50% of their AGI. Contributions exceeding the 50% limit may be carried forward for up to five additional years. California does not impose a 0.5% AGI floor on charitable contribution deductions, and people who do not itemize cannot claim a charitable deduction.

Example. Talia files as a single taxpayer in 2026 and has a federal AGI of $150,000. After receiving a large tax-free inheritance, she contributes $97,500 in cash to Stanford University, a qualified public charity. Because cash contributions to public charities are limited to 60% of AGI, Talia's current-year federal deduction is capped at $90,000 ($150,000 × 60%). Then, the 0.5% AGI floor reduces Talia's contribution pool by $750 ($150,000 × 0.5%), leaving $89,250 potentially deductible. The remaining $8,250 may generally be carried forward for up to five years. California generally limits charitable deductions to 50% of AGI and does not conform to the federal 0.5% floor. Talia's California deduction is therefore limited to $75,000 ($150,000 × 50%). The remaining $22,500 may be carried forward for up to five years.

	FEDERAL	CALIFORNIA
Cash contribution limit for public charities	60% of AGI (permanent)	50% of federal AGI
Itemized Deduction Floor	0.5% of AGI must be exceeded	No floor (deductible from first dollar)
Carryforward period for excess contributions	5 years	5 years
Non-itemizer charitable deduction	Up to $1,000 single / $2,000 joint	None

CASUALTY AND THEFT LOSSES

FEDERAL

Under IRC Section 165(h), as amended by the TCJA and made permanent by the OBBBA, personal casualty and theft losses are deductible only if they are attributable to

a federally declared disaster. This limitation applies to tax years beginning after December 31, 2017, and is now permanent.

In addition, the OBBBA expanded the deduction to include certain qualifying state-declared disasters. Accordingly, beginning in 2026, individuals generally may deduct personal casualty and theft losses only if the loss is attributable to either:
● A federally declared disaster; or
● A qualifying state-declared disaster under IRC Section 165(h)(5).

Federally declared disasters. For an itemizer who incurred a loss due to a federally declared disaster, the deduction is allowed only if each separate loss exceeds $100. Additionally, all qualified losses for the year (reduced by the $100 per-event floor) must exceed 10% of the taxpayer's AGI. The loss is also reduced by any insurance or other reimbursement received.

State-declared disasters (new for 2026). Beginning with tax years starting after December 31, 2025, the OBBBA expands the deductible disaster category to include state-declared disasters [IRC Section 165(h), as amended]. A state-declared disaster is defined as a natural catastrophe — such as a wildfire — that both:
● The governor of the state declares it to be of sufficient severity; and
● The Secretary of the Treasury concurs that it is significant enough to warrant federal tax relief.

This "Treasury approval" rule means that a governor's declaration, while an important first step, does not automatically allow the federal tax deduction. The $100 per-event floor and the 10%-of-AGI limit still apply to state-declared disaster losses.

Timing of deduction. Taxpayers generally deduct casualty losses in the year the loss occurs. However, IRC Section 165(i) permits taxpayers affected by a federally declared disaster to elect to deduct the loss on their prior-year return. This election may generate a quicker tax refund that can help taxpayers recover sooner after a disaster.

Postponement of filing deadlines. In addition to the prior-year election, taxpayers in federally declared disaster areas may receive an IRS postponement of filing and payment deadlines. Deadlines that may be postponed for up to one year include those for filing returns, paying taxes, and making IRA contributions. The IRS may also abate interest and penalties on underpaid income tax for the duration of any postponement period.

CALIFORNIA
Like federal law, California allows deductions for personal casualty and theft losses, subject to a $100 reduction per event and a 10% of AGI threshold. However, California does not follow the federal rule that restricts these deductions to official disaster events. This means California taxpayers can still claim itemized deductions on their state return for common, non-disaster events, such as:
● House fires;

● Automobile accidents or vehicle theft;
● Home burglaries and physical vandalism;
● Water damage; and
● Storm or wind damage.

Example: In 2026, Jazmin and Horacio, California residents filing jointly, have an AGI of $110,000. During the year, a plumbing failure causes $19,000 of uninsured water damage to their home. The event is not connected to a federally or state-declared disaster. For federal purposes, the couple cannot deduct the loss because federal law limits personal casualty losses to official disaster events. However, California still allows a deduction for qualifying non-disaster casualty losses. Their California casualty loss deduction is computed as follows:
● The uninsured water damage is $19,000.
● Now subtract the $100 reduction per event.
● The remaining loss is $18,900.
● Now subtract the 10% of AGI threshold, which is $11,000.
● The allowable California itemized deduction equals $7,900.

As a result, Jazmin and Horacio may claim a $7,900 California itemized deduction even though no federal deduction is allowed.

In California, both disaster-related and non-disaster personal casualty and theft losses may be deductible, but official disaster losses receive more favorable treatment. For example, disaster victims may qualify for the IRC Section 165(i) election to claim the loss on the prior-year return. Declared disasters may also trigger postponement of tax deadlines and extended carryover periods for excess losses.

Disaster losses in California. Under California law, a casualty loss becomes a disaster loss when both of the following conditions are met:
● The taxpayer sustains the loss in an area the President of the United States or the Governor of California declares a state of emergency; and
● The taxpayer sustains the loss because of the declared disaster.

Prior-year election in California. California generally follows federal law for disaster loss elections. Qualifying taxpayers may elect to claim their disaster loss either in the year the loss occurred or in the year preceding the loss. The election deadline is six months after the regular due date for the disaster year return. For example, for a 2026 disaster, the election must be made by October 15, 2027. As with the federal election, claiming the loss in the prior year may accelerate a refund from the FTB.

Postponement of deadlines. The IRS and the FTB may each postpone tax deadlines for eligible taxpayers in disaster areas. Postponable deadlines include those for filing returns, paying taxes, and making IRA contributions. Both the IRS and FTB may abate interest and penalties on underpaid income taxes during any applicable postponement period.

California carryover rules. R&TC Section 17207(b) provides that a casualty loss exceeding taxable income shall be carried forward for five years. For California purposes, a loss from a disaster officially declared by the governor may be carried over for up to 15 years. There is no comparable extended federal carryover for personal casualty losses.

	FEDERAL	CALIFORNIA
Personal Losses — Non-disaster events	Permanently nondeductible for all non-declared events	Deductible (subject to $100 and 10% AGI limits)
Federally Declared Disasters	Deductible (subject to $100 and 10% AGI limits)	Deductible (subject to $100 and 10% AGI limits)
State-Declared Disasters	Deductible beginning 2026 (with Treasury concurrence)	Deductible if Governor or President declares emergency
$100 floor per casualty event	Yes	Yes
10%-of-AGI limitation	Yes	Yes
Carryovers	No special federal carryover for personal losses	5-year general carryover; 15-year carryover for Governor-declared disasters
Deadline Postponement	IRS may postpone deadlines up to 1 year; interest/penalty abatement available	FTB may postpone deadlines up to 1 year; interest/penalty abatement available

MISCELLANEOUS ITEMIZED DEDUCTIONS

FEDERAL

Before 2018, the lower portion of Schedule A displayed two fields for expenses not covered by the major itemized deduction categories:

- "Job Expenses and Certain Miscellaneous Deductions," subject to the 2%-of-AGI floor; and
- "Other Itemized Deductions," not subject to the 2% limit.

The TCJA suspended all miscellaneous itemized deductions subject to the 2% floor for tax years 2018 through 2025. The OBBBA permanently eliminates miscellaneous itemized deductions subject to the 2%-of-AGI floor for tax years beginning after 2025. As a result, the federal deduction remains unavailable for expenses such as tax preparation fees, unreimbursed employee business expenses, union dues, professional memberships, investment advisory fees, and similar items.

"Other Itemized Deductions" not subject to the 2% limitation remain deductible on the 2026 Schedule A — specifically, on line 16, which covers the following items:

- Gambling losses (limited to 90% of gambling winnings beginning in 2026);
- Impairment-related work expenses;
- Claim-of-right repayments;

● Casualty or theft losses on income-producing property; and
● Estate tax attributable to income in respect of a decedent (IRD).

The OBBBA introduces a new non-2% itemized deduction for K-12 educator expenses. This allows teachers to deduct unreimbursed classroom expenses that exceed the standard $350 above-the-line deduction, without any dollar cap.

CALIFORNIA

Miscellaneous deductions subject to the 2%-of-AGI floor. California does not follow the current federal prohibition on miscellaneous itemized deductions. Since the state did not adopt the TCJA and OBBBA changes, California still allows miscellaneous itemized deductions if they exceed the 2% floor. The following fees or expenses are still deductible on Schedule CA:
● Tax-preparation fees;
● Unreimbursed employee business expenses;
● Investment advisory fees;
● Certain legal fees; and
● Hobby expenses to the extent of hobby income.

Example. Karmen is a California resident with an AGI of $120,000 in 2026. Her total miscellaneous itemized deductions equal $4,200 — spent on unreimbursed employee business expenses, investment advisory fees, and tax-preparation fees. California allows these deductions only to the extent they exceed 2% of AGI. Karmen's 2% floor is $2,400 ($120,000 × .02). Because her expenses exceed the floor by $1,800, California permits a $1,800 itemized deduction even though the federal deduction is zero.

Other itemized deductions not subject to the 2%-of-AGI floor. California generally conforms to the federal treatment of non-2% itemized deductions for impairment-related work expenses, IRD-related estate tax, claim-of-right repayments, and income-producing property casualty losses. However, the state completely rejects recent federal modifications to gambling and educator deductions.

● Gambling losses. Before 2026, taxpayers who itemized deductions on Schedule A could deduct 100% of their gambling losses to the extent of their gambling winnings (reported on Schedule 1). Losses in excess of winnings were not deductible.

Beginning in 2026, the OBBBA limits the deduction for gambling losses to 90% of total losses for the year. Taxpayers still cannot deduct more than they won. This change means that even if a taxpayer's losses match their winnings, some gambling income could be taxable.

California does not conform to this new 10% haircut. As a result, California taxpayers can still deduct gambling losses up to the amount of their gambling winnings, which is more favorable than the federal rule that takes effect in 2026.

Example. In 2026, Kalen wins $10,000 and also has $10,000 in losses. He can deduct the full $10,000 for California, but only $9,000 for federal purposes. To claim this benefit on his state return, Kalen needs to adjust Schedule CA and reduce his California taxable income by the $1,000 that was not allowed on his federal return.

● Educator expenses. Eligible K-12 educators claim a $350 above-the-line deduction for unreimbursed classroom expenses under IRC Section 62(a)(2)(D). Beginning in 2026, the OBBBA converts excess educator expenses into an uncapped itemized deduction on Schedule A — but only for taxpayers who itemize.

California does not follow either of these federal provisions. The state does not allow the $350 above-the-line deduction, so taxpayers must add that amount back to their California income on Schedule CA. California also does not allow the new unlimited itemized deduction from the OBBBA. Instead, all unreimbursed classroom costs are treated as miscellaneous itemized deductions subject to the state's 2%-of-AGI floor on Schedule CA. This means many educators receive a federal benefit but no California benefit — unless they itemize on Schedule CA and their expenses exceed 2% of AGI.

OVERALL LIMITATION ON ITEMIZED DEDUCTIONS

FEDERAL

Before 2018, high-income taxpayers were subject to the so-called "Pease limitation" under IRC Section 68. This rule reduced otherwise allowable itemized deductions by 3% of the amount by which AGI exceeded specified thresholds, up to a maximum reduction of 80% of itemized deductions.

The TCJA put the Pease limit on hold from 2018 through 2025. Without further legislation, the Pease limit would have snapped back in 2026 for single filers earning more than about $339,850 and for joint filers earning more than about $407,850.

Enter the OBBBA. Under the OBBBA, the Pease limitation is permanently eliminated. In its place, high earners in the top 37% tax bracket are now limited to a $0.35 tax benefit per $1 of itemized deductions.

Beginning in the 2026 tax year, high earners face a flat reduction if their income enters the top 37% marginal tax bracket. Under this new system, itemized deductions are reduced by 2/37 of the lesser of two amounts:
● The total otherwise allowable itemized deductions.
● The taxable income that exceeds the threshold where the 37% tax bracket begins.

The new rule is more surgical than its predecessor. Unlike the old Pease limitation, which over the years affected more middle-income households, the 2/37 rule now limits only taxpayers whose income falls in the top bracket, currently above $640,600 for single filers or $768,700 for joint filers.

This limitation applies after all other itemized deduction limitations, including the new SALT cap and charitable floors, making it a “last-but-not-least” hit to high earners.

CALIFORNIA

California does not conform to federal law governing the overall limitation on itemized deductions. Although federal Pease limitations were suspended through 2025 and then permanently replaced beginning in 2026 by the OBBBA’s “2/37 rule,” California continues to apply a customized limitation based on older Pease concepts.

The California limitation is tied to California AGI and inflation-indexed thresholds. The reduction equals 6% of the excess AGI over the threshold, capped at 80% of affected itemized deductions. California applies this limitation on the state tax return using the “Itemized Deductions Worksheet” found within the FTB Schedule CA Instructions. A reduction in California itemized deductions occurs when a taxpayer exceeds the AGI threshold for their filing status.

REDUCTION IN ITEMIZED DEDUCTIONS	
Filing status	**AGI threshold***
Single or married/RDP filing separately	$252,203
Head of household	$378,310
Married/RDP filing jointly or surviving spouse	$504,411
* The FTB will adjust these thresholds in the last quarter of 2026.	

High-income taxpayers calculate their reduction on Schedule CA using the four-step process described below.

Step 1. Determine the amount by which the taxpayer’s California AGI exceeds the applicable threshold for their filing status.

Step 2. Multiply that excess AGI by 6%.

Step 3. Multiply the taxpayer’s affected itemized deductions by 80%. Certain deductions, including medical expenses, investment interest expense, casualty losses, and gambling losses, are generally excluded from the limitation.

Step 4: Reduce the affected itemized deductions by the amount calculated in Step 2 (6% of excess AGI) or Step 3 (80% of itemized deductions), whichever is lower.

Example. Anita is filing as single with a California AGI of $300,000. Her initial total California itemized deductions equal $50,000. To find her reduction, we go through the four steps described above:

- Anita's excess AGI is $47,797 ($300,000 – $252,203).
- 6% of her excess AGI is $2,867.82 ($47,797 × 0.06).
- 80% of her itemized deductions is $40,000 ($50,000 × 0.80).
- The lesser of those two figures is $2,867.82.

Consequently, Anita's itemized deductions are reduced by $2,867.82, leaving her with a final California itemized deduction total of $47,132.18 ($50,000 – $2,867.82).

REVIEW QUESTIONS

51. Reina is a 67-year-old single California resident. Her mortgage interest and property taxes exceed California's standard deduction on Form 540. Reina's total itemized deductions are below the federal standard deduction, including the additional age-related deduction. For 2026, which filing combination correctly reflects her federal and California positions?
{A}. Itemize on both Form 1040 and Form 540.
{B}. Claim the standard deduction on both Form 1040 and Form 540.
{C}. Itemize on Form 1040 and claim California's standard deduction on Form 540.
{D}. Claim the federal standard deduction on Form 1040 and itemize on Form 540.

52. In 2026, a California taxpayer with AGI of $150,000 paid $13,750 in unreimbursed medical expenses solely for their registered domestic partner (RDP). The RDP does not qualify as the taxpayer's federal dependent. The taxpayer itemizes deductions on both the federal and California returns. What is the maximum medical expense deduction allowed on the federal and state tax returns?
{A}. Federal: $0; California: $0.
{B}. Federal: $2,500; California: $2,500.
{C}. Federal: $0; California: $2,500.
{D}. Federal: $13,750; California: $13,750.

53. California sets its own limit on itemized deductions for higher-income residents, which is different from federal rules like the OBBBA's 2/37 rule. For instance, Elvin lives in California and has an AGI of $292,203. His itemized deductions that are subject to limitation total $55,000. The California AGI limit for Elvin's filing status is $252,203. How do you calculate the reduction in his California itemized deductions?
{A}. 6% of the AGI exceeding the threshold, capped at 80% of the affected deductions.
{B}. 3% of the AGI exceeding the threshold, capped at 40% of the affected deductions.
{C}. California does not reduce itemized deductions for high-income taxpayers.
{D}. California automatically reduces all itemized deductions by a flat 10% for this bracket.

Part E reveals the correct answers to all end-of-chapter review questions while providing feedback on both correct and incorrect responses.

Chapter 18. TAX PROVISIONS FOR BUSINESSES IN CA

Learning objectives: By the end of this chapter, you will be able to spot the main differences between California and federal tax rules for small businesses. This includes topics like depreciation, Section 179 deductions, business meal deductions, cannabis deductions, loss limits, and the PTE elective tax. You will be able to report differences and make the necessary adjustments on the appropriate California tax forms.

Chapter Topics

- Cost recovery for California small businesses
  - » Depreciation basics
  - » Bonus depreciation
  - » Section 179 expensing
  - » Passenger automobiles
- Business deductions
  - » Qualified Business Income (QBI) deduction
  - » Deduction for business meals and entertainment
  - » Cannabis businesses
- Business loss limitations
  - » Passive activity losses
  - » Net operating losses
  - » Excess business losses
- Pass-Through Entity (PTE) elective tax and credit
  - » Background
  - » California's PTE tax with state credit
  - » Prepayment requirement

This chapter explains how business tax rules work after Senate Bill 711 (SB 711) and the federal OBBBA. Although SB 711 updated conformity through January 1, 2025, many key provisions still require separate California treatment. Tax professionals should be aware of these differences, as they often require separate calculations and adjustments on California tax returns.

ENTITY TYPE	PASS-THROUGH ENTITY?	CALIFORNIA TAX / FILING OBLIGATION
Sole proprietorship	Yes	Schedule C reported on Form 540; no entity-level tax
General partnership	Yes	Form 565; no entity-level income tax
Limited partnership / LLP	Yes	Form 565; no entity-level income tax, but $800 minimum franchise tax
LLC (single-member)	Usually yes	Treated as disregarded entity; $800 annual tax plus LLC fee
LLC (multi-member)	Usually yes	Form 568; $800 annual tax + LLC fee based on total income
S corporation	Yes	Form 100S; 1.5% net income tax (minimum $800)
C corporation	No	Form 100; 8.84% net income tax (minimum $800)

COST RECOVERY FOR CALIFORNIA SMALL BUSINESSES

DEPRECIATION BASICS

Federal. Since 1986, federal tax depreciation has mostly used the Modified Accelerated Cost Recovery System (MACRS). This system assigns assets to set recovery periods — such as 5, 7, or 15 years — and uses faster depreciation methods, such as 150% or 200% declining balance. In addition to regular MACRS depreciation, federal law also allows immediate cost recovery through Section 179 expensing and bonus depreciation under Section 168(k).

California. California generally uses the same MACRS methods and recovery periods as the federal system for individuals, partnerships, and S corporations. However, it does not follow certain federal acceleration provisions, such as bonus depreciation and expanded Section 179 limits. Because of this, taxpayers need to keep separate California depreciation records using FTB Form 3885A (Form 3885L for LLCs or Form 3885 for corporations). California depreciation generally results in slower cost recovery and a higher adjusted basis at sale, so Schedule CA adjustments are needed.

BONUS DEPRECIATION

Federal. Under the TCJA, 100% bonus depreciation was allowed for qualified property placed in service between September 28, 2017, and December 31, 2022. However, the TCJA planned to reduce bonus depreciation by 20% each year after 2022, ending it in 2027.

The OBBBA permanently restored 100% bonus depreciation for qualified property acquired and placed in service after January 19, 2025. This cancels the earlier plan to phase it out.

California. While federal tax law often provides for accelerated and bonus depreciation, California generally takes a more conservative approach, resulting in slower depreciation.

R&TC sections 17250, 24349, and 24349.1 do not follow bonus depreciation rules under IRC Section 168(k). Small business owners must keep separate depreciation records for federal and California taxes, typically using FTB Form 3885A. They must make annual adjustments to balance these differences.

Example. Chandler owns a pass-through business that generated a net loss in 2026. During the year, he purchased and placed into service several business assets used 100% for business purposes. Chandler elected bonus depreciation on his federal tax return because IRC Section 179 expensing would provide a limited immediate benefit in a loss year. California does not conform to federal bonus depreciation rules. As a result, Chandler must add back the bonus depreciation deduction on his California return and instead depreciate the assets over their applicable California recovery periods. Chandler reports the California depreciation adjustments on FTB Form 3885A and Schedule CA.

Qualified Production Property (QPP). The OBBBA also created a new category, Qualified Production Property (QPP), under IRC Section 168(n). This lets businesses immediately expense 100% of improvements to nonresidential real estate used in qualified domestic production activities.

California does not follow Section 168(n). Any QPP that is expensed on the federal return must be treated as a capital asset and depreciated over 39 years using the straight-line method on the California return.

Depreciation and Amortization Adjustments

CALIFORNIA FORM **3885A**

Do not complete this form if your California depreciation amounts are the same as federal amounts.

Name(s) as shown on tax return | SSN or ITIN

Part I Identify the Activity as Passive or Nonpassive. (See instructions.)

1 ☐ This form is being completed for a passive activity.
☐ This form is being completed for a nonpassive activity.

Business or activity to which form FTB 3885A relates

Part II Election to Expense Certain Tangible Property (IRC Section 179).

2 Enter the amount from line 12 of the Tangible Property Expense Worksheet in the instructions . . . . . ◉ 2 _____

Part III Depreciation	(a) Description of property placed in service	(b) Date placed in service mm/dd/yyyy	(c) California basis for depreciation	(d) Method	(e) Life or rate	(f) California depreciation deduction
3						

4 Add the amounts on line 3, column (f) . . . . . 4 _____

5 California depreciation for assets placed in service prior to 2018. . . . . 5 _____

6 Total California depreciation from this activity. Add the amounts on line 2, line 4, and line 5 . . . . . 6 _____

7 Total federal depreciation from this activity. Enter depreciation from federal Form 4562, line 22 . . . . . 7 _____

8 a If line 6 is **more** than line 7, enter the difference here and see instructions. . . . . 8a _____

b If line 6 is **less** than line 7, enter the difference here and see instructions. . . . . 8b _____

SECTION 179 EXPENSING

Federal. Section 179 provided relatively small deduction limits of less than $25,000 for much of its history. In 1996, the expensing provisions were amended (in the Small Business Job Protection Act) to allow the dollar limitation to increase over several years, and the Section 179 benefit reached $25,000 in 2003. Since then, Congress raised the Section 179 limit to over $2 million. However, for vehicles with a gross vehicle weight rating (GVWR) of 6,001 to 14,000 pounds, the Section 179 deduction is capped at $32,000.

Before the OBBBA, a taxpayer could deduct up to $1,250,000 for qualifying property placed in service in 2025. This limit would decrease (but not below zero) if the total cost of qualifying property placed in service that year went over $3,130,000.

The OBBBA greatly increased Section 179 expensing by raising the maximum deduction to $2.5 million and the phaseout limit to $4 million, both adjusted for inflation starting in 2025. For 2026, the maximum deduction is $2,560,000, and the deduction begins to decrease when the qualifying property placed in service exceeds $4,090,000; it is completely phased out at $6,650,000.

California. Subject to the limits described below, California law also allows businesses to expense the cost of tangible personal property in the tax year that such property is placed into service. R&TC sections 17255 and 24356 partially conform to the IRC Section 179 expensing provisions, as written in 2003. California did not adopt the federal increases to the maximum deduction and phaseout limits made after 2003.

Instead, California kept the $25,000 deduction limit and $200,000 phaseout threshold from 2003.

FEDERAL ACCELERATED COST RECOVERY METHODS VS. CALIFORNIA'S SLOWER COST RECOVERY METHODS		
Method	***Federal***	***California***
Bonus depreciation	100% of the cost of eligible assets placed in service after 1/19/2025.	Regular depreciation is available, with no first-year "bonus."
Section 179	Up to $2,560,000 of the cost of eligible assets in the year they are placed in service.	Up to $25,000 of the cost of eligible assets in the year they are placed in service.

California's version of Section 179 has its own rules about what counts as "qualifying property." For example, the state does NOT allow Section 179 deductions for roofs, HVAC units, fire protection or alarm systems, and security systems installed in nonresidential buildings [R&TC sections 17024.5(a) and 23051].

Also, California does not adopt the federal provision that allows off-the-shelf computer software to be expensed under Section 179. In California, depreciable property eligible for immediate expensing is generally limited to tangible personal property rather than intangible or real property.

R&TC Section 17255 limits the first-year deduction for new business assets to $25,000 or the business's taxable income, whichever is less. If the deduction is reduced because of this income limit, the unused amount can be carried forward indefinitely.

California business owners can take full advantage of this special deduction until their equipment purchases reach $200,000. After spending $200,000 on equipment, the deduction decreases dollar-for-dollar.

Example. Alcala & Zuniga, or A&Z, is a two-member partnership operating in California. A&Z purchases $220,000 worth of business equipment that qualifies for federal and state expensing under Section 179. The business places this equipment into service in 2026. Before reaching California's $200,000 threshold, the partnership was eligible for a $25,000 deduction. However, since A&Z surpassed the $200,000 threshold, the partnership must phase out its $25,000 deduction by the amount by which it exceeds the threshold. Thus, A&Z's California deduction under Section 179 will be $5,000 [$25,000 – ($220,000 – $200,000)].

California's Section 179 deduction limit is $25,000 (not adjusted for inflation) for all qualifying business assets, including vehicles with a GVWR over 6,000 pounds. California did not adopt the TCJA rule that raises the deduction limit for certain heavy vehicles (those weighing 6,001 to 14,000 pounds). So, a California resident can deduct

up to $32,000 for an eligible business vehicle on their 2026 federal return, but only $25,000 on their state return.

PASSENGER AUTOMOBILES (GVWR ≤ 6,000 POUNDS)

Federal. Passenger automobiles are labeled as "listed property" under IRC Section 280F(d)(4), and Section 280F(a) limits the annual cost recovery deduction for certain passenger automobiles. This limitation is commonly referred to as the "luxury automobile depreciation limitation."

The term "luxury vehicle" is not just for brands like Mercedes-Benz, BMW, and Lexus. Any four-wheeled vehicle made mainly for use on public roads and weighing 6,000 pounds or less (when unloaded) is considered a "luxury vehicle" and subject to depreciation limits [IRC Section 280F(d)(5)(A)].

For passenger automobiles placed in service during 2026, for which bonus depreciation under IRC Section 168(k) is not claimed, the maximum allowable depreciation is $12,300 for the first year.

In addition to the regular depreciation limits, federal law allows taxpayers to add an $8,000 bonus depreciation to the first-year deduction for a passenger car used 100% for business. If the vehicle is used less than 100% for business, the bonus depreciation is reduced based on business use.

	FEDERAL	CALIFORNIA
Year 1 (no bonus)	Regular depreciation: Up to $12,300	$3,860
Year 1 (with 100% bonus)	PLUS up to $8,000 = $20,300 combined	$3,860 (no bonus allowed)

California. California law does not allow bonus depreciation under IRC Section 168(k). This ban also applies to the $8,000 bonus depreciation for passenger cars used 100% for business.

California does not automatically follow recent federal changes to regular depreciation limits for personal-use property and passenger cars (for example, the updated $12,300 first-year limit for 2026).

Below are California's regular depreciation limitations for ***passenger automobiles*** (there is no bonus depreciation added to these amounts):

Tax Year	Amount
Year 1	$3,860
Year 2	$6,100
Year 3	$3,650
Each succeeding year	$2,175

Below are California's regular depreciation limitations for ***trucks and vans*** (there is no bonus depreciation added to these amounts):

Tax Year	Amount
Year 1	$4,360
Year 2	$6,900
Year 3	$4,150
Each succeeding year	$2,475

Example. Jason buys a new car for $65,000 in 2026 and uses it 85% for business. His depreciable basis is $55,250 ($65,000 cost × 85% business use). Jason's regular depreciation for 2026 would be 20% × $55,250 = $11,050. Because the car is a light passenger vehicle subject to limitations, his total federal deduction for 2026 is limited to $10,455 (85% business use × $12,300 annual limit) plus $6,800 of bonus depreciation (85% × $8,000 bonus). Therefore, his first-year write-off for the $65,000 car is $17,255 on his federal return. On his California return, Jason can only claim $3,281 (85% × $3,860) of regular depreciation for the business vehicle purchase. There is no bonus depreciation component in California.

For noncorporate taxpayers, any differences between federal and California depreciation amounts are usually adjusted on FTB 3885A before transferring the resulting numbers to Schedule CA, Section B.

BUSINESS DEDUCTIONS

QUALIFIED BUSINESS INCOME (QBI) DEDUCTION

Federal. The OBBBA has made the Section 199A QBI deduction permanent. This means eligible taxpayers can deduct up to 20% of their qualified business income under federal law, subject to various limitations.

California. California does not conform to IRC Section 199A. Because of this, California taxable income for pass-through owners is consistently higher than federal taxable income by the amount of the QBI deduction.

Example. Jakob is a California resident who owns an S corporation consulting business. In 2026, his business earns $200,000 in QBI, and he qualifies for the full federal Section 199A deduction. On Jakob's federal tax return, he deducts $40,000 ($200,000 × 20%), so only $160,000 is subject to federal income tax. Since California does not follow IRC Section 199A, Jakob cannot take the $40,000 deduction on his state return and must report the full $200,000 as California taxable income.

For many California owners of S corporations, partnerships, and LLCs taxed as partnerships, the lack of conformity to Section 199A is one of the biggest ongoing differences between federal and California taxable income.

DEDUCTION FOR BUSINESS MEALS AND ENTERTAINMENT

Federal. Federal law allows deductions for some business meal expenses paid or incurred in 2026, but the deduction percentage depends on the type of expense. Generally, entertainment expenses cannot be deducted unless they are treated as taxable pay to the recipient.

A business meal expense can be deducted only if all these conditions are met:
● The expense is ordinary and necessary in carrying on a trade or business.
● The expense is not lavish or extravagant under the circumstances.
● The taxpayer or an employee is present at the meal.
● The meal is provided to a current or potential business customer, client, consultant, or other bona fide business contact.
● If food or beverages are provided during an entertainment activity, the food and beverages must be purchased separately from the entertainment or separately stated on receipts, invoices, or billing statements.

Examples of 100% deductible meal expenses include:
● Meals or snacks provided at a company-wide holiday party, picnic, or similar employee-appreciation event open to substantially all employees.
● Food or beverages provided free of charge to the general public (e.g., sample stands, promotional events, open-house refreshments).
● Meals or food included in taxable compensation to employees (e.g., reported on Forms W-2) or nonemployees (e.g., reported on Forms 1099-NEC).
● Meals that are sold to customers in a bona fide transaction for full and adequate consideration (part of normal restaurant operations).

Examples of 50% deductible meal expenses include:
● Meals with clients or customers where business is discussed;
● Employee meals while traveling away from home on business;
● Meals provided during board meetings or business conferences; and
● Meals purchased separately from entertainment activities.

For expenses paid or incurred after December 31, 2025, no deduction is allowed for meals provided for the employer's convenience or for costs related to employer-run eating facilities. This OBBBA change affects many expenses that were deductible before, such as:

- Meals furnished at employer cafeterias;
- Meals provided so employees remain available for emergencies or short meal breaks; and
- Regularly provided on-premises meals and beverages furnished primarily for the employer's convenience.

California. California does not follow the federal changes under the TCJA or OBBBA. The state still allows deductions for meals and entertainment under the older pre-TCJA rules, with a 50% limit unless an exception applies. Because of this, there will be differences between California and federal taxes for businesses with cafeteria meals, convenience meals, and de minimis food and beverage expenses. These may still be deductible in California, but not at the federal level.

California generally follows the older federal rules for many entertainment expenses. This means costs like client golf outings, sporting event tickets, and theater tickets may still get a partial deduction in California, even if they are not deductible at the federal level.

When California allows a deduction that federal law does not, the difference is usually reported on Schedule CA (Part I, Section B, line 3, column C).

The following chart summarizes the federal and California treatment of common meals and entertainment expenses.

Meals and Entertainment Expenses		
Expense Category	**Federal (2026)**	**California (2026)**
Entertainment (sporting events, theater, golf)	0% deductible	50% deductible
Client meals not separately stated from entertainment	0% deductible	50% deductible
Meals purchased separately from entertainment activities	50% deductible	50% deductible
Meals for employer convenience (e.g., cafeteria meals, overtime meals, office snacks)	0% deductible (changed by OBBBA)	100% deductible if de minimis; otherwise 50%
De minimis fringe benefit food and beverages, such as breakroom coffee, bottled water, and snacks	0% deductible (changed by OBBBA)	100% deductible if de minimis; otherwise 50%
Client meals directly related to a business meeting	50% deductible	50% deductible
Meals for employees while traveling for business	50% deductible	50% deductible
Holiday parties, company picnics, and other employee recreational or social events (all employees invited)	100% deductible	100% deductible
Meals treated as taxable compensation (included on Forms W-2 or 1099)	100% deductible	100% deductible

CANNABIS BUSINESSES

Federal. IRC Section 280E prohibits businesses from deducting any expenses from their gross income if those expenses involve "trafficking" controlled substances. Federal law still classifies marijuana (also called cannabis) as a Schedule I controlled substance.

Section 61 of the Internal Revenue Code requires reporting gross income from any source (unless an exception applies). This means that income from a marijuana business, even if it is illegal under federal law, still has to be reported for federal taxes.

Federal law does not allow businesses to deduct expenses related to commercial cannabis activities. As a result, marijuana businesses must pay income tax on their gross profits before subtracting expenses, instead of paying tax only on what is left after expenses.

Section 280E still allows marijuana businesses to subtract the cost of goods sold (COGS) from their gross receipts to calculate gross income. COGS covers the cost of the product itself and certain inventory-related expenses needed to acquire or produce it, such as inbound shipping costs to deliver cannabis to the seller.

However, marijuana businesses are not allowed to include selling, distribution, or other non-inventory costs in their COGS. Expenses that cannot be deducted include outbound shipping or delivery to customers, rent, contractor payments, maintenance and repairs, health insurance, marketing and advertising, utilities, and employee expenditures that are not related to producing or acquiring inventory.

SECTION 280E DISALLOWANCE OF MARIJUANA BUSINESS DEDUCTIONS		
	Marijuana Retailer (state-legal licensed dispensary)	**Traditional Retailer**
Gross receipts	$330,000	$330,000
Rent	~~$45,000~~ (not allowed)	$45,000
Section 179 equipment	~~$2,000~~ (not allowed)	$2,000
Utilities	~~$2,000~~ (not allowed)	$2,000
Maintenance	~~$1,000~~ (not allowed)	$1,000
Cost of goods sold	$180,000	$180,000
Net profit	$150,000	$100,000

California. California is one of the states that has legalized marijuana for medical and recreational use. In recent years, California has created rules for the legal marijuana industry. In this state, a "commercial cannabis activity" means a business licensed under the California Medicinal and Adult-Use Cannabis Regulation and Safety Act (MAUCRSA).

California law [R&TC Section 17209] lets taxpayers claim credits and deductions for business expenses paid or incurred during the year for a commercial cannabis activity. Because of this, a commercial cannabis business will report different deduction amounts on federal and California tax returns. Taxpayers can enter the extra deductions allowed by California (but not by federal law) on Schedule CA, Part I, Section B, line 3, column B.

Schedule CA (Section B) adjustment for a California cannabis dispensary

	Federal Amount	CA Subtraction	CA Additions
3 Business income or (loss). See instructions. 3	◉ $150,000	◉ $50,000	◉
4 Other gains or (losses) 4	◉	◉	◉
5 Rental real estate, royalties, partnerships, S corporations, trusts, etc. 5	◉	◉	◉

Taxpayers running a commercial cannabis business licensed under MAUCRSA must file Form FTB 4197, *Information on Tax Expenditure Items*. They use this form to report tax items like deductions, credits, exclusions, and exemptions.

BUSINESS LOSS LIMITATIONS

PASSIVE ACTIVITY LOSSES

Federal. A passive activity is one in which the taxpayer does not materially participate on a regular, continuous, and substantial basis.

Generally, the taxpayer cannot offset taxes on nonpassive income with losses from passive activities, but there is an exception to this rule. A rental real estate activity can be transformed from passive to nonpassive if someone actively or materially participates in it.

Active participation is a less stringent standard than material participation and applies only to rental real estate activities. Provided that a taxpayer participates in management decisions in a bona fide sense (e.g., approving new tenants or repairs), they are considered to be actively engaging in the real estate rental activity.

When property owners actively participate in the rental activity, they can write off up to $25,000 of their property losses against other income. To qualify for this write-off, the property owner must have an AGI of $100,000 or less. The property owner's ability to claim the passive activity loss deduction begins to decrease by $1 for every $2 of income over the $100,000 threshold. Once AGI exceeds $150,000, the $25,000 offset is reduced to zero.

Rental property losses that exceed the $25,000 limit are not lost forever. Taxpayers can carry forward excess losses to use in a future year. This carryforward option will benefit landlords who incur major expenses (over $25,000), such as when an apartment must be thoroughly renovated after a long-term tenant vacates.

For federal purposes, rental real estate activities are not passive if the taxpayer qualifies as a "real estate professional." When a taxpayer is a real estate professional, losses from rental real estate are not limited to the $25,000 special allowance discussed above.

Eligible real estate professionals can deduct their rental losses from their non-rental income, regardless of their income or loss amounts.

An individual does not need to be a licensed real estate agent or realtor to receive this tax benefit. To qualify as a real estate professional, an eligible individual must meet both of the following criteria:
● Perform more than 50% of personal services in real property trades or businesses in which they materially participate.
● Log more than 750 hours of service during the tax year in those real property trades or businesses.

California. Like federal law, California does permit taxpayers to offset nonpassive income by up to $25,000 in passive losses if they actively participate in a rental real estate activity (losses exceeding $25,000 may be carried over). The $25,000 limitation is reduced when an individual's AGI exceeds $100,000. When AGI surpasses $150,000, the $25,000 offset is zeroed out (because the passive activity loss deduction goes down by $1 for every $2 in income over the $100,000 threshold).

California does not conform to the federal rule that allows real estate professionals to treat rental real estate activities as nonpassive. For state tax purposes, passive activity loss rules apply to real estate professionals. Because California disallows the real estate professional exception under R&TC Section 17561, the rental loss that was fully deducted on the federal return must be added back on the California return, effectively increasing California taxable income. A California resident who fully deducts rental real estate losses on a federal return under the real estate professional exception must compute allowable California passive losses using FTB Form 3801, *Passive Activity Loss Limitations*. Once FTB Form 3801 determines the limited California-allowable loss, the difference between the fully deductible federal amount and the limited state amount is carried over to Schedule CA (Part I, Section B, line 5, Column C).

Example. Erik owns a rental property that produced a $40,000 loss. Erik could not utilize that loss under the active participation standard because he earned over $150,000 in 2026. However, Erik qualifies as a real estate professional for federal tax purposes. Because he is a real estate professional, Erik can fully deduct the $40,000 passive loss against his ordinary income on his federal return. California has no "real estate professional" exception or a material participation test to determine whether taxpayers can fully deduct their rental losses. Under California law, landlords who are active participants in a rental activity can offset up to $25,000 of their rental property losses against other income. To be eligible for this write-off, the property owner must have an AGI of $100,000 or less. Since Erik's AGI is over $150,000, he does not qualify for the $25,000 offset. In the end, Erik's $40,000 passive activity loss was fully deducted on his federal return, but he was ineligible for any deduction on his California return.

SPECIAL ALLOWANCE FOR PASSIVE ACTIVITY LOSS (PAL)	
Deduct up to $25,000 in rental losses against nonpassive income	
	➤ When taxpayer meets the active participation standard
	➤ When taxpayer owns at least 10% of the property
PAL deduction starts to phase out when AGI reaches $100,000	
	➤ PAL deduction is eliminated when AGI is $150,000 or more
	➤ Having real estate professional status does not alter the tax treatment of passive activity losses in California

NET OPERATING LOSSES

When a business loss exceeds current-year taxable income, the owner has a net operating loss (NOL). The NOL deduction allows businesses to manage their losses by offsetting or deducting one tax year's losses from another tax year's profits.

California and federal law are alike in that businesses may not carry back net operating losses but may carry forward NOLs. However, California does not conform to the TCJA rules that:

● Allow unlimited NOL carryforwards (California still limits NOL carryforwards to 20 years); and

● Limit the NOL deduction to 80% of taxable income (taxpayers may still deduct 100% of their NOL amounts on California returns).

A taxpayer would use the appropriate FTB form (in most cases, Form 3805V) to compute their NOL using California rules. Whenever a noncorporate taxpayer has a different NOL amount on their federal return (specifically, line 8a on Schedule 1), an adjustment must be made on Schedule CA, Section B, line 8a.

Temporary NOL deduction suspension. Despite the more favorable uncapped structure, California has temporarily suspended NOL carryover deductions for tax years 2024, 2025, and 2026. The NOL suspension provisions apply to individuals, pass-through entities, and C corporations. However, the NOL suspension rules do not apply to small businesses with net income or MAGI of less than $1 million. Small business owners may continue to compute and carry over an NOL during the suspension period.

The state's 20-year NOL carryforward may be extended by taxpayers impacted by the NOL suspension for up to 3 years if the losses cannot be utilized due to the NOL suspension. The carryover periods for the suspended NOL deductions would be extended as follows:

● Three years for losses incurred in tax years beginning before January 1, 2024.

● Two years for losses incurred in tax years beginning on or after January 1, 2024, and before January 1, 2025.

● One year for losses incurred in tax years beginning on or after January 1, 2025, and before January 1, 2026.

SB 175 includes a provision that could result in early termination of the NOL suspension if California's General Fund revenues are sufficient to support earlier reinstatement. In other words, if the State Director of Finance determines the California General Fund contains a sufficient revenue surplus, the NOL suspension could be prematurely deactivated for 2026. Given ongoing fiscal deficits, the suspension remains fully active.

EXCESS BUSINESS LOSSES

Federal. The noncorporate business loss limitation, also known as the excess business loss (EBL) limitation, is a provision in IRC Section 461(l) that limits the amount of business losses noncorporate taxpayers can deduct against their nonbusiness income, such as wages and investment income.

Business losses over a designated threshold amount cannot offset nonbusiness income in the year of the loss. The inflation-adjusted threshold amount in 2026 is $512,000 for married individuals filing jointly and $256,000 for other individuals [IRC Section 461(l)(3)(A)].

Excess business losses are not permanently disallowed. Instead, they are treated as an NOL carryforward to the following tax year. Under federal law, any excess business loss is carried forward indefinitely under the NOL rules to offset 80% of the business owner's taxable income in the carryforward year.

The OBBBA makes the EBL limitation permanent, removing the previous sunset date of December 31, 2028.

California. R&TC Section 17560.5 has incorporated IRC Section 461(l) with modifications.

California updates its thresholds annually, but they are not tied to the federal inflation adjustments. California disallows deductions for excess business losses over $313,000 for a single filer and $626,000 for joint filers. Noncorporate business owners with net losses exceeding these amounts must complete FTB Form 3461, *California Limitation on Business Losses*, and attach it to their state tax return.

For California purposes, any disallowed loss is treated as a carryover excess business loss for the following tax year and not as an NOL carryover subject to the 80% of federal taxable income limit. In other words, the excess business loss carried over to next year's California tax return may offset 100% of taxable income (assuming that the taxable income is not more than the thresholds mentioned above).

Example. A married couple filing jointly has W-2 wages of $250,000, capital gains of $476,000, and a $750,000 partnership loss. W-2 wages will not factor into the computation, and accordingly, the excess business loss will be $124,000 ($750,000 net business loss – $626,000 threshold). The couple's net taxable income will be $100,000 ($250,000 in W-2 wages + $476,000 in capital gains – $626,000 in deductible business

loss). Without the EBL limitation, this couple would have had zero taxable income and an NOL of $24,000 on their California return.

COMMON CALIFORNIA BUSINESS ADJUSTMENT FORMS	
FTB 3885A	Depreciation and amortization adjustments
FTB 3885L	LLC depreciation adjustments
FTB 4197	Cannabis activity reporting
FTB 3801	Passive Activity Loss Limitations
FTB 3805V	NOL computation
FTB 3461	Excess business loss limitation
FTB 3804	PTE elective tax

PASS-THROUGH ENTITY (PTE) ELECTIVE TAX AND CREDIT

BACKGROUND

When the TCJA was enacted in 2017, one controversial provision was the $10,000 limitation on itemized deductions for state and local taxes (SALT). For California business owners with significant state tax obligations, this cap eliminated most or all of their previously available SALT deduction.

The SALT cap applies to individuals, but not entities. Armed with this distinction, many states enacted laws giving pass-through entities (PTEs) the option to pay state taxes at the entity level. A "PTE tax" is similar to a traditional corporate tax but applies to partnerships and S corporations. When a PTE pays taxes at the entity level rather than at the individual level, the taxes paid to states are deductible from federal taxable income. Because of this, taxes paid to states by eligible pass-through entities are deducted at the federal level and are not subject to the SALT deduction cap.

CALIFORNIA'S PTE TAX WITH STATE CREDIT

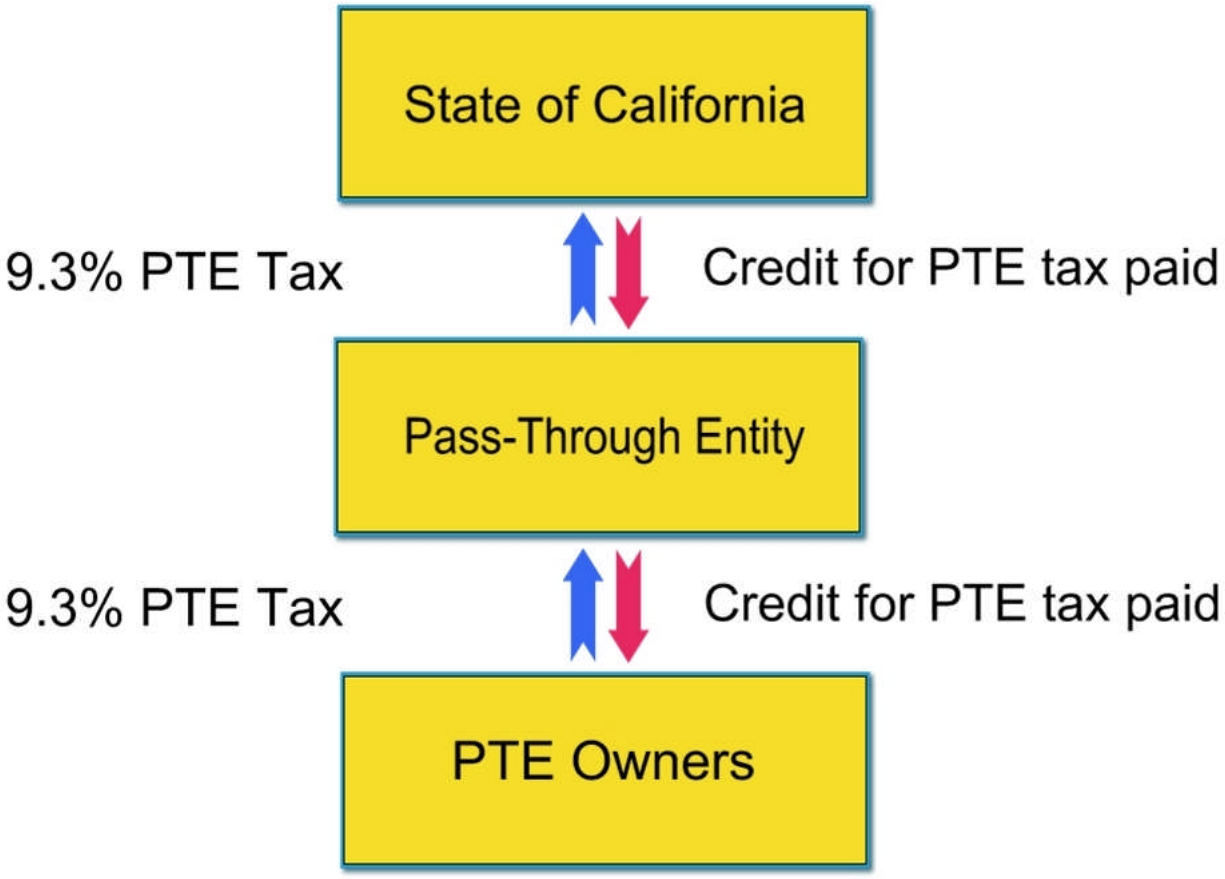
The California SALT cap workaround was enacted in 2021 with an expiration date of December 31, 2025. However, the PTE elective tax and credit was recently extended to apply to tax years beginning on or after January 1, 2026, and before January 1, 2031. This extension ensures that California small-business owners can continue to use the PTE workaround through the 2030 tax year.

The business provision allows many partnerships, LLCs taxed as partnerships, and S corporations to pay an entity-level tax based on the owners' share of income. A qualifying PTE is not a sole proprietorship, a publicly traded partnership, or an entity that is part of a combined reporting group (combined reporting treats the parent and most subsidiaries as one corporation for state income tax purposes).

Eligible taxpayers can pay the elective 9.3% tax on their net income and then claim a nonrefundable credit on their personal tax returns. This state tax payment is a deduction on the federal return and is passed through to the owners on Schedule K-1.

Eligible entities that make the election will pay a 9.3% tax on the total of each consenting owner's pro-rata share of the entity's income that is subject to tax in California. Residents will apply the PTE tax to all of their distributive income. The tax base for nonresidents will only include the distributive share of California-sourced income. The PTE elective tax is computed on FTB 3804.

Qualifying owners who consent to the entity-level tax receive a credit proportionate to the PTE tax paid for their allocable share of pass-through income. The tax credit is authorized by R&TC Section 17052.10. The net effect is that the individual owner pays no more California income tax than they would have paid had the election not been made.



Example. Three people residing in California are equal owners of an LLC taxed as a partnership. Each member of the LLC consents to having their share of the LLC's income taxed at the entity level. In 2026, the LLC's taxable income is $1,354,839 ($451,613 per LLC member). The applicable California tax rate of 9.3% would result in the LLC paying $126,000 ($1,354,839 × 9.3%) in PTE taxes; this means each LLC

member would pay $42,000 in PTE taxes ($126,000 ÷ 3). These California taxes paid by the business entity are deductible for federal purposes but not for California purposes. In this simplified example, each LLC member's federal K-1 income would be reduced by $42,000 — their share of the $126,000 in California PTE taxes paid by the LLC. As a result, each LLC member gets a federal K-1 reporting income of $409,613 ($451,613 – $42,000). Each LLC member gets a California K-1 reporting income of $451,613. In addition, the LLC passes through a $42,000 California tax credit to each owner. The nonrefundable PTE credit thus reduces each LLC member's California tax liability while circumventing the federal cap on SALT deductions.

If the allowed credit exceeds the net tax reported on the business owner's return, the excess will be carried forward to reduce the tax in the next tax year and the following four years (for a total of five years).

PREPAYMENT REQUIREMENT

California's PTE elective tax is paid in two installments each year. The first installment is due by June 15 and equals the greater of $1,000 or 50% of the elective tax paid in the prior tax year. The second installment is due on the entity's original return due date (typically March 15 for calendar-year S corporations and partnerships).

Example. Carr & Barr, a California partnership, paid $80,000 in PTE elective tax for 2025. For 2026, the required June 15 prepayment is $40,000 (50% × $80,000), since that amount exceeds $1,000. The remaining balance is due by the partnership's original return due date.

Before 2026. For tax years beginning before January 1, 2026, failing to make the required June 15 prepayment generally prevented the partnership or S corporation from making the elective tax election for that year. As a result, qualified owners could not claim the related California PTE tax credit or utilize the SALT deduction workaround for that tax year.

Starting January 1, 2026. For tax years beginning on or after January 1, 2026, California adopted a more flexible approach. If a PTE fails to make the required June 15 prepayment or makes a prepayment for less than the required amount, the entity may still make the election. However, the owners' credit is reduced by 12.5%.

Tax year	June 15 payment made?	Election allowed?	Effect on owners' credit
Before 2026	No	No	No elective tax credit
2026 and later	No or short payment	Yes	Credit reduced by 12.5%

REVIEW QUESTIONS

54. A sole proprietor buys a new $50,000 passenger automobile in 2026 and uses it 100% for business. The car has a GVWR of 4,800 pounds. Which statement best describes the federal and California first-year depreciation treatment?
{A}. Federal law allows bonus depreciation; California disallows it.
{B}. Both the federal and California governments disallow bonus depreciation.
{C}. Both federal and California cap first-year depreciation at $12,300.
{D}. Both the federal and California governments allow the $8,000 bonus depreciation amount.

55. Alisha qualifies as a “real estate professional” under federal rules for passive activity losses. She actively participated in managing a rental property that generated a $30,000 loss. Assuming no phaseout applies, how much of this passive loss can Alisha deduct from her nonpassive income on her California tax return (Form 540)?
{A}. $0; passive losses can never offset nonpassive income on Form 540.
{B}. $5,000; real estate professionals can only deduct passive losses exceeding $25,000 on Form 540.
{C}. $25,000; California does not conform to the federal real estate professional rule, so Alisha cannot deduct more than $25,000 of her rental loss on Form 540.
{D}. $30,000; California conforms to the federal rule permitting real estate professionals to treat rental losses as nonpassive without limit.

56. A small business has $100,000 in gross income and $150,000 in allowable deductions in 2026. This business has a net operating loss (NOL) of $50,000. Businesses can generally carry over NOLs to different years to offset taxable income in those profitable years. Under current California law, how does a small business apply an NOL incurred in 2026?
{A}. The 2026 NOL must be carried back to 2025.
{B}. The 2026 NOL can be carried forward to future tax years.
{C}. The 2026 NOL is split into two parts; 50% is carried back to 2025, and 50% is carried forward to 2027.
{D}. California has permanently prohibited all businesses (big or small) from applying NOLs to any past or future tax year.

Part E reveals the correct answers to all end-of-chapter review questions while providing feedback on both correct and incorrect responses.

Chapter 19. CALIFORNIA TAX RATES & CAPITAL GAINS

Learning objectives: By the end of this chapter, you will know how to apply California's personal income tax rates, including AMT rules. You will be able to calculate capital gains and losses under California law, see how California treats capital gain deferrals and exclusions differently from federal law, and understand the tax effects of QSBS, QOZ investments, and like-kind exchanges on a California tax return.

Chapter Topics

- California personal income tax rate framework
  - » Ordinary income tax rates
  - » Alternative Minimum Tax (AMT)
  - » Computing capital gains and losses
- Capital gain deferrals & exclusion
  - » Qualified Small Business Stock (QSBS)
  - » Qualified Opportunity Zone (QOZ) investments
  - » Like-kind exchanges [IRC Section 1031]

California's personal income tax system is among the most complex in the country. The state begins with many federal tax concepts but often changes the rules, which can significantly affect taxable income, deductions, exclusions, and the final tax owed on Form 540. These differences are especially important when dealing with AMT, capital gains, investment income, and special gain-deferral rules.

The gap between federal and California law grew even wider after major federal tax changes implemented by the TCJA and later the OBBBA. California selectively conforms to portions of federal tax law through legislation such as Senate Bill 711 (SB 711), but many federal tax benefits remain unavailable in California.

This chapter covers California's personal income tax system, including ordinary tax rates, alternative minimum tax rules, how capital gains are calculated, and how investment income is treated. It also examines where California follows or differs from federal rules on capital gain deferral and exclusion, including Qualified Small Business Stock, Qualified Opportunity Zone investments, and like-kind exchanges.

CALIFORNIA PERSONAL INCOME TAX RATE FRAMEWORK

ORDINARY INCOME TAX RATES

Federal. After finding the exact dollar amount of taxable income, a person uses the appropriate tax rate schedule. The Internal Revenue Code provides different tax rate schedules for individuals based on filing status. Ordinary income tax rates increase progressively as earnings rise. In 2017, the TCJA set seven ordinary income tax rates: 10%, 12%, 22%, 24%, 32%, 35%, and 37%. These brackets were supposed to end after 2025, but the OBBBA made them permanent.

California. California's personal income tax, under the Revenue and Taxation Code, is completely separate from the federal rate schedule. While California starts with federal AGI on Form 540, it has its own tax brackets, marginal rates, and inflation adjustments.

California uses a progressive tax system with nine income brackets: 1%, 2%, 4%, 6%, 8%, 9.3%, 10.3%, 11.3%, and 12.3%. Each year, these brackets are adjusted for inflation using the California Consumer Price Index (CCPI), which is different from the federal Chained Consumer Price Index (C-CPI-U).

Tax rate	Single / Married filing separately*	Married filing jointly*	Head of household*
1%	$0 to $11,079	$0 to $22,158	$0 to $22,173
2%	$11,080 to $26,264	$22,159 to $52,528	$22,174 to $52,530
4%	$26,265 to $41,452	$52,529 to $82,904	$52,531 to $67,716
6%	$41,453 to $57,542	$82,905 to $115,084	$67,717 to $83,805
8%	$57,543 to $72,724	$115,085 to $145,448	$83,806 to $98,990
9.3%	$72,725 to $371,479	$145,449 to $742,958	$98,991 to $505,208
10.3%	$371,480 to $445,771	$742,959 to $891,542	$505,209 to $606,251
11.3%	$445,772 to $742,953	$891,543 to $1,485,906	$606,252 to $1,010,417
12.3%	$742,954 or more	$1,485,907 or more	$1,010,418 or more
* The FTB will adjust these brackets in the last quarter of 2026.			

The Mental Health Services Act, approved by California voters in 2004 as Proposition 63, adds a 1% income tax on individual taxable income over $1 million. This tax does not apply to corporations. Revenues from the "millionaire tax" fund county mental health programs. It works like a regular income tax and raises California's highest tax rate to 13.3%. When this tax applies, California effectively has a tenth tax bracket.

ALTERNATIVE MINIMUM TAX (AMT)

Federal. The federal Alternative Minimum Tax (AMT) is a parallel tax system intended to ensure that higher-income taxpayers pay at least a minimum amount of tax despite deductions, exclusions, or preference items that may substantially reduce regular taxable income. A taxpayer's federal AMT is the amount by which the tentative minimum tax is higher than the regular tax. Tentative minimum tax is computed by:

- Starting with regular taxable income;
- Adding back or adjusting specified preference and adjustment items to arrive at alternative minimum taxable income (AMTI);
- Subtracting the applicable AMT exemption; and
- Applying the 26% or 28% AMT rates.

The OBBBA permanently preserves the higher federal AMT exemption amounts (with inflation indexing) but lowers the AMT phaseout thresholds and accelerates the phaseout rate beginning in 2026.

California. California's AMT system is separate from the federal AMT system, so taxpayers may owe state AMT even if they are not subject to the federal AMT. California's AMT adds another layer of complexity to state taxes, especially for high-income earners, investors, and business owners.

The California AMT is similar to the federal AMT in many ways, but California uses its own AMT exemption amounts and phaseout limits, which are adjusted for inflation. The federal AMT exemption and limits do not apply in California.

The starting point for determining the AMT in California is regular taxable income. Like the federal AMT, the California alternative minimum tax base is calculated by adding and subtracting certain amounts from regular taxable income. IRC Section 56, which California incorporates with modifications in R&TC Section 17062, requires taxpayers to treat some items differently when calculating AMTI.

One of the most common triggers for California's AMT is the exercise of incentive stock options (ISOs). ISOs are not taxed under regular income tax, but they count as taxable income under AMT rules. Similarly, large capital gains from asset sales can increase AMTI, increasing the likelihood of AMT liability.

After income adjustments are made, the AMT exemption amount is deducted. For California, the AMT exemption is $92,749 for singles and $123,667 for joint filers. The exemption decreases by 25 cents for every dollar earned above $347,808 for singles and $463,745 for joint filers. Once AMTI reaches $718,804 for singles or $958,413 for joint filers, the exemption is no longer available.

Filing status	California's AMT exemption amounts	California's AMT exemption phaseout range
Married/RDP filing jointly or surviving spouse	$123,667	$463,745 – $958,413
Single or head of household	$92,749	$347,808 – $718,804
Married/RDP filing separately, estates, or trusts	$61,830	$231,868 – $479,188

Example. DeAngelo and Catrina, a couple filing jointly, have an AMT income of $250,000 in 2026. In this case, their AMT exemption is the full amount of $123,667 for joint filers (because the phaseout begins at $463,745). If DeAngelo had decided to file

separately (while assuming Catrina has no income), then he would need to reduce his exemption amount to:

$$\$61,830 – [(\$250,000 – \$231,868) \times .25] = \$57,297$$

Now that DeAngelo knows his California AMT exemption amount, he can calculate his alternative minimum tax base: $250,000 minus $57,297 equals $192,703.

Once the alternative minimum tax base has been calculated, it is multiplied by a 7% AMT rate to determine the "tentative minimum tax," the total tax calculated under AMT rules. A taxpayer must pay the greater of the tentative minimum tax (computed on California Schedule P) or the regular tax. When the tentative minimum tax is more than the regular tax, the difference between these two numbers would be entered on the California tax return (i.e., line 61 on Form 540), and this entry will push up the income tax to what the state considers the "minimum" amount for that taxpayer's circumstances.

COMPUTING CAPITAL GAINS AND LOSSES

A capital gain is a profit realized from selling any capital asset where the sales price exceeds the basis. Conversely, if an investor loses money on an investment, they incur a capital loss.

Capital gains. At the federal level, a short-term capital gains tax is assessed on gains from the sale of an asset held for one year or less. Short-term capital gains are taxed as ordinary income according to federal income tax brackets.

Long-term capital gains tax applies to gains from selling an asset held for more than one year. The tax rates are 0%, 15%, or 20%, depending on the investor's taxable income and filing status.

While federal law taxes long-term capital gains at lower rates, California treats all capital gains as ordinary income. California does not have special tax rates for capital gains. Because the R&TC treats capital gains as ordinary income, the amount of California tax on these gains is not dependent on the length of time the asset is held. Whether an asset is held for ten days or ten years, the realized gain is aggregated with ordinary wages, business income, and short-term gains. The entire sum is then subjected to California's 10-tier progressive ordinary tax bracket structure, up to the maximum rate of 13.3%.

One challenge in calculating California capital gains is that the California basis and federal basis may differ, especially when depreciation is involved. California does not follow federal bonus depreciation rules under IRC Section 168(k), so an asset fully depreciated for federal taxes may still have a higher basis for California. As a result, when the taxpayer sells the asset, California gain is often smaller than federal gain, or

California loss is larger. Taxpayers must adjust for the difference on Schedule CA or Schedule D (Form 540).

EXAMPLE		
	FEDERAL	**CALIFORNIA**
Cost	$100,000	$100,000
Year 1 Depreciation	-$100,000 (100% bonus)	-$28,570 (MACRS)
Adjusted Basis	$0	$71,430
Sale Price	$120,000	$120,000
Less: Adjusted Basis	-$0	-$71,430
Gain	$120,000	$48,570
Result		The taxpayer subtracts $71,430 on Schedule CA (Column C) to reduce the federal gain to the correct California amount.

Capital losses. California conforms to the federal rule limiting the annual deduction of net capital losses against ordinary income. Under both federal and California law, a taxpayer may deduct net capital losses of up to $3,000 ($1,500 for married filing separately) against ordinary income per year. Any excess net capital loss can be carried forward to future years.

California follows the federal wash sale rules under IRC Section 1091. If a taxpayer sells stock or securities at a loss and acquires substantially identical stock or securities within a 61-day window (30 days before and 30 days after the sale), the loss is disallowed for tax purposes. The disallowed loss is added to the basis of the newly purchased securities.

	Federal Tax System	**California Tax System**
Short-Term Capital Gain Rates	Graduated Ordinary Rates (Up to 37%)	Graduated Ordinary Rates (Up to 13.3%)
Long-Term Capital Gain Rates	Preferential Rates (0% / 15% / 20%)	Graduated Ordinary Rates (Up to 13.3%)
Qualified Dividend Rates	Preferential Rates (0% / 15% / 20%)	Graduated Ordinary Rates (Up to 13.3%)
Net Capital Loss Annual Limit	$3,000 Maximum Offset vs. Ordinary Income	$3,000 Maximum Offset vs. Ordinary Income
Bonus Depreciation [IRC §168(k)]	Fully Allowed; Lowers Basis Rapidly	Disallowed; Creates Higher State Basis

CAPITAL GAIN DEFERRALS & EXCLUSION

QUALIFIED SMALL BUSINESS STOCK (QSBS)

Federal. IRC Section 1202 allows eligible taxpayers to exclude part or all of the gain realized from the sale of Qualified Small Business Stock (QSBS). Historically, the federal exclusion percentage depended on the stock issuance date. To qualify, the stock generally must:

- Be issued by a qualifying C corporation;
- Satisfy gross asset limitations;
- Meet active business requirements; and
- Be held for the required holding period.

The OBBBA made significant changes to federal QSBS benefits. Here are the main updates:

- Exclusion rates now depend on how long the investor holds the stock. Instead of a flat 100% exclusion for stock after 2010, the OBBBA uses a tiered schedule. Investors can exclude 50% if they hold the stock for at least 3 years, 75% if they hold it for at least 4 years, and 100% if they hold it for at least 5 years.
- The limit on the amount of gain investors can exclude is higher. Now, investors can exclude up to $15 million, or 10 times the adjusted basis, whichever is greater. The previous limit was $10 million.
- The asset limit for an issuing corporation to qualify under Section 1202 has increased. Now, "qualified small businesses" with up to $75 million in total assets are eligible, up from the previous limit of $50 million.

California. California formerly allowed a 50% exclusion of any capital gain from the sale of QSBS issued after August 10, 1993, that were held for more than five years, provided that 80% of the issuing corporation's payroll was attributable to employment in California.

In Cutler v. Franchise Tax Board (2012), a California appeals court ruled that California's QSBS provisions were unconstitutional and invalid. Following the Cutler decision, the California Legislature repealed the state's QSBS statutory framework.

California does not follow the federal Section 1202 exclusion. Because California has completely decoupled from IRC Section 1202, all gains from the sale of QSBS are fully taxable in California. This gain is added to the taxpayer's regular income and taxed up to California's top rate of 13.3%.

Example. A California resident sells qualifying QSBS and excludes $1 million of gain federally under Section 1202. California does not recognize the exclusion, so the investor will owe approximately $133,000 in California income tax on that gain (at 13.3%), despite owing zero federal income tax on the excluded portion.

Holding period	Federal exclusion (post-OBBBA)	California exclusion
Less than 3 years	0%	0%
At least 3 years	50%	0%
At least 4 years	75%	0%
At least 5 years	100%	0%

QUALIFIED OPPORTUNITY ZONE (QOZ) INVESTMENTS

Federal. The federal Qualified Opportunity Zone (QOZ) program was created to encourage investment in designated economically distressed communities. Under the federal rules, taxpayers may obtain tax benefits by investing eligible gains into Qualified Opportunity Funds (QOFs).

The OBBBA made the federal QOZ program permanent and substantially revised its structure. The core federal benefits are listed below:

● Deferral of recognized gain by the amount invested in a QOF within 180 days;

● A step-up in basis of the QOF investment after specified holding periods (partially eliminating deferred gain at the time it is recognized); and

● Exclusion of all post-investment appreciation in the QOF if the investment is held for at least ten years.

● The OBBBA introduces a new vehicle, the Qualified Rural Opportunity Fund (QROF), which provides enhanced incentives for investments in rural designated zones.

California. California does not conform to the federal QOZ program. As a result, QOZ investments in the state do not offer any tax deferral, exclusion, or other tax benefits.

● No deferral of gain. When a taxpayer reinvests a capital gain into a federal QOZ fund, the deferral does not apply to their California return. The full original capital gain must be reported as taxable income on California Schedule D in the year of the original sale.

● No basis step-up. The federal increase in basis, which reduces deferred gain after holding the investment for five or seven years, does not exist in California. California calculates the basis in the QOF investment using its regular basis rules.

● No exclusion of post-investment appreciation. Even if a taxpayer holds a QOF investment for more than ten years and qualifies for the federal exclusion of all post-investment appreciation, California taxes that appreciation as ordinary income in the year of disposition.

● No recognition of QROF. The state of California does not recognize the OBBBA's new Qualified Rural Opportunity Fund category. Investments in QROFs are not eligible for any California deferral or exclusion benefits.

Because California taxes the original gain right away, California's basis in the QOF investment is the full amount invested, rather than the reduced basis under federal law during the deferral period. When the QOF investment is eventually sold, California will compute the gain using its own (higher) basis, reflecting that the state has already taxed the original gain.

Example. Phyllis sells a rental condo in 2026 and realizes a $150,000 capital gain. Within 180 days, she reinvests the entire gain into a Qualified Opportunity Fund. Under federal law, Phyllis may defer the $150,000 gain and begin the holding-period requirements for potential basis step-ups and future exclusion of post-investment appreciation. In California, these benefits do not apply. Phyllis must report the full $150,000 as taxable income on her 2026 California return, and her California basis in the QOF investment is the full $150,000. When she later sells the QOF interest, California will compute the gain using this higher basis, reflecting that the state has already taxed the original gain.

LIKE-KIND EXCHANGES [IRC SECTION 1031]

Background. Before discussing like-kind exchanges, it helps to know the difference between realized gain, recognized gain, and deferred gain. A ***realized gain*** is the total economic profit you actually achieve upon disposing of a property, calculated simply as the property's fair market value minus its adjusted tax basis. A ***recognized gain***, by contrast, is the portion of that realized profit that you must actually report on your current-year tax return and pay taxes on immediately. Usually, in a regular sale, realized gain and recognized gain are the same. Section 1031 alters this outcome by allowing for a ***gain deferral***, which means you legally postpone recognizing that profit — and paying the associated tax. In short, realized gain is your total profit, recognized gain is the part you pay tax on now, and deferred gain is the part you pay tax on later.

Example. Juan owns a small warehouse with an adjusted basis of $300,000 and exchanges it for another warehouse worth $500,000. The realized gain is $200,000, which is the difference between the market value and the basis. In a regular sale, Juan would report the $200,000 and pay tax on it that year. But if the deal qualifies under IRC Section 1031, he does not report any of the gain in the year of the exchange. Instead, the entire $200,000 is deferred. The tax on that gain will be paid when the new property is eventually sold in a taxable sale.

California. R&TC sections 18031 and 24941 generally conform to the federal rules for the exchange of like-kind property under IRC Section 1031.

A properly structured exchange occurs when a taxpayer trades relinquished properties for one or more like-kind properties. Furthermore, deferral of federal and state taxes is allowed only when both relinquished and replacement properties are held for business or investment purposes. In other words, a taxpayer is not eligible for a Section 1031 deferral if the taxpayer swaps a primary residence for another home.

Before 2025, California taxpayers could exchange “personal property” used for business or investment to defer capital gains taxes. However, personal property does not mean property used for personal reasons, because Section 1031 requires all property, whether real or personal, to be used for business or investment purposes. Instead, personal property means the type of asset. Examples include vehicles, heavy equipment, and business assets.

California allowed personal property exchanges as long as individuals had AGI of $250,000 or less ($500,000 for joint filers or heads of household) in the year the exchange began. In other words, California taxpayers with incomes below these limits could still do like-kind exchanges of personal property.

Senate Bill 711. SB 711, passed in 2025, mostly aligned California’s Section 1031 rules with federal law. SB 711 removes California’s earlier exception for exchanges of certain types of personal property, aligning with the federal rule that only real property qualifies. Personal property exchanges that previously qualified for California deferral are now fully taxable in California.

The previous California limit based on adjusted gross income ($500,000 for joint filers and $250,000 for singles) is removed. However, SB 711 sets an annual limit on the amount of gain that can be deferred in a qualifying like-kind exchange. The limit is $500,000 per year. This $500,000 deferral cap applies to all taxpayers, regardless of income.

Extended example. In 2026, Holly exchanges a California apartment building for a California office building in a transaction that satisfies all of the requirements of IRC Section 1031. The apartment building has an adjusted basis of $1 million and a fair market value of $2.1 million. As a result, Holly realizes a $1.1 million gain.

Under prior California law, Holly’s income level could have affected her eligibility for certain like-kind exchange benefits. However, SB 711 eliminated the former AGI-based limitations and replaced them with an annual gain-deferral cap. Accordingly, Holly may defer only $500,000 of her $1.1 million realized gain in 2026.

The remaining $600,000 ($1.1 million − $500,000) must be recognized and taxed by California in the 2026 tax year. The $500,000 deferred gain retains its tax-deferred status. The $600,000 of recognized gain is added to the basis of the replacement property, ensuring Holly is not taxed on this specific appreciation a second time upon a future sale.

California’s claw-back provision. Most states generally conform to the federal treatment of tax-deferred exchanges under Section 1031 of the Internal Revenue Code. Capital gains tax is deferred until the replacement property is ultimately sold in a taxable transaction. In many states, the original state where the relinquished property was located does not continue to tax the deferred gain after the taxpayer exchanges into property located elsewhere.

Example. Danielle's original investment property was in Arizona. She completes a Section 1031 exchange and acquires replacement property in Hawaii. When she later sells the Hawaii property in a taxable transaction, Arizona generally does not tax the deferred gain merely because the original property was located there.

California, Oregon, Massachusetts, and Montana take a different approach. Under California's claw-back rules, gain deferred from the exchange of California real estate remains California-source income. If a taxpayer exchanges California property for property located outside California and later sells the replacement property in a taxable transaction, California taxes the deferred gain attributable to the original California property. As a result, California may continue to tax gain that originated from California real estate even after the taxpayer has exchanged into property located in another state.

Example. Mable and Nathaniel were California residents in 2018. That year, they exchanged a California apartment building with a basis of $550,000 and an FMV of $1 million for another apartment building in Texas with an FMV of $1 million. The exchange qualifies for Section 1031 treatment, so Mable and Nathaniel may defer $450,000 ($1 million minus $550,000) in gain for federal and California purposes. In 2022, Mable and Nathaniel moved to Texas and became nonresidents of California. In 2026, they sold the apartment building in Texas for $1.4 million, recognizing a gain of $850,000 on their federal return ($450,000 deferred on the exchange plus $400,000 gained on the sale). Texas does not levy a tax on Mable and Nathaniel's capital gains (Texas is one of seven states without a personal income tax). However, the couple will need to file a California nonresident return and report the $450,000 taxable gain deferred back in 2018 (the later $400,000 gain is not sourced to California).

Annual reporting on out-of-state assets. If an investor sells property in California and uses a 1031 exchange to buy property outside the state, they must file an information return with the FTB every year. This rule comes from R&TC sections 18032 and 24953.

Investors who defer gain under IRC Section 1031 by selling California properties and buying like-kind properties outside California must file FTB 3840, *California Like-Kind Exchanges*, to keep track of their deferred California gains.

California residents who buy replacement property outside the state must attach FTB 3840 to their state tax return. Even if the resident does not need to file a California tax return in a year, they must still submit FTB 3840 for that year. Nonresidents also need to file FTB 3840 as an information return.

If investors do not file FTB 3840, the state may estimate their deferred gain and charge taxes, penalties, and interest. California can do this even if the investor has not sold the out-of-state property and is still deferring federal taxes.

FTB 3840 will generally be required to be filed annually until the deferred California-sourced gain is recognized. The California taxes previously deferred will be due when

investors sell their out-of-state properties and elect to take their profits rather than continue deferring taxes through another 1031 exchange.

Category	1031 Exchange	Qualified Opportunity Fund
Eligible Assets	Like-kind real estate investments	Any capital gain from the sale of assets
Gain Liquidity	Principal and capital gains must be reinvested	Only capital gains must be invested
Transactional Window	Replacement property must be identified within 45 days and acquired within 180 days	No identification requirement; investment generally must be made within 180 days
Diversification	Generally involves exchanging into a specific replacement property	Investments may be diversified across multiple properties and sectors
Federal benefits?	Deferral only (no exclusion or step-up)	Deferral + basis step-up + 10-year appreciation exclusion
California benefits?	Partial — Generally conforms but with $500,000 cap and claw-back	None — California does not conform at all
California investor warning	If exchanging California property out-of-state, must file FTB 3840 annually	Pay California tax upfront on full gain; no QOF benefits at state level

REVIEW QUESTIONS

57. Mallory and Albert file jointly in 2026. Their regular California income tax is $15,200. The couple calculates a tentative minimum tax of $18,500 on Schedule P. Under California AMT rules, what happens?
{A}. They pay the lesser amount, $15,200.
{B}. The $3,300 excess is treated as a nonrefundable AMT credit.
{C}. They pay $33,700 because both amounts are added together.
{D}. The $3,300 excess is added on Form 540 to raise the total tax to $18,500.

58. Emilia exchanges California rental property for replacement rental property in California. Deshawn exchanges a California rental property for a replacement rental property in Arizona. Emilia and Deshawn each realize a gain of $400,000. Both transactions qualify under IRC Section 1031. Which taxpayer must file FTB 3840 annually until the deferred California-sourced gain is recognized?
{A}. Emilia only.
{B}. Deshawn only.
{C}. Both Emilia and Deshawn.
{D}. Neither Emilia nor Deshawn.

Part E reveals the correct answers to all end-of-chapter review questions while providing feedback on both correct and incorrect responses.

Chapter 20. FAMILY-ORIENTED CREDITS IN CALIFORNIA

Learning objectives: By the end of this chapter, you will have a clearer understanding of California's family tax credits on Form 540, such as the CalEITC, YCTC, CDCTC, and the adoption tax credit. Among other things, you will know who can claim these credits and when they begin to phase out.

Chapter Topics

- Income-based refundable credits
  - » Important disclosure on tax year figures
  - » California Earned Income Tax Credit (CalEITC)
  - » Young Child Tax Credit (YCTC)
  - » Foster Youth Tax Credit (FYTC)
  - » Due diligence for CalEITC, YCTC, and FYTC claims
- Expense-based nonrefundable credits
  - » Child and dependent care tax credit
  - » Child adoption credit
- Household and family support credits
  - » Joint custody head of household credit
  - » Dependent parent credit
  - » Senior head of household credit

Earlier chapters examined California's conformity and nonconformity provisions in the wake of Senate Bill 711 and the federal OBBBA. Those chapters focused largely on deductions, business-related provisions, exclusions, and deferrals. This chapter closes the loop on California tax return preparation by bringing together the credits that are most likely to appear in a Form 540 workflow. These credits frequently determine refund outcomes for low- and moderate-income households and require careful attention to filing status, residency, and due diligence rules.

INCOME-BASED REFUNDABLE CREDITS

IMPORTANT DISCLOSURE ON TAX YEAR FIGURES

California has not yet released the 2026 inflation-adjusted amounts for the three refundable credits covered in this chapter (the CalEITC, YCTC, and FYTC). The dollar amounts cited throughout this section — including credit maximums and income limits — are based on the most recent data from the FTB available at the time of publication (generally 2025 figures). The FTB will update and finalize these amounts for the 2026 tax year during the final quarter of 2026. For updates occurring after the publication of this book, please read Part F.

CALIFORNIA EARNED INCOME TAX CREDIT (CalEITC)

The California Earned Income Tax Credit (CalEITC) is a state tax credit for low- and middle-income workers and families. It is modeled after the federal EITC but only

applies in California. Because it is refundable, CalEITC can issue a refund even if the claimant owes no California income tax.

Requirements for the qualifying child. Parents must follow rules about qualifying children if they claim any dependents. California generally follows the federal EITC qualifying-child rules regarding relationship, residency, and age. A qualifying child usually must be the taxpayer's child or a close relative, live with the taxpayer in California for more than half the year, and satisfy the applicable age requirements. For the age requirement, the qualifying child must be:
● Under age 19 at the end of the year;
● Under age 24 if a full-time student for at least five months of the year; or
● Any age if permanently and totally disabled.

Requirements for the claimant. California borrows many federal rules that determine whether a ***child*** qualifies for the EITC. However, California differs from federal law in several respects when determining whether the ***taxpayer*** qualifies for the CalEITC.

● Age requirement for the claimant. The general rule is that the claimant must be at least 18 years old or be the caregiver of a qualifying child.

A California resident who is 18 or older can qualify for the CalEITC even without children. By comparison, the federal EITC does not apply to people without children who are under 25.

● Earned income. For CalEITC purposes, earned income includes wages, salaries, tips, and other employee compensation that are subject to California income tax. Earnings from self-employment are also counted as earned income.

Unearned income does not count for the CalEITC. Unearned income includes money from dividends, interest, rent, pensions, and other sources not earned by working.

Californians may elect to include all nontaxable military combat pay in earned income for state purposes, whether or not they elect to include it for federal purposes.

Claimants can choose to include or exclude Medicaid waiver payments or In-Home Supportive Services (IHSS) payments as earned income for the CalEITC, regardless of their choice for the federal EITC.

A claimant who excludes any amount of foreign earned income on Form 2555 is not eligible for the CalEITC, even if they report taxable earned income on the California return.

● Earned income limit. Eligibility for the CalEITC depends on earned income, adjusted gross income, and the number of qualifying children supported by the taxpayer. Currently, taxpayers may qualify for the CalEITC if their earned income is $32,900 or less.

The amount of the credit depends on income and family size. The maximum CalEITC is currently $3,756.

● Claimant's investment income. To qualify for the EITC, a taxpayer must have earned income in the US but cannot have investment income above a set limit. Taxpayers with investment income exceeding the annual adjusted limit cannot claim the EITC. The federal limit is $12,200 for 2026.

California has a lower limit. At this time, taxpayers cannot claim the CalEITC if their investment income exceeds $4,814.

● Taxpayer identification numbers. The IRS created the Individual Taxpayer Identification Number (ITIN) for taxpayers who do not qualify for a Social Security number (SSN) because of their immigration status. Undocumented residents commonly use ITINs to file tax returns and pay taxes.

Generally, taxpayers must have valid SSNs to claim the federal EITC.

The CalEITC allows eligible taxpayers, their children, or claimants without children to use federal ITINs. If a family includes both undocumented members and legal residents or citizens, the taxpayer can still qualify for CalEITC as long as they meet all other requirements and have a valid ITIN.

An Adoption Taxpayer Identification Number (ATIN) cannot be used to claim a qualifying child for the CalEITC. If the child later obtains a valid SSN or ITIN, the taxpayer might be able to amend a prior tax return to claim the credit.

● Residence requirement. For the federal EITC, taxpayers must live in the US for more than half the year. For the CalEITC, taxpayers must live in California for more than half the year.

● MFS filing status. Single filers, joint filers, surviving spouses, and head-of-household filers may all qualify for the CalEITC. The only filing status that might disqualify a taxpayer is married filing separately (MFS). However, California follows federal rules that let some MFS taxpayers claim the credit. A married person can claim the CalEITC on a separate return if a qualifying child lived with them for more than six months during the year and either:
» The taxpayer did not live with their spouse or registered domestic partner during the last six months of the year; or
» The taxpayer was legally separated under California law pursuant to a written separation agreement and was not a member of the same household as the spouse or registered domestic partner at the end of the tax year.

If the taxpayer qualifies under these rules, the box at the top of Form FTB 3514 should be checked.

CalEITC versus federal EITC. Although California modeled the CalEITC after the federal EITC, the two credits differ in credit amounts, income limits, who can claim them, residency rules, and age rules for people without qualifying children.

QUICK COMPARISON OF CALEITC AND FEDERAL EITC (2025)		
	CalEITC	***Federal EITC***
Maximum Credit	$3,756	$8,046
Maximum Income	$32,900	$68,675 (the upper limit for joint filers with 3+ kids)
Maximum investment income	$4,814	$11,950
Immigrant Eligibility	Qualifying children and tax filers may have an ITIN	Tax filers must have SSNs that are valid for work
Residence requirement	Claimants must have lived in California for more than six months	Claimants must have lived in the US for more than six months
Age of Tax Filer Without Dependents	18 or older	25 or older

YOUNG CHILD TAX CREDIT (YCTC)

If parents qualify for the CalEITC and have a child under the age of 6, they may also be eligible for the refundable Young Child Tax Credit (YCTC). This credit is claimed on Part VII of Form FTB 3514 (and on Part VIII for part-year residents).

Individuals with earned income up to $32,900 may qualify for the YCTC. The YCTC differs from the CalEITC in that it allows some taxpayers with no earned income to qualify if they meet all other CalEITC rules and special loss limits. Currently, a household can have a net loss of up to $35,640 and still claim the credit, as long as total wages, salaries, tips, and other pay do not exceed $35,640. This rule helps families with very low earnings, including those with net losses.

Unlike the CalEITC, the YCTC does not increase with more children. A family with one qualifying child can get the same maximum YCTC as a family with three children under age 6.

The YCTC gives a $1,189 credit to each qualifying family with earnings under $27,425. The credit decreases by $21.71 for every $100 of income over $27,425. The credit goes to zero when income reaches $32,901.

Example. Ophelia has a four-year-old son; her earned income is $28,425. Since $28,425 is $1,000 ($100 × 10) more than the threshold, Ophelia's YCTC will be reduced by $217.10 ($21.71 × 10). As a result, she will round to the nearest dollar and claim a YCTC of $972 on her California tax return.

YCTC shares many of the CalEITC's requirements. Parents of young children may qualify for the YCTC if they meet all of the following requirements:

- Taxpayers who file California returns using an ITIN may qualify for the YCTC.
- Certain MFS taxpayers may qualify if the requirements pertaining to living arrangements and legal separation are satisfied.
- The taxpayer must have lived in California for more than half of the tax year.
- The child must live with the taxpayer in the same principal residence in California for more than half the year (at least 183 days).

YCTC versus federal CTC. California's YCTC is different from the federal Child Tax Credit (CTC) in several ways:

- The YCTC may be claimed by eligible taxpayers and children who use either SSNs or ITINs.
- The YCTC provides up to $1,189 per family, regardless of size, whereas the federal CTC provides up to $2,200 per child.
- The YCTC only applies to children under age 6, whereas the federal CTC applies to children under age 17.
- The YCTC helps low-income taxpayers who qualify for the CalEITC, while the federal CTC is available to many middle- and higher-income families.
- The YCTC is fully refundable. In contrast, the federal CTC is nonrefundable, but part of it may be refunded through the Additional Child Tax Credit (ACTC).
- Unlike the federal CTC, a custodial parent cannot sign away the right to the CalEITC or YCTC to a noncustodial parent using IRS Form 8332. The California credit strictly stays with the parent where the child actually stayed for the majority of the year.

	Young Child Tax Credit	***Federal Child Tax Credit***
Maximum Credit	Up to $1,189 per family	Up to $2,200 per child
Annual Income Bracket	$0 to $32,901 (or net loss under $35,640)	Phaseout begins at $200,000 ($400,000 MFJ)
Refundability	Fully refundable	CTC is nonrefundable (although the ACTC may provide a partial refund)
Age of Qualifying Children	Under 6	Under 17
Which tax ID number is required for the kids?	Qualifying children may have SSNs or ITINs	Qualifying children must have SSNs

FOSTER YOUTH TAX CREDIT (FYTC)

The Foster Youth Tax Credit (FYTC), enacted in 2022, is California's newest refundable income tax credit for individual taxpayers. This credit is claimed on Part IX of Form FTB 3514 (and on Part X for part-year residents).

The maximum credit for each eligible individual is $1,189. If a married or registered domestic partner couple files jointly and both meet the credit rules, the household can claim up to $2,378 ($1,189 × 2). The FYTC starts to decrease when earned income goes over $27,425 and drops to zero when income reaches $32,901.

Current and former foster youth must satisfy all of the following criteria to qualify for the credit:

- The claimant must meet all requirements to qualify for the CalEITC.
- The claimant must be between the ages of 18 and 25 at the end of the tax year.
- The claimant must have been in the California foster care system at age 13 or older, placed via an authorized California agency, probation department, or tribal organization.

The FTB can check the claimant's age and CalEITC eligibility on its own, but it relies on the California Department of Social Services (CDSS) to confirm foster youth status. To claim the FYTC, a taxpayer must prove they qualify in one of two ways:

- By checking the consent box on Form FTB 3514 (Line 33). This authorizes the CDSS to match the filer's identity against the statewide foster care database.
- By attaching an official foster youth verification letter when paper filing or uploading the digital letter when e-filing.

If a taxpayer does not check the consent box or provide a letter upfront, the FTB will mail them a letter requesting proof before releasing the credit. If the taxpayer does not send proof, their credit will be denied.

DUE DILIGENCE FOR CalEITC, YCTC, AND FYTC CLAIMS

Refundable credits are among the most heavily audited individual tax benefits. Anyone who prepares returns for compensation must maintain documentation supporting all eligibility elements — including the client's California residency, earned income, qualifying-child status, foster-youth status, and taxpayer identification numbers.

California imposes due diligence requirements on those who claim the CalEITC, YCTC, or FYTC on behalf of clients. For each return claiming any of these refundable credits, FTB Form 3596, *Paid Preparer's Due Diligence Checklist*, must be completed.

EXPENSE-BASED NONREFUNDABLE CREDITS

California's expense-based credits are different from refundable family credits. Instead of functioning as cash support for low-income workers, these credits help pay for or reduce certain family expenses, but only to the extent of tax liability and only under California rules. The two credits covered here are the child and dependent care expenses credit and the child adoption credit. Unlike the income-based refundable

credits discussed earlier, the dollar amounts in this section are not subject to annual inflation adjustments, so the figures shown are the final amounts for 2026.

CHILD AND DEPENDENT CARE TAX CREDIT

California's Child and Dependent Care Expenses Credit (CDCTC) is based on the federal nonrefundable credit but has some important state-specific limits.

Both the federal and California credits require the taxpayer (and spouse, if filing jointly) to have earned income. California generally follows the federal definition of earned income, so wages, salaries, tips, and net earnings from self-employment count. The CDCTC is not available if income is derived solely from unearned sources, such as alimony, child support, interest, dividends, pensions, Social Security, unemployment, or other passive income.

The state credit also shares the same cost limits as the federal credit. In other words, a California taxpayer may claim up to $3,000 in care expenses for one qualifying person and up to $6,000 for two or more qualifying persons. Expenses reimbursed through a dependent care assistance program cannot be used to calculate the California credit.

There are a few differences between California's credit and the federal one. To begin with, California only allows the CDCTC when care is provided in California and only for taxpayers with a federal AGI of $100,000 or less (the federal credit has no income limit). Nonresidents face an additional restriction: only California-sourced earned income counts toward the earned-income requirement. If a nonresident only paid care providers outside California, or had no earned income sourced to California, they do not qualify for the California CDCTC.

California conforms to the federal CDCTC, with some modifications that affect how the state credit is calculated. According to R&TC Section 17052.6(b)(2), California's CDCTC is a percentage of the federal credit, with the precise ratio depending on the taxpayer's federal AGI.

If Federal AGI Is:	The California Credit Is:
$40,000 or less	50% of the federal credit
$40,001 to $70,000	43% of the federal credit
$70,001 to $100,000	34% of the federal credit
Over $100,000	0% (No California credit allowed)

Example. Anita and Vance have two children, ages 9 and 11. After accounting for all sources of income, their combined AGI is $65,000. Anita and Vance paid $6,500 in childcare expenses for the year. Because they have two qualifying persons, the dollar limit is $6,000. The applicable percentage for an AGI of $65,000 is 35% on the federal level, so Anita and Vance may claim a federal credit of $2,100 ($6,000 × 35%). The California credit the married couple can take is $903 because their federal AGI is $65,000. At this income level, the California credit is 43% of the federal credit ($2,100 × 43% = $903).

To qualify, taxpayers need to have California-sourced earned income during the year, a federal AGI of $100,000 or less, and the care must take place in California. Here are the other requirements:

● Married couples or registered domestic partners usually need to file a joint return. However, similar to the CalEITC, YCTC, and FYTC, they may claim the California CDCTC when filing separately if they were legally separated and lived apart from their spouse for at least the last six months of the year.

● The taxpayer must have paid for care so they (and their spouse or partner, if applicable) could work or look for work. If they do not find a job and have no earned income, they do not qualify.

● The taxpayer and the person receiving care must live in the same home for more than half the year.

● Taxpayers cannot claim the credit if they hire their spouse, or the child's parent, to provide the care.

● The credit is also disallowed when the taxpayer hires their child under age 19 to provide care. However, it may be claimed when the care provider is their adult child age 19 or older.

● The taxpayer must provide the required information about the care provider on the credit form.

Qualifying person. A child is a qualifying person when they are the worker's dependent under the age of 13. A child who turns 13 during the year is a qualifying person until their birthday. Childcare expenses incurred on and after the child's 13th birthday do not count toward the credit.

A person of any age who was physically or mentally incapable of self-care is a qualifying person for state credit purposes. Normally, a disabled person must be the worker's dependent to qualify for the credit. However, an exception applies when the disabled person would qualify as a dependent except for one of the following reasons:
● The disabled person's gross income exceeds the federal threshold amount for the tax year ($5,300 in 2026).

● The disabled person files a joint return with a spouse.

Even though they cannot be claimed as a ***dependent*** for these reasons, they can still be treated as a ***qualifying person*** for the CDCTC. Even the worker's spouse or RDP who was physically or mentally incapable of self-care can be a qualifying person for state credit purposes.

Relationship test. The state relationship test is the same as the federal one described in IRC Section 152(c)(2). This test is met if the qualifying person is "a child of the taxpayer or a descendant of such a child, or ... a brother, sister, stepbrother, or stepsister of the taxpayer or a descendant of any such relative." The word "child" in this statute includes a stepchild, an adopted child (even if the adoption is not yet final), and a foster child (placed with the taxpayer by an authorized agency or by a court).

Residency test. The state residency test is nearly identical to the federal residency test described in IRC Section 152(c)(1)(B). This test is met if the child "has the same principal place of abode as the taxpayer" for more than half the year, although the state tweaks this rule by requiring the place of abode to be in California.

Support test. The support test in California is the same as that described in IRC Section 152(c)(1)(D). This test is met if the supported individual (e.g., the child) did not provide "over one-half of such individual's own support for the calendar year."

Citizenship test. California follows the federal citizenship test described in IRC Section 152(b)(3)(A). This test is met when the child is a citizen or resident of the United States. Children who are residents of "a country contiguous to the United States," meaning Mexico and Canada, also meet the citizenship test requirement.

Which expenses qualify? Qualifying expenses are amounts paid for the well-being and protection of a qualifying person while the taxpayer is working (or seeking work). A taxpayer may use the following costs to calculate California's child and dependent care expenses credit:

● Since California conforms to IRC Section 21(b)(2)(A), eligible expenses include those for babysitting and household services that are at least partly for the care of a qualifying person. The taxpayer's costs for engaging the services of nannies, housekeepers, and au pairs may qualify for the California CDCTC.

● Qualified expenses include the cost of an educational program below the kindergarten level, such as nursery school or preschool. Since California agrees with Treasury Regulation 1.21-1(d)(5), expenses for education at the kindergarten level or higher do not qualify for the credit. Costs related to summer school and tutoring would not be allowed for the California CDCTC. However, before-school or after-school care of a child in kindergarten or higher grades may be a qualifying expense.

● Since California conforms to IRC Section 21(b)(2)(C), eligible expenses include the cost of care provided by a dependent care center that complies with all applicable state and local regulations.

● Since California follows Treasury Regulation 1.21-1(d)(7), eligible expenses include the cost of day camp, even if the camp specializes in a particular activity, such as soccer. However, overnight camp is not a qualifying expense.

CHILD ADOPTION CREDIT

California allows a nonrefundable credit for a portion of the costs paid or incurred to adopt a minor child. California's adoption credit (credit code "197") is a standalone provision in R&TC Section 17052.25 and does not align with federal definitions, expense categories, or eligibility rules.

The California adoption credit equals 50% of qualified adoption costs, up to a maximum credit of $2,500 per child. The credit is nonrefundable, but any unused amount may be carried forward indefinitely until fully used.

The state-level incentive is significantly smaller and features strict residency requirements that do not apply to the federal program. To qualify, the adopted child must be a US citizen or legal resident who was in the custody of a California public agency or a California political subdivision. Consequently, California disallows the credit for:

● International adoptions;
● Failed or incomplete adoptions;
● Private or independent (attorney-facilitated) adoptions;
● Surrogacy arrangements (reimbursements or fees paid to a surrogate mother);
● Stepparent or relative adoptions (unless the child was a ward of a California public agency);
● Out-of-state adoptions (where the child was in the custody of another state's public agency).

Eligible expenses. The federal credit encompasses a broad range of qualifying expenses — including adoption fees, attorney fees, court costs, and other reasonable and necessary costs directly related to the adoption. California's rules are more restrictive. Under R&TC Section 17052.25(b), eligible expenses are limited to:

● Adoption fees paid to a California public agency or political subdivision.
● Travel expenses incurred by the adoptive family that are directly related to the adoption.
● Medical fees and expenses that are directly related to the adoption process and are not reimbursed by insurance.

The credit is claimed in the year in which the order or decree of adoption is entered. Qualifying costs paid or incurred in prior years may also be included when computing the credit amount.

Example. Bertha adopts a nine-year-old child who was in the custody of a California county child welfare agency. The adoption becomes final in 2026. During the adoption process, she pays $2,000 in agency fees, incurs $1,200 of travel expenses directly related to the adoption, and pays $800 of unreimbursed medical expenses associated

with the adoption. The total qualified California adoption expenses are $4,000. California allows a credit equal to 50% of qualified adoption costs, subject to a maximum credit of $2,500 per child. Therefore, Bertha may claim a California adoption credit of $2,000 ($4,000 × 50%) on her 2026 return.

Income limits and carryforward. Despite its lower cap, California's standalone credit has two advantages over the federal credit. First, California's adoption credit is not subject to income limitations. Therefore, higher-income taxpayers are not phased out of the credit as they may be under federal law.

Second, any unused California adoption credit may be carried forward indefinitely until exhausted, whereas the federal adoption credit has historically been subject to a limited carryforward period. Because the credit is nonrefundable, higher-income taxpayers often benefit most from the unlimited carryforward provision.

	FEDERAL CREDIT	CALIFORNIA CREDIT
Eligible adoptions	Domestic and foreign adoptions may qualify	Only children in California agency/subdivision custody
Income phaseout	Credit phases out between $265,080 and $305,080 (2026)	No income limitations or phaseout thresholds.
Qualified expenses	All legitimate expenses directly related to the adoption	Limited to adoption fees, travel, and medical costs
Maximum credit	100% of expenses, up to $17,670 (2026)	50% of expenses, up to $2,500
Inflation adjustments	Yes	No
Carryforward	Up to 5 years	Unlimited
Refundability	Partially refundable up to $5,000	Fully nonrefundable

HOUSEHOLD AND FAMILY SUPPORT CREDITS

Unlike the refundable and expense-based credits covered earlier, the next trio of credits focuses on specific family situations and household support. These credits are nonrefundable and apply to smaller groups of taxpayers.

JOINT CUSTODY HEAD OF HOUSEHOLD CREDIT

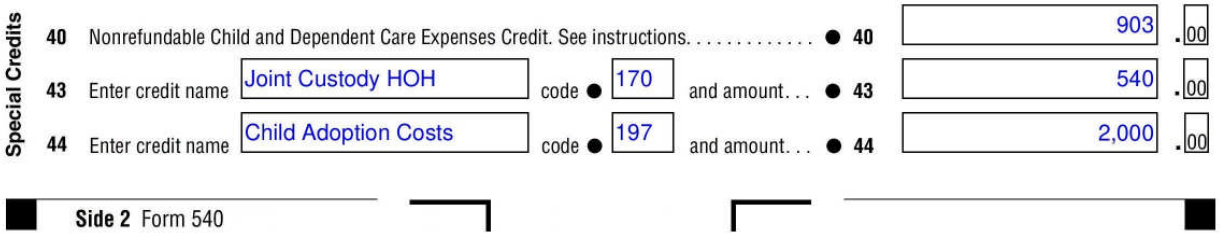
The joint custody head of household credit (credit code "170") is a California tax credit for unmarried or MFS taxpayers who share custody of a qualifying child but do not qualify for the head of household (HOH) filing status. This credit supports parents who provide a home for their child for a substantial portion of the year but are not eligible for the more beneficial HOH status.

The taxpayer must have furnished more than 50% of the household expenses for their home, which was also their child's main home for at least 146 days but not more than 219 days of the year.

A taxpayer qualifies for this credit only if their spouse or RDP was not a household member for the entire year (joint filers are ineligible). Accordingly, the taxpayer must have used the single or married filing separately status. The custody arrangement must also be formalized — either through a decree of dissolution or legal separation, or through a written agreement between the parents when a final decree has not yet been issued (but proceedings have been initiated).

Currently, the most a taxpayer can claim under this credit is $610, calculated as 30% of net tax under R&TC Section 17054.5(a)(1).

Example. Deshawn and Kimberlyn are divorced and have a five-year-old son. Kimberlyn has primary custody, but their son stays with Deshawn on weekends and during some school vacations. The child lives with Deshawn for 170 days during the year. Deshawn pays all of the costs of maintaining his home, is not remarried, and files using the single filing status. Since he meets the joint custody requirements but does not qualify for HOH status, Deshawn can claim the joint custody HOH credit on his California tax return. If Deshawn's California net tax is $1,800, the credit is 30% of that amount, or $540 ($1,800 × 30%). He should enter this amount on Form 540, Side 2, line 43 or line 44.



DEPENDENT PARENT CREDIT

The Dependent Parent Credit (credit code "173") provides relief to certain married taxpayers who maintain a household for a dependent parent while filing separately from their spouse.

To qualify for the credit, all of the following requirements must be met:

- The taxpayer uses the married filing separately or registered domestic partner filing separately status.
- The taxpayer's spouse or registered domestic partner was not a member of the household during the last six months of the year.
- The taxpayer furnished more than one-half of the household expenses for a dependent mother's or father's home, whether or not the parent lived with the taxpayer.

The credit is computed in the same manner as the joint custody HOH credit. Currently, the maximum credit is $610.

If the taxpayer qualifies for both the joint custody HOH credit and the dependent parent credit, they may claim only one of these credits on the California return. Taxpayers should select the credit that provides the greater benefit.

SENIOR HEAD OF HOUSEHOLD CREDIT

The senior head of household credit (credit code "163") is a California nonrefundable credit intended for older taxpayers who previously qualified for HOH status but no longer do so because their qualifying individual has died.

To qualify, the taxpayer generally must:

- Be age 65 or older by the end of the tax year.
- Have qualified for head of household filing status in at least one of the two preceding tax years.
- No longer qualify for head of household status because the qualifying individual died during one of those two preceding years.
- Have California AGI below the annual inflation-adjusted threshold.

The credit equals 2% of California taxable income, subject to an annual maximum. The California AGI limit is $98,652, and the maximum credit is $1,860. Taxpayers with California AGI at or above the applicable income limitation are not eligible for the credit.

Example. Aldo is 66 years old and has no dependents in 2026. He qualified for HOH status in 2024 and 2025 because he maintained a home for his mother. His mother died in December 2025, causing him to lose eligibility for HOH filing status in 2026. If Aldo's California AGI is $55,000 (which is under the $98,652 limitation) and his taxable income on Form 540 is $43,807, he may be eligible for a senior HOH credit of $876 ($43,807 × 2%), or up to his actual California tax liability, whichever is less.

	Joint Custody HOH Credit	**Dependent Parent Credit**	**Senior HOH Credit**
*Maximum Credit**	$610	$610	$1,860
Basis	30% of net tax	30% of net tax	2% of taxable income
Filing Status	Single or MFS	MFS only	Any (but must not qualify for HOH)
Key Requirement	Child lives with taxpayer 146–219 days	Taxpayer supports dependent parent	Age 65+ and HOH in prior 2 years
Purpose	Relief for shared-custody parents not eligible for HOH	Relief for MFS filers supporting a parent	Relief for seniors who lost HOH due to the death of a dependent
*Income Limit**	None	None	$98,652
* The FTB will adjust these dollar amounts in the last quarter of 2026.			

REVIEW QUESTIONS

59. A California couple files jointly and has three children under age 6 (a newborn and 4-year-old twins). They earned $0 in wages and reported a net business loss of $20,000. The couple meets all other CalEITC requirements. What is their maximum Young Child Tax Credit (YCTC)?
{A}. $3,567; the YCTC is calculated per qualifying child, yielding three times the base credit.
{B}. $2,378; joint filers may double the YCTC when they have two or more children.
{C}. $1,189; the YCTC allows net losses up to $35,640 and does not increase with additional children.
{D}. $0; they cannot claim the YCTC because they have no earned income.

60. Velma is a single mom living in Sacramento with her 10-year-old son. In the summer, she pays for her son's soccer day camp and tutoring, both in California. Velma also pays for an overnight camp at Lake Tahoe, Nevada. She works full-time while her son is at these activities. Which of these costs count for California's child and dependent care expenses credit?
{A}. All three expenses qualify.
{B}. Only the tutoring qualifies.
{C}. Only the overnight camp qualifies.
{D}. Only the soccer day camp qualifies.

Part E reveals the correct answers to all end-of-chapter review questions while providing feedback on both correct and incorrect responses.

Part E. Answers to Review Questions

Chapter 1. INTRODUCTION TO THE OBBBA

1. The highest marginal individual income tax rate under the OBBBA:
➔ {A}. stays at 37% — Correct. The OBBBA keeps the individual income tax rate cuts from the TCJA permanent. Before this law, the top rate would have returned to 39.6% on January 1, 2026. By making the current rates permanent, the OBBBA ensures the highest individual income tax rate remains at 37%.
{B}. is decreased to 35% beginning in 2026 — Incorrect. While the OBBBA introduces a new rule starting in 2026 that effectively caps the value of itemized deductions at the 35% tax bracket level for high earners (known as the "2/37 rule"), it does not change the actual marginal tax rate to 35%.
{C}. is increased to 39.6% beginning in 2026 — Incorrect. This increase was scheduled under prior law (the TCJA sunset), but the OBBBA specifically prevents this from happening.
{D}. is repealed and replaced with one flat tax rate of 21% for all taxpayers — Incorrect. The OBBBA keeps the progressive seven-bracket system (10%, 12%, 22%, 24%, 32%, 35%, and 37%). The 21% rate in this option refers to the permanent federal corporate tax rate, not a flat tax for individuals.

2. The OBBBA retained the AMT and made higher exemption amounts permanent. Which of the following statements regarding AMT rates is correct?
{A}. AMT applies a flat 28% rate — Incorrect. The AMT is not a flat tax; it features a two-tiered graduated system where the rate increases from 26% to 28% based on income levels.
{B}. AMT applies capital gains rates only — Incorrect. Preferential capital gains rates apply within both systems, but the AMT base still taxes standard ordinary Alternative Minimum Taxable Income (AMTI) elements like added-back wages.
{C}. AMT uses the same seven rates as the regular tax system — Incorrect. The regular tax has seven brackets (10% to 37%), but the AMT uses only two rates.
➔ {D}. AMT applies 26% up to an income threshold and 28% above it — Correct. The AMT uses a two-tier graduated rate structure. The 26% rate applies to the first tier of AMTI, while the 28% rate applies to AMTI above a certain threshold. For 2026, this higher rate starts at $244,500 for most taxpayers ($122,250 for married individuals filing separately).

Chapter 2. TAX BENEFITS FOR EDUCATION AND YOUTH

3. The ABLE Age Adjustment Act, effective January 1, 2026, expanded eligibility for ABLE accounts by changing the age of disability onset requirement. Which of the following correctly states this change?
{A}. The age of onset was increased from 18 to 26, making young adults newly eligible — Incorrect. {A} is incorrect because the age was not raised to 26; 26 was the old limit. The change raised the onset age from 26, not to 26.

➔ {B}. The age of onset was increased from 26 to 46, estimated to make 6 million additional Americans eligible — Correct. The ABLE Age Adjustment Act (part of the SECURE 2.0 Act of 2022) expands who can open ABLE accounts by raising the age limit for disability onset from before 26 to before 46, starting January 1, 2026. This change is projected to make roughly 6 million additional Americans eligible to open ABLE accounts and receive the associated tax benefits.
{C}. The age-of-onset criterion was eliminated, making all disabled individuals eligible regardless of when their disability began — Incorrect. {C} is incorrect because the age of onset requirement was not eliminated. Under the new rules, the individual's disability must still have occurred before age 46 — the requirement was modified, not removed.
{D}. The age of onset was increased from 26 to 36, making approximately 3 million additional Americans eligible — Incorrect. The SECURE 2.0 expansion increased the age-of-onset ceiling to 46 (not 36), making an estimated 6 million more Americans newly eligible for ABLE benefits.

4. A designated 529 beneficiary has a brother and a sister, each with student loan debt. The beneficiary also has student loan debt. What is the maximum total amount that can be withdrawn from the 529 plan penalty-free for student loan repayment for all three individuals?
{A}. $10,000 total, shared among all three borrowers — Incorrect. {A} is wrong because the $10,000 limit is per borrower, not a single shared pool. The $10,000 limit is per borrower, not per account or per family — each eligible individual has their own separate $10,000 lifetime cap.
{B}. $20,000; $10,000 for the beneficiary and $10,000 combined for the siblings — Incorrect. {B} is wrong because siblings each receive their own $10,000 limit. An additional $10,000 for each of a beneficiary's siblings can be withdrawn from a 529 account to pay down the student loans of the beneficiary's siblings. With two siblings (a brother and a sister), that's $10,000 each — not $10,000 combined.
➔ {C}. $30,000; $10,000 per individual for the beneficiary and each sibling — Correct. The law allows a lifetime limit of $10,000 in student loan repayments per 529 plan beneficiary plus $10,000 for each sibling. Siblings include brothers, sisters, stepbrothers, or stepsisters. Here, with the beneficiary and two siblings, the total is $30,000.
{D}. Unlimited, as long as the funds are used for student loan repayment — Incorrect. Qualified 529 plan distributions used for student loan repayments are bound by a strict, non-indexed $10,000 lifetime limit per individual borrower across all accounts.

5. An employer pays $5,000 toward an employee's student loans under a qualified Section 127 plan. The employer's payment covered both principal and interest. Which of the following is true regarding the student loan interest deduction?
{A}. The employee may claim a student loan interest deduction for the same $5,000 — Incorrect. {A} is wrong because this is a clear "no double dipping" prohibition. You cannot claim the Student Loan Interest Deduction on interest that your employer paid through a tax-free Section 127 program. You can only deduct interest that you paid out of your own pocket.
{B}. The employee may claim a deduction only for the principal portion of the employer's payment — Incorrect. {B} is wrong because the disallowance is not limited to just the

principal portion — it applies to the full employer payment. The statute disallows the deduction for any amount covered by the Section 127 exclusion, whether principal or interest.
{C}. The employee may claim a deduction only for the interest portion of the employer's payment — Incorrect. Employer-paid interest under a tax-free Section 127 program cannot also be deducted by the employee.
➔ {D}. The employee cannot claim a student loan interest deduction for amounts covered by the Section 127 benefit — Correct. The Tax Code says you cannot deduct student loan interest that your employer already paid tax-free under Section 127.

6. Under the OBBBA, which of the following accurately describes the treatment of a federal tax credit for contributions to a qualifying SGO when the credit exceeds the taxpayer's federal tax liability in the contribution year?
{A}. The excess credit is refunded to the taxpayer as a tax refund — Incorrect. {A} is wrong because the credit is explicitly nonrefundable. It can't exceed your tax liability; if you've also claimed a state-level credit for the same contribution, the federal credit will be reduced accordingly. Because it is nonrefundable, no cash refund is issued for any excess.
{B}. The excess credit is lost and may not be used in any future year — Incorrect. {B} is wrong because the excess credit is not simply lost. Unused credits may be carried forward for up to five years, preserving the benefit for future tax years rather than forfeiting it.
➔ {C}. The excess credit may be carried forward to subsequent tax years — Correct. The SGO tax credit is nonrefundable, meaning it can reduce a taxpayer's federal tax bill but will not result in a refund if the credit exceeds the taxpayer's tax liability. Any excess credit generally can be carried forward for up to five years.
{D}. The excess credit may be applied to reduce the taxpayer's state income tax liability — Incorrect. This is a federal credit with no provision to offset state income tax. The relationship runs the other way: the federal credit is reduced by any state credit already received for the same contribution. The federal credit offsets federal tax only, and any excess carries forward federally.

Chapter 3. NON-ITEMIZED DEDUCTIONS IN THE OBBBA

7. Which of the following HSA distributions would be subject to both ordinary income tax and the 20% additional penalty?
➔ {A}. A distribution taken by a 45-year-old account holder to pay for gym membership fees — Correct. This is the only scenario triggering both ordinary income tax and the 20% penalty. Nonqualified HSA distributions are taxed as ordinary income, plus a 20% penalty if the holder is under 65. Gym membership is not a qualified medical expense under IRS Publication 502, so the distribution is fully nonqualified, and at 45 the holder is under 65 with no exception.
{B}. A distribution taken by a 66-year-old account holder for non-medical expenses — Incorrect. The rules for HSA distributions change once an account holder reaches age 65 — the 20% penalty no longer applies, and the account holder can withdraw funds for

any purpose, paying only ordinary income tax. At 66, the taxpayer owes income tax on a non-medical distribution but escapes the penalty entirely.
{C}. A distribution taken after the account holder becomes permanently disabled — Incorrect. There is no additional tax on distributions made after the date the account holder becomes disabled. A permanently disabled account holder still owes ordinary income tax on non-medical distributions, but the 20% penalty is waived entirely.
{D}. A distribution taken by a beneficiary following the account holder's death — Incorrect. The death exception eliminates the 20% penalty for the beneficiary. Income tax treatment then depends on the beneficiary: a spouse can roll over the HSA, while a non-spouse must include the balance in gross income.

8. Olga has a qualified student loan used to pay graduate-school tuition. Her employer offers a Section 127 student-loan repayment assistance program and pays $2,000 of Olga's student-loan interest in 2026. That amount is excluded from her gross income under IRC Section 127. She also pays $1,000 out of pocket on loan interest. Which of the following best describes what Olga may deduct in 2026?
{A}. She may deduct the full $3,000 of interest paid, up to the $2,500 ceiling — Incorrect. Olga did not pay $3,000 out of pocket. The $2,000 employer payment was excluded from income under Section 127. Claiming a deduction for it would produce a double tax benefit (income exclusion plus deduction), which Section 221(e)(1) expressly prohibits.
➔ {B}. Olga may deduct only the $1,000 of interest she paid out of her own pocket — Correct. Section 221(e)(1) bars a double tax benefit on employer-paid interest excluded under Section 127. While the $2,000 employer portion is nondeductible, Olga's $1,000 out-of-pocket payment remains deductible subject to statutory phaseouts.
{C}. She may deduct nothing because the employer-paid interest disqualifies her from the deduction entirely — Incorrect. The employer-paid interest does not poison the well for the rest of Olga's deduction. The disallowance under Section 221 applies specifically to amounts for which an exclusion is allowable under Section 127 — that is, only the employer-paid portion is blocked. Olga's out-of-pocket $1,000 is untainted and remains deductible.
{D}. Olga may deduct the $2,000 of employer-paid interest, but not the $1,000 she paid out of pocket — Incorrect. The $2,000 employer-paid amount is the portion that cannot be deducted (it was already excluded from income). The $1,000 Olga paid herself is the portion that can be deducted.

9. Wayne is single. He contributes $1,900 in cash to qualified public charities in 2026 but does not itemize. According to the OBBBA's charitable deduction under IRC Section 170(p), Wayne may deduct:
{A}. the full $1,900 in 2026 — Incorrect. The deduction is capped at $1,000 for single filers regardless of how much more was contributed. The above-the-line deduction permits up to $1,000 for single filers and $2,000 for joint filers in cash contributions. Wayne's $1,900 donation does not entitle him to deduct the full amount.
{B}. $1,000 in 2026, and $900 is carried forward to 2027 — Incorrect. {B} is wrong because IRC Section 170(p) provides no carryforward mechanism. Carryforwards apply only to itemized charitable deductions under Section 170(b).

➔ {C}. $1,000 in 2026, but $900 provides no tax benefit in the present or future — Correct. The OBBBA's non-itemizer above-the-line cash charitable deduction is capped at $1,000 for single filers. Any excess contribution cannot be carried forward and yields no current or future tax benefit.
{D}. $0 because he does not itemize — Incorrect. This answer reflects pre-OBBBA law (and the law as it stood from 2022–2025 after the pandemic-era deduction expired). The OBBBA reinstated the non-itemizer charitable deduction beginning in tax year 2026, so non-itemizers are no longer categorically excluded. Wayne does get a deduction, but only up to $1,000.

Chapter 4. ITEMIZED DEDUCTIONS AFTER THE OBBBA

10. Which of the following statements correctly reflects the timing rule for deductible medical expenses?
➔ {A}. Medical expenses are deductible in the year paid — Correct. Most individual taxpayers use the cash method, meaning they deduct expenses in the year they actually pay them, regardless of when the services were performed. This applies to medical expenses.
{B}. Medical expenses are deductible when reimbursed — Incorrect. Reimbursement is actually the enemy of a medical deduction, not its trigger. If an expense is reimbursed by insurance or an HSA, it is not deductible. The deduction arises from an out-of-pocket payment, not a reimbursement.
{C}. Medical expenses are deductible in the year the services are provided, regardless of when paid — Incorrect. This describes an accrual-basis approach. Individuals are not accrual-basis taxpayers. A bill incurred in December 2026 but paid in January 2027 is deductible in 2027 — the year of payment — not 2026, the year the service was provided.
{D}. Because of a change implemented by the OBBBA, medical expenses are no longer deductible — Incorrect. The medical expense deduction still exists. The OBBBA did not repeal it. The deduction remains available for qualifying expenses exceeding 7.5% of AGI under IRC Section 213.

11. Warren paid $2,921 in state income taxes (as shown in box 17 of Form W-2). Box 14 of his Form W-2 shows an entry of $1,200 for California State Disability Insurance (SDI). Based on these numbers, how much can Warren (a single filer) deduct on Schedule A of Form 1040 for state and local income taxes?
➔ {A}. $4,121; state income taxes ($2,921) plus SDI ($1,200) — Correct. California SDI is treated as a deductible state income tax. Warren may deduct both the state withholding and SDI, for a total of $4,121.
{B}. Just $2,921 because the IRS does not consider SDI to be a deductible tax — Incorrect. This answer incorrectly treats SDI as a nondeductible item. The IRS specifically recognizes California SDI and similar mandatory state income tax programs as deductible state income taxes. Excluding it is an error.
{C}. $0; the OBBBA has repealed the itemized deduction for state and local income taxes — Incorrect. The OBBBA did not repeal the SALT deduction. It modified the cap

on SALT deductions, but the deduction itself survives. A flat $0 answer is simply incorrect under current law.
{D}. Just $1,200 because the IRS does not consider box 17 of Form W-2 to be a deductible tax — Incorrect. Box 17 reflects state income tax withheld, which is plainly deductible. Box 14 entries like SDI require analysis, but box 17 does not. Treating box 17 as nondeductible while allowing only the box 14 SDI inverts the correct analysis.

12. A California client presents a property tax bill containing several line items. Which of the following items is deductible as a real estate tax on Schedule A?
{A}. A direct levy for local park maintenance and lighting — Incorrect. Assessments targeting specific neighborhood localized improvements or service benefits (like neighborhood lighting) are special assessments, which Section 164(c)(1) bars from being treated as deductible ad valorem real estate taxes.
{B}. A flat "parcel tax" used to fund the local library system — Incorrect. A flat "parcel tax" is charged at a fixed dollar amount per parcel, regardless of the property's assessed value. Because it is not ad valorem, it fails the key test for deductibility as a real estate tax. Fixed-amount parcel taxes are nondeductible regardless of their worthy purpose (like library funding).
{C}. A fixed charge for services such as garbage pickup or sewer maintenance — Incorrect. Charges for specific services — garbage pickup, sewer maintenance, water service — are fees for services, not taxes. IRC Section 164(c)(1) explicitly bars deduction of charges made for local benefits or services rendered to the property. These are treated as personal living expenses, not deductible taxes.
➔ {D}. The 1% ad valorem tax applied under Proposition 13 based on the property's assessed value — Correct. Section 164 permits a deduction only for real estate taxes levied on an ad valorem basis. California's base 1% Proposition 13 tax directly satisfies this property valuation standard.

13. In 2026, Eliana donates a sofa, dining table, and lamps to a qualified charity. She values the items at $420 in the aggregate. The items are picked up from her porch, and Eliana keeps a detailed written list describing each item, its condition, and estimated value. She also takes photos. Which of the following is the most accurate statement regarding substantiation?
{A}. She must complete Section B of Form 8283 because the donation exceeds $250 — Incorrect. {A} is wrong because Section B of Form 8283 applies to noncash contributions where the claimed deduction for any item (or group of similar items) exceeds $5,000 (or certain lower thresholds with appraisal); her $420 total does not trigger this.
➔ {B}. She needs a contemporaneous written acknowledgment (CWA) from the charity because the donation exceeds $250 — Correct. For any single donation of $250 or more, you must receive a written acknowledgment from the charity describing what you gave and whether you received anything in return. Eliana’s list and photos help assess the items' value but don’t replace the acknowledgment. Since her total is $420 (under $500), she doesn’t need to file Form 8283.

{C}. She must get a formal appraisal of the donated property and attach it to her return — Incorrect. {C} is wrong because a qualified appraisal is required only for noncash contributions exceeding $5,000 per item/group (with exceptions for certain property).
{D}. She is not required to obtain a CWA because the donation's value is under $500 — Incorrect. {D} is wrong because the CWA requirement is triggered at $250 per contribution, not $500. The $500 threshold relates only to when Form 8283 must be filed for noncash contributions overall.

14. The OBBBA's new overall limitation on itemized deductions is effective January 1, 2026. This limitation is triggered when a taxpayer's "modified taxable income" (computed without regard to itemized deductions) exceeds which specific benchmark?
{A}. The SALT cap — Incorrect. {A} is wrong because the SALT cap is a separate limit (raised temporarily by OBBBA but not the trigger for this new overall limitation).
{B}. The Pease limitation — Incorrect. {B} is wrong because the OBBBA repeals (does not reinstate) the Pease limitation.
➔ {C}. The threshold for the 37% tax bracket — Correct. Beginning in 2026, the OBBBA replaces the Pease limitation with a new rule tied to the start of the 37% tax bracket. For affected taxpayers, itemized deductions effectively provide a benefit at no more than the 35% rate.
{D}. A flat amount of $384,350 for all filing statuses — Incorrect. {D} is wrong because there is no flat $384,350 benchmark across all filing statuses; the trigger is tied to the 37% bracket threshold, which varies by filing status (e.g., it is higher for joint filers).

15. Carol is a commission-based outside salesperson who works for a small company. Her employer does not provide an accountable plan. In 2026, Carol incurred $4,200 in unreimbursed business travel expenses and $600 in tax preparation fees for her personal return. Carol's AGI is $90,000. How much of these expenses may the W-2 employee deduct as itemized deductions on her 2026 Schedule A?
{A}. $4,800, since both categories are now fully deductible — Incorrect. {A} is wrong because neither category is "fully deductible"; both remain nondeductible for employees.
{B}. $3,000, after applying the 2%-of-AGI floor to the aggregate expenses — Incorrect. {B} is wrong because the 2% floor no longer applies; the entire category is eliminated.
{C}. $600, because tax preparation fees are the only category that survived the OBBBA — Incorrect. {C} is wrong because tax preparation fees (personal) did not "survive" as a separate deductible item; they were part of the suspended miscellaneous category and remain nondeductible for individuals without a business component.
➔ {D}. $0; these expenses are not deductible under current law — Correct. Unreimbursed employee business expenses (like Carol's $4,200 travel) and personal tax preparation fees were miscellaneous itemized deductions subject to the 2%-of-AGI floor before the TCJA. The TCJA suspended them for 2018–2025, and OBBBA made this suspension permanent (eliminating the deduction for most W-2 employees). No accountable plan means no exclusion from income, but the expenses are also not deductible on Schedule A.

16. Gwen owns four rental properties. She could be eligible for the QBI deduction on that rental income if her real estate activity rises to the level of a Section 162 business. Separate books and records are maintained for each rental real estate enterprise, and Gwen retains contemporaneous records. Which of the following rental scenarios is specifically **EXCLUDED** from the Section 199A safe harbor?
{A}. A single-family rental home where Gwen records 260 hours of service annually — Incorrect. A single-family rental with 260 hours of annual service can qualify under the safe harbor. The 250-hour minimum threshold is met, separate books are maintained, and contemporaneous records are kept; all requirements are satisfied.
{B}. A multi-unit residential property with 300 hours of employee service per year — Incorrect. A multi-unit residential property with 300 combined hours of owner, employee, and contractor service also clears every safe harbor hurdle. Hours from employees and independent contractors count toward the 250-hour minimum, so this property qualifies.
➔ {C}. A property leased under a triple net lease where the tenant is responsible for taxes, insurance, and maintenance — Correct. The Section 199A safe harbor excludes triple-net-leased property. There the tenant pays taxes, insurance, and maintenance, so the owner does little active management. The IRS treats this as a passive investment, not a real business, so it fails the safe harbor regardless of the owner's hours or records.
{D}. A residential property with a hired property manager who spends 275 hours per year on tenant services — Incorrect. Using a hired property manager does not disqualify a property. Hours performed by employees and contractors on behalf of the owner count toward the 250-hour threshold. With 275 qualifying hours logged, this property meets the safe harbor requirements.

17. Ted is a single taxpayer with taxable income of $180,000 and $100,000 of QBI from his non-SSTB pass-through business. The business pays W-2 wages and has tangible business property, subject to depreciation. Which of the following best describes the application of the wage/property limitation to Ted’s QBI deduction?
{A}. The wage/property limitation **fully applies** because Ted’s taxable income is above the threshold — Incorrect. {A} is incorrect because $180,000 is below the threshold.
➔ {B}. The wage/property limitation **does not apply** because Ted's taxable income is below the threshold — Correct. For 2026, a single taxpayer's threshold is $201,750. Ted's taxable income is $180,000, which is below the threshold. When taxable income is below the threshold, the wage/property limitation does NOT apply. Ted is eligible for the full 20% QBI deduction regardless of wages or property.
{C}. The wage/property limitation **partially applies** because Ted is within the phaseout range — Incorrect. {C} is incorrect because the phaseout range starts above his current income level.
{D}. The wage/property limitation **applies only if** wages and property exceed $1 million — Incorrect. {D} is incorrect because the $1 million figure is not a standard threshold for the application of these specific QBI limits.

18. Nerisa is a single pediatrician (SSTB) with $100,000 of QBI. Nerisa's 2026 taxable income is $231,750, placing her $30,000 into the $75,000 phaseout range. Nerisa's reduction ratio is 40%, and her applicable percentage is 60%. She pays wages to her office staff and owns depreciable medical equipment with UBIA. Which statement best describes how Nerisa's Section 199A QBI deduction is determined?

➔ {A}. Her deduction is calculated by applying the **applicable percentage (60%)** directly to Nerisa's QBI, W-2 wages, and UBIA of qualified property — Correct. For an SSTB owner within the phaseout range, the applicable percentage is applied to QBI, W-2 wages, and UBIA before computing the deduction and wage/property limitation.

{B}. Her deduction is calculated by applying the **reduction ratio (40%)** directly to Nerisa's QBI, W-2 wages, and UBIA of qualified property — Incorrect. The reduction ratio (40%) is not applied directly to QBI, wages, and UBIA. The reduction ratio is an intermediate calculation used to derive the applicable percentage (100% − 40% = 60%). It's the applicable percentage, not the reduction ratio, that scales down the inputs.

{C}. Her deduction is limited to **20% of her QBI**, as the wage and property limitations apply only to non-SSTB entities — Incorrect. The wage and property limitations are not exclusive to non-SSTB entities. For SSTB owners in the phaseout range, the wage/property limitation does apply. However, it is calculated using the reduced (applicable percentage-adjusted) figures for wages and UBIA, not the full amounts.

{D}. Because she is an SSTB owner above the $201,750 threshold, her deduction is **$0** regardless of wages paid or property owned — Incorrect. A deduction of $0 would only result if Nerisa's income exceeded the top of the phaseout range ($276,950 for single filers in 2026: $201,950 + $75,000). At $231,750, she is still within the range and retains a partial deduction based on her 60% applicable percentage.

19. Rashaad and Pamela file jointly in 2026. Rashaad's non-SSTB business pays $60,000 in W-2 wages. His share of UBIA is $0. The couple's taxable income is $410,000. If their taxable income had been less than $403,500, Rashaad's QBI of $350,000 would have resulted in a $70,000 write-off ($350,000 × 20%). What is Rashaad's QBI deduction after applying the wage and property formula?

{A}. The wage and property limits don't apply to a non-SSTB, so Rashaad's final deduction amount will remain $70,000 — Incorrect. {A} is incorrect because wage/property limits apply to all businesses (non-SSTB and SSTB) once the income threshold is crossed.

➔ {B}. 50% of W-2 wages ($60,000) equals $30,000. This is Rashaad's tentative deduction before applying the reduction ratio and excess amount — Correct. For joint filers inside the 2026 phaseout window, the tentative deduction faces the wage/property cap. Here, the greater of the tracking limits is 50% of W-2 wages ($30,000).

{C}. 25% of W-2 wages ($60,000) equals $15,000, plus 2.5% of $0 in business property, for a total of $15,000. This is Rashaad's final deduction amount — Incorrect. {C} is incorrect because the calculation uses the greater of the two wage/property formulas, which would be $30,000, not $15,000.

{D}. Rashaad's taxable income exceeded the threshold, so his deduction will be $0 — Incorrect. {D} is incorrect because being above the threshold only results in a $0 deduction for SSTBs; for a non-SSTB, you still get a deduction limited by wages and property.

Chapter 6. OTHER BUSINESS PROVISIONS UNDER OBBBA

20. Under the OBBBA, which of the following is a key difference between 100% bonus depreciation [Section 168(k)] and the new QPP expensing [Section 168(n)]?
{A}. Bonus depreciation is only for new property, while QPP expensing allows for used property — Incorrect. Bonus depreciation under Section 168(k) can still be taken on both new and used property. The claim that bonus depreciation is "only for new property" was true under earlier versions of the law, but the TCJA and OBBBA both allow used property to qualify.
➔ {B}. Bonus depreciation applies to most tangible personal property, while QPP expensing is specifically for certain nonresidential real estate — Correct. Bonus depreciation generally applies to qualifying personal property, while Section 168(n) expensing applies to certain qualifying production facilities.
{C}. QPP expensing is a permanent provision, while 100% bonus depreciation is scheduled to expire in 2029 — Incorrect. The OBBBA permanently restores 100% bonus depreciation under Section 168(k), providing long-term certainty, while Section 168(n) QPP expensing is only a temporary provision for production-related real property. It's QPP that is temporary (with construction needing to begin before 2029), not bonus depreciation.
{D}. Bonus depreciation requires construction to begin before 2029, while QPP expensing has no such start-date requirement — Incorrect. Under Section 168(n), qualified production property is any domestic manufacturing or production facility the construction of which begins after January 19, 2025, and before January 1, 2029. So it is QPP expensing, not bonus depreciation, that carries the construction start-date requirement. Answer {D} has the two provisions switched.

21. An investor places $100,000 of eligible gain into a Qualified Rural Opportunity Fund (QROF) in 2027. After holding the investment for five years, what is the amount of the original deferred gain that must be recognized, assuming the QOF interest has not been sold?
{A}. $100,000; no basis step-up is available for investments made after 2021 — Incorrect. The OBBBA adds an automatic 30% basis step-up after five years for qualifying investments in qualified rural opportunity funds. The entire purpose of the QROF structure is to provide enhanced step-up benefits for rural investments.
{B}. $90,000; reflecting a 10% basis step-up — Incorrect. The 10% step-up (leaving $90,000 recognized) applies to standard QOFs, not QROFs. A QROF receives a 30% basis step-up after five years. Because the gain went into a rural opportunity fund, the enhanced 30% applies, not 10%.
➔ {C}. $70,000; reflecting a 30% basis step-up — Correct. A QROF provides a 30% basis increase for investments held for at least 5 years, with deferred gains recognized on the fifth anniversary. Here, the investor deferred $100,000 in 2027 and holds for five years. At five years, a 30% step-up reduces the gain by $30,000, so only $70,000 is recognized.
{D}. $0; the gain is permanently excluded because it was invested in a rural zone — Incorrect. Investing in a rural zone does not permanently exclude the gain. Deferred gains are recognized on the fifth anniversary; only post-investment appreciation in the

QOF/QROF qualifies for permanent exclusion, and only after a 10-year hold. The original deferred gain, net of the basis step-up, must still be recognized.

22. Mason, who is single, launches an unincorporated business in 2026. By the end of the year, the business had racked up a net loss of $290,000. Mason also has $290,000 of nonbusiness investment income in 2026. The Section 461(l) threshold for single noncorporate taxpayers is currently $256,000. What can Mason do with the excess business loss of $34,000?
{A}. He can use it to claim a $34,000 tax refund in 2026 — Incorrect. The EBL cannot generate a 2026 refund. Section 461(l) disallows the excess portion in the current year and carries it forward as a net operating loss—preventing exactly this kind of current-year refund.
{B}. He can carry back the 2026 excess business loss to 2025 — Incorrect. The EBL cannot be carried back to 2025. The excess business loss is treated as a net operating loss carryover for subsequent years, meaning it only goes forward. Under current NOL rules, non-farm NOLs generally have no carryback; the EBL converts to an NOL and carries forward only.
{C}. Nothing; the excess business loss of $34,000 is lost money that will never convey any tax benefits to Mason — Incorrect. The $34,000 is not permanently lost. An excess business loss carries forward as a net operating loss, which may offset up to 80% of taxable income in a later year. The EBL cannot be used now, but it retains value and benefits Mason once he has sufficient future income..
➔ {D}. $256,000 of the loss is allowed to offset positive income in 2026; the remaining $34,000 is an excess business loss carried forward as an NOL to 2027 — Correct. Section 461(l) limits noncorporate trade losses to $256,000 for single taxpayers in 2026. The allowable $256,000 offsets current income, while the remaining $34,000 excess business loss carries forward as an NOL.

Chapter 7. THE CHILD TAX CREDIT & ITS ALTERNATIVES

23. Each of the kids listed below is six years old, and their parents hold valid SSNs. Which of them is eligible for the child tax credit on their parents' 2026 return?
{A}. Joel is a green card holder (a resident alien) with a Social Security Number (SSN) and has lived with his parents all year — This answer is correct, but options {B} and {C} are also right, so {D} is the best answer.
{B}. Samantha has an SSN and resides with her custodial parent (the taxpayer seeking to claim the child tax credit) for 200 full days during the year — This answer is correct, but options {A} and {C} are also right, so {D} is the best answer.
{C}. Izaiah had an SSN when he was officially adopted in January (when he started living with his new parents) — This answer is correct, but options {A} and {B} are also right, so {D} is the best answer.
➔ {D}. All of the kids above are eligible for the CTC on their parents' 2026 tax returns — Correct.

24. Rich and Marylu are married, file jointly, and have two kids under the age of 17. Their joint income is $420,000, meaning they will lose some of their child tax credit.

Since Rich and Marylu's MAGI exceeds the $400,000 phaseout threshold for married couples by $20,000, they must reduce their credit by $50 for every $1,000 over the limit. What is Rich and Marylu's final credit amount?
➔ {A}. They can claim a $3,400 child tax credit [($2,200 × 2 kids) – (20 × $50)] — Correct. The 2026 CTC is $2,200 per qualifying child. With two children, the couple's full credit is $4,400. The phaseout for married filing jointly begins at $400,000 MAGI. Rich and Marylu's income is $420,000, which is $20,000 over the threshold. The CTC is reduced by $50 for every $1,000 (or fraction thereof) above the threshold. Thus, {A} correctly applies both the credit amount and the phaseout formula.
{B}. They can claim a $1,000 child tax credit [($1,000 × 2 kids) – (20 × $50)] — Incorrect. {B} assumes the CTC is $1,000 per child, which is outdated. For 2026, the credit is $2,200 per qualifying child, not $1,000. It also subtracts the correct $1,000 phaseout, but from the wrong starting amount. Therefore, the final number is based on an incorrect credit structure.
{C}. They can claim a $2,000 child tax credit ($1,000 × 2 kids) — Incorrect. {C} again uses $1,000 per child, which is not the 2026 amount. It also ignores the phaseout entirely. Since Rich and Marylu exceed the $400,000 threshold, they must reduce their credit.
{D}. They can claim a $4,000 child tax credit ($2,000 × 2 kids) — Incorrect. {D} uses $2,000 per child, which is the pre-2025 TCJA amount, not the 2026 amount. Even if $2,000 were correct, this option ignores the required phaseout reduction. At a MAGI of $420,000, Rich and Marylu cannot claim the full credit.

Chapter 8. THE CHILD & DEPENDENT CARE TAX CREDIT

25. Dominic and Silvia are joint filers who work as teachers for nine months during the year. They pay $300 per month for childcare (they do not work for three months of the year). For purposes of the child and dependent care credit, their allowable expenses are limited to:
{A}. $300 per month for the three months of vacation ($900 of allowable expenses) — Incorrect. Vacation months do not count because there is no earned income during those months.
{B}. $300 per month for all 12 months of the year ($3,600 of allowable expenses) — Incorrect. You cannot claim expenses for months without work; the CDCTC is tied to work-related care.
{C}. $0; none of Dominic and Silvia's expenses qualify for the child and dependent care credit — Incorrect. They do have qualifying expenses during the months they worked, so the allowable amount is not zero.
➔ {D}. $300 per month for the nine months of work ($2,700 of allowable expenses) — Correct. CDCTC expenses are allowed only for months in which the taxpayer (or spouse) has earned income. Dominic and Silvia worked for nine months, so only the childcare expenses for those nine months qualify.

26. Ida has a 4-year-old daughter and will file as a head of household. Her earned income and AGI equal $60,578. Her taxable income is $36,428, which puts her in the 12% tax bracket. Ida spends about $6,000 annually on childcare for the one dependent.

Her employer has recently offered her a dependent care FSA. Which one of the two tax breaks would bring about a greater reduction in Ida's federal taxes?
➔ {A}. The FSA is better than the CDCTC because it can reduce Ida's federal tax liability by about $1,179 [($6,000 × .12 income tax) + ($6,000 × .0765 FICA tax)] — Correct. A dependent care FSA reduces both income and FICA taxes on contributions up to $6,000. In this bracket, the combined tax savings outpace the capped benefit provided by the CDCTC.
{B}. The CDCTC is better than the FSA because it can reduce Ida's federal tax liability by $1,050 ($3,000 × 35%) — Incorrect. {B} is wrong because the CDCTC on $3,000 at 35% is not the larger tax savings here, and the question asks which break is better overall.
{C}. Ida can use the same childcare expenses for both the FSA and the CDCTC, so she will save $2,229 in federal taxes by claiming both benefits simultaneously — Incorrect. {C} is wrong because the same childcare expenses cannot be counted for both benefits; no double-dipping is allowed.
{D}. None of the above; the FSA is only for healthcare, and Ida's AGI is too high for the CDCTC — Incorrect. {D} is wrong because dependent care FSAs are not limited to healthcare, and Ida's AGI does not make her ineligible for the CDCTC on these facts.

Chapter 9. THE ADOPTION TAX CREDIT

27. In 2026, Elsa finalizes the adoption of two non-special-needs foreign children, incurring $14,000 of qualified adoption expenses per child ($28,000 total). All credit requirements are met, and Elsa's MAGI is well below the income threshold. Before considering tax liability, what is the allowable credit for these two adoptions?
{A}. $0; foreign children do not qualify — Incorrect. Foreign adoptions qualify once finalized.
{B}. $17,670; the annual ceiling applies per return, not per child — Incorrect. {B} is incorrect because the limit is per child, not per return.
➔ {C}. $28,000; in this case, the credit equals $14,000 per child (covering the qualified adoption expenses) — Correct. For non-special-needs children, the credit is limited to the actual qualified expenses up to the yearly maximum per child. Since $14,000 is less than the 2026 limit of $17,670, the full $14,000 per child is allowed.
{D}. $35,340; Elsa receives the maximum credit ($17,670) for each child, regardless of actual expenses — Incorrect. {D} is incorrect because for non-special-needs children, you only get what you actually spent; the "flat" maximum credit only applies to special-needs domestic adoptions.

28. Reece and Lane try to adopt a US infant through an independent adoption in 2026. Throughout the year, the couple pays $12,693 in qualified adoption expenses (such as attorneys' fees), but their 2026 adoption effort ultimately fails. Reece and Lane can claim the adoption credit for the costs incurred in 2026 on:
{A}. the amended version of their 2025 tax return — Incorrect. There is no provision to amend a prior-year return for adoption expenses from a failed adoption. The rule looks forward, not backward.

{B}. the 2026 tax return — Incorrect. For a successful domestic adoption, you'd claim it in the year it was paid. But for a failed one, the credit shifts to the following year, not the current year.
➔ {C}. the 2027 tax return — Correct. For a failed domestic adoption, the rule is that expenses are deductible in the year after they are paid. Since the expenses were paid in 2026 and the adoption failed, Reece and Lane claim the credit on their 2027 return. This is a specific timing rule for failed or unsuccessful domestic adoptions.
{D}. none of the above; this couple cannot claim a tax credit for a failed domestic adoption — Incorrect. Failed domestic adoptions absolutely can qualify for the credit. The credit is not limited to successful adoptions for domestic attempts. Failed foreign adoptions are a different story; those expenses do not qualify.

Chapter 10. REPEALED, EXPIRED, & RESTRICTED CREDITS

29. Arman's income is 420% of the federal poverty level. He continues to receive advance PTC payments in 2026 based on an outdated 2025 income estimate. Upon filing his 2026 return, what is Arman's repayment obligation regarding the excess PTC received?
{A}. Repayment continues to be limited by income-based caps — Incorrect. {A} is wrong because the income-based repayment caps ended after tax year 2025.
➔ {B}. Arman must now repay the full amount of excess PTC received — Correct. For tax years after 2025, the repayment caps no longer apply, and if the advance premium tax credit exceeds the allowed amount on the return, the taxpayer repays the full excess.
{C}. Thanks to the OBBBA, no repayment is required beginning in 2026 — Incorrect. {C} is wrong because there is no blanket OBBBA waiver eliminating repayment in 2026.
{D}. Repayment is now capped at $1,000, regardless of Arman's income — Incorrect. {D} is wrong because the $1,000 cap is not the 2026 rule; the cap is gone for 2026 and later tax years.

30. In 2024, a small business owner claimed a retroactive credit for pandemic-era payroll expenditures. Specifically, they filed a Form 941-X in March 2024 claiming an ERTC for the fourth quarter of 2021. The IRS had not issued a refund as of July 4, 2025. Under the OBBBA, what is the status of the claim in 2026?
{A}. The refund claim is still valid because it was filed before April 15, 2025, the statutory deadline for 2021 ERTC claims — Incorrect. The OBBBA superseded the prior statutory filing deadline. Filing before April 15, 2025, is no longer the relevant test; the January 31, 2024, plus July 4, 2025, twin deadlines now govern.
➔ {B}. The claim is disallowed because it was filed after January 31, 2024, and no refund was issued before July 4, 2025 — Correct. ERTC claims filed after January 31, 2024, that were not paid by July 4, 2025, are disallowed under the OBBBA.
{C}. The 2024 refund claim remains eligible for processing under the extended six-year statute of limitations — Incorrect. The six-year statute of limitations does not override the OBBBA's specific ERTC cutoff provisions. The extended SOL is irrelevant here.
{D}. The 2024 refund claim expired on July 4, 2025, so you should help this client submit a new Form 941-X in 2026 — Incorrect. You cannot simply refile a new Form

941-X to revive a claim the OBBBA has already disallowed. The window has closed, and a new filing would face the same bar.

Chapter 11. IRS GUIDANCE INTERPRETING OBBBA

31. A married couple files jointly for 2026. They purchase a new US-assembled SUV for personal use and finance the purchase with a qualified loan. Their MAGI is below the phaseout threshold, and they claim the standard deduction. Which statement is correct?
➔ {A}. The deduction may be claimed even though they take the standard deduction — Correct. The qualified passenger vehicle loan interest deduction is a below-the-line deduction available in addition to the standard deduction, so the couple loses nothing by not itemizing.
{B}. The deduction is allowed only for used vehicles financed after 2024 — Incorrect. {B} is wrong because the vehicle must be new with final assembly in the US; used vehicles don't qualify.
{C}. The deduction is available only for vehicles used in a trade or business — Incorrect. The provision is specifically for personal-use vehicles. Business-use interest is handled under ordinary business expense rules, not this deduction.
{D}. The deduction is available only if the taxpayers elect to itemize deductions — Incorrect. {D} is the opposite of the law—itemizing is not required.

32. A sole proprietor purchased a qualifying passenger vehicle in 2026 and uses it 30% for business and 70% for personal purposes. During 2026, he paid $6,000 of interest on the vehicle loan. He deducts the business-use portion of the interest ($1,800) on Schedule C. His MAGI is below the phaseout threshold. What amount can he deduct as qualified passenger vehicle loan interest (QPVLI)?
➔ {A}. $4,200, because only personal-use interest is deductible — Correct. QPVLI covers the personal-use portion of the interest. The business share (30% × $6,000 = $1,800) is deducted on Schedule C; the remaining personal share (70% × $6,000 = $4,200) is the amount eligible for the new personal-vehicle interest deduction.
{B}. $0, because the vehicle is not used primarily for business — Incorrect. Primary business use is not required; QPVLI applies to personal-use interest.
{C}. $1,800, because only business-use interest is deductible — Incorrect. This reverses the rule; QPVLI is not for business-use interest.
{D}. $6,000; the total interest paid — Incorrect. The full $6,000 is not deductible because the business portion is already deducted elsewhere.

33. Marcy opens an IRC Section 530A Trump Account for her 5-year-old child. By June 10, 2026, Form 4547 has been filed, and the child's identity has been verified through the Trump Accounts app. Marcy wants to fund the account **as soon as possible**. When may she first make a valid monetary contribution?
{A}. Immediately after identity verification is completed (June 10, 2026) — Incorrect. {A} is wrong because completing identity verification on June 10 makes the account active, but it does not bypass the statutory July 4 start date for funding.
➔ {B}. On or after July 4, 2026, when contributions first become permissible — Correct. Under IRC Section 530A and Notice 2025-68, no monetary contributions to a Trump

Account may be accepted before July 4, 2026 (12 months after the OBBBA's enactment), regardless of how early the account is opened or verified.
{C}. Monetary deposits cannot legally begin until January 1, 2027 — Incorrect. Contributions do not have to wait until 2027.
{D}. When Marcy files her 2026 tax return on April 15, 2027 — Incorrect. Contributions are not tied to the filing of the parent's tax return.

34. In 2026, Irma adopts a child, and her qualified adoption expenses support the full $17,670 adoption credit. Irma's tax liability is $2,000. She has no withholding or other credits, and her MAGI is below the phaseout range. What is the maximum refundable portion of Irma's adoption credit for 2026?
{A}. $0, because the adoption credit remains entirely nonrefundable — Incorrect. The credit is partially refundable beginning in 2025; it is not entirely nonrefundable.
➔ {B}. $5,120, the 2026 refundable limit per qualifying child — Correct. The OBBBA made a portion of the adoption credit refundable, capped at the indexed amount of $5,120 per qualifying child for 2026 (FS-2026-03). Irma's $2,000 liability is irrelevant to the refundable computation—she gets up to $5,120 refundable, with the nonrefundable balance carried forward.
{C}. $15,670, because all credit exceeding tax liability becomes refundable — Incorrect. Refundability is capped and does not automatically equal the amount exceeding tax liability.
{D}. $17,670, because the OBBBA made the entire credit refundable — Incorrect. Congress did not make the entire adoption credit refundable.

35. Sprocket Rocket LLC constructs a 100,000-square-foot manufacturing facility. The building contains 96,000 square feet of production space and 4,000 square feet of office and breakroom space. Assuming all other requirements are met, how is the facility treated under IRC Section 168(n)?
{A}. The building is depreciated over 39 years — Incorrect. Assuming qualification under Section 168(n), the building is eligible for special first-year expensing rather than normal 39-year depreciation.
{B}. The building must be partitioned; only production space receives QPP treatment — Incorrect. The statute does not require partitioning a qualifying building into production and nonproduction portions when the substantially-all test is met.
➔ {C}. The building is treated as qualified production property; a 100% deduction is allowed — Correct. A facility that satisfies the substantially-all requirement qualifies as Section 168(n) qualified production property. Because 96% of the building is production space, the entire facility qualifies.
{D}. The building does not qualify for a deduction because it includes administrative space — Incorrect. Limited office and breakroom space does not automatically disqualify an otherwise qualifying facility.

Chapter 12. OTHER IRS DEVELOPMENTS IN 2026

36. A wildfire is declared a state-level disaster in August 2026 but receives no presidential major-disaster declaration. Following the governor's request under PL 119-29, the IRS grants relief to taxpayers in designated counties. What suspension period applies?
{A}. 60 days from the disaster declaration date — Incorrect. {A} is wrong because 60 days was the old standard before PL 119-29 doubled it.
{B}. 90 days from the end of the incident period — Incorrect. The relief period is longer than 90 days.
➔ {C}. 120 days from the later of the declaration date or the end of the incident period — Correct. Relief under PL 119-29 for a state-declared disaster (no presidential declaration) runs 120 days from the later of the declaration date or the end of the incident period. The "later of" anchor is the key—it ties the window to whichever event closes last.
{D}. 180 days from the disaster declaration date — Incorrect. The statute does not establish a standard 180-day postponement period.

37. A business taxpayer received Letter 106-C disallowing its ERTC claim on December 1, 2024. His practitioner immediately filed a written protest, but the case remains pending in IRS Compliance review. Without a Form 907 extension, when does the taxpayer's right to file a refund suit expire?
➔ {A}. December 1, 2026 — Correct. Under IRC Section 6532(a), the refund-suit clock is two years from the mailing of the notice of disallowance (Letter 106-C, December 1, 2024), expiring December 1, 2026.
{B}. The taxpayer lost the right to sue on December 1, 2025 — Incorrect. The right to sue does not expire after one year.
{C}. The limitations period is suspended while the protest is pending — Incorrect. Filing a protest or seeking administrative review generally does not suspend the two-year refund-suit period.
{D}. December 1, 2027 (the protest automatically extends the refund-suit period by one year) — Incorrect. A protest does not automatically extend the limitations period by one year.

Chapter 13. SECURE 2.0 UPDATES FOR 2026

38. Your client believes SECURE 2.0 took effect all at once and is asking whether the higher RMD age, 529 Plan-to-Roth IRA rollovers, Roth catch-up contributions, and other retirement rules all started in 2023. Which statement best explains how SECURE 2.0 actually became effective?
{A}. SECURE 2.0 became effective for all retirement-plan provisions in 2023 — Incorrect. Not all provisions became effective in 2023.
{B}. SECURE 2.0 provisions became effective on January 1, 2024, but IRS guidance delayed enforcement of some provisions — Incorrect. January 1, 2024. was not the universal effective date.

{C}. SECURE 2.0 generally became effective on January 1, 2025, although taxpayers could elect to apply selected provisions earlier — Incorrect. January 1, 2025, was not the general effective date for all provisions.
➔ {D}. SECURE 2.0 implemented numerous retirement provisions over several years, with effective dates ranging from 2023 through 2027 — Correct. SECURE 2.0 implemented numerous retirement provisions over several years, with effective dates ranging from 2023 through 2027.

39. A small-business client adopts a 401(k) feature allowing employees to elect designated Roth employer matching contributions. The client believes these contributions are tax-free to employees and exempt from withholding. Under SECURE 2.0 and Notice 2024-2, how are designated Roth employer contributions treated for the employee?
{A}. They are exempt from tax and withholding — Incorrect. {A} is wrong because Roth contributions are made with after-tax dollars; they cannot be tax-free upon contribution.
{B}. They are taxable W-2 wages subject to FICA withholding — Incorrect. They are not treated as W-2 wages subject to FICA withholding.
{C}. They are taxable W-2 wages subject to income tax withholding — Incorrect. They are not reported as W-2 wages subject to income tax withholding.
➔ {D}. They are taxable and reported on Form 1099-R, but not subject to withholding (for FICA or income taxes) — Correct. Per SECURE 2.0 and Notice 2024-2, employee-elected designated Roth employer contributions are includible in the employee's gross income in the year contributed, reported on Form 1099-R (not Form W-2), and are not subject to income tax or FICA/FUTA withholding.

Chapter 14. CIRCULAR 230 ESSENTIALS

40. The Annual Filing Season Program (AFSP) is a voluntary program designed to reward participants (who are not attorneys, CPAs, or EAs) with special benefits if they choose to expand their knowledge of federal tax matters. After AFSP participants agree to follow Circular 230 standards (through their online PTIN account), the IRS will:
{A}. issue a Record of Completion to the AFSP participant — This answer is correct, but options {B} and {C} are also right, so {D} is the best answer.
{B}. list the AFSP participant’s name in a public directory of qualified tax professionals — This answer is correct, but options {A} and {C} are also right, so {D} is the best answer.
{C}. allow the AFSP participant to have limited representation rights — This answer is correct, but options {A} and {B} are also right, so {D} is the best answer.
➔ {D}. all of the above — Correct.

41. Adelina holds an AFSP Record of Completion for both 2025 and 2026. She prepared and signed a 2025 tax return for her client, Barry. In 2026, Barry's 2025 return is flagged for audit, and he later receives a notice of intent to levy for an unpaid balance from 2024. Under the proposed Section 10.7(c)(1)(viii) of Circular 230, which of the following is true regarding Adelina's representation rights?

{A}. Adelina may represent Barry before a Revenue Agent regarding the 2025 audit AND before a Revenue Officer regarding the 2024 levy — Incorrect. Only practitioners with unlimited rights, such as Enrolled Agents, CPAs, or Attorneys, can represent taxpayers in collection matters, such as levies.
➔ {B}. Adelina may represent Barry before a Revenue Agent regarding the 2025 audit, BUT she cannot represent him before a Revenue Officer regarding the levy — Correct. Adelina may represent Barry in the audit because she prepared the return and holds valid AFSP credentials. She may not represent him before a Revenue Officer in a collection matter.
{C}. Adelina cannot represent Barry before a Revenue Agent regarding the 2025 audit, BUT she can represent him before a Revenue Officer regarding the levy — Incorrect. As mentioned above, Adelina may represent Barry before a Revenue Agent regarding the 2025 audit, but she cannot represent him before a Revenue Officer regarding the levy.
{D}. Adelina cannot represent Barry before any IRS employee (AFSP participants have no representation rights) — Incorrect. Under Circular 230 Section 10.7(c)(1)(viii), an AFSP participant holding a valid Record of Completion has limited rights: they may represent a taxpayer before Revenue Agents on returns they prepared and signed, but not before Revenue Officers in collection matters such as levies or liens.

42. Greg prepares a federal tax return package for Beatrice. Beatrice refuses to pay the invoiced amount for the service and demands the return of all records. What documents may Greg **withhold** until he receives payment from Beatrice?
➔ {A}. The Form 1040 prepared by Greg for Beatrice during the current representation — Correct. Since Greg prepared the Form 1040 during the current representation and has not yet delivered it, it is considered his work product. He is legally permitted to withhold this document until Beatrice fulfills her contractual obligation to pay for its preparation.
{B}. Beatrice’s W-2 form and receipts — Incorrect. Returnable client records include all documents or materials provided to, or obtained by, the practitioner in the course of representing the client that predate the client's retention of the tax practitioner. The practitioner should return all written or electronic documents generated by parties other than the practitioner, such as W-2 forms and receipts.
{C]. Beatrice's 1098 and 1099 forms — Incorrect. Similar to W-2s, these are documents obtained from third parties to facilitate tax preparation. They are considered "records of the client" and cannot be withheld due to a fee dispute.
{D}. According to Circular 230 Section 10.28, Greg could withhold all of the above from Beatrice — Incorrect. Greg must return client records but may withhold his own undelivered work product, such as the prepared Form 1040, during a fee dispute.

43. A CRTP participating in the Annual Filing Season Program directs several clients' refunds into a single bank account controlled by the preparer. The preparer then issues cashier's checks to the clients after deducting preparation fees. Which potential consequences could apply?

{A}. A penalty under IRC Section 6695(f) only — Incorrect. While Section 6695(f) penalties do apply, this conduct also violates Circular 230 standards, so discipline is not limited to just the statutory penalty.
{B}. Discipline under Circular 230 only — Incorrect. This is incorrect because the civil penalty under Section 6695(f) is a standard statutory consequence for any paid preparer who negotiates a client refund. Therefore, it is not only a Circular 230 issue.
➔ {C}. Both IRC Section 6695(f) penalties and Circular 230 discipline — Correct. Under IRC Section 6695(f), a tax return preparer may be penalized for directing multiple clients' refunds into a bank account controlled by the preparer, even if the preparer later remits the funds to the clients after deducting fees. Circular 230 also prohibits redirecting refunds into the preparer's account.
{D}. No consequences if clients provided written consent — Incorrect. Client consent does not override the statutory or regulatory prohibition. Even with consent, the preparer cannot negotiate or direct refunds to their personal or business accounts.

44. Camille retired last year and then moved to Mexico. She no longer has a US bank account. Camille and her California-based tax preparer, Damion, conducted their meetings online via Zoom. It turns out that Camille will receive a tax refund this year. Which of the following is true regarding the issuance of Camille's refund?
{A}. The IRS does not allow a direct deposit of a tax refund into a foreign bank account — This answer is correct, but options {B} and {C} are also right, so {D} is the best answer.
{B}. As a result of Executive Order 14247, the IRS has largely ceased issuing paper checks for federal payments, requiring a move toward electronic disbursements — This answer is correct, but options {A} and {C} are also right, so {D} is the best answer.
{C}. Under a new rule, Camille cannot receive her refund by paper check, and Damion is prohibited by Circular 230 from receiving the refund as a direct deposit on her behalf — This answer is correct, but options {A} and {B} are also right, so {D} is the best answer.
➔ {D}. All of the statements above are true — Correct. The IRS generally does not allow direct deposit into foreign bank accounts, Executive Order 14247 promotes electronic federal payments, and Circular 230 prohibits Damion from receiving the refund on Camille's behalf.

45. A sole practitioner without employees prepares 150 individual returns annually and stores all client data electronically. Which statement is correct?
{A}. A WISP is only required if the practitioner stores paper records — Incorrect. The Safeguards Rule applies to electronic and non-electronic records. The requirement is triggered by handling customer information, not by the storage format.
{B}. A WISP is optional if the practitioner uses commercial tax software — Incorrect. Using commercial tax software does not exempt a practitioner from the WISP requirement. Even if the software provider has its own security measures, the practitioner must implement safeguards and maintain a written plan.
➔ {C}. The practitioner must maintain a WISP that is appropriately scaled to the practice — Correct. Tax preparers who handle client information must maintain a WISP. The plan should be scaled to the size and complexity of the practice.

{D}. The practitioner is exempt from maintaining a WISP due to firm size — Incorrect. Firm size does not create an exemption. Even sole practitioners who handle client information must maintain a WISP.

Chapter 15. EXCLUSIONS FROM CALIFORNIA GROSS INCOME

46. California updated its IRC conformity date to January 1, 2025, under the Conformity Act of 2025 (Senate Bill 711). Which federal law listed below was enacted after that date and therefore falls outside the state's updated fixed-date conformity window?
{A}. The Tax Cuts and Jobs Act — Incorrect. The TCJA was enacted in December 2017, which is before January 1, 2025. It therefore falls inside the conformity window. That said, California continues to decouple from several TCJA changes, but that is a matter of selective decoupling, not of the law falling outside the conformity date.
{B}. The American Rescue Plan Act — Incorrect. The American Rescue Plan Act was signed in March 2021, which is also before January 1, 2025, placing it within the conformity window.
{C}. The Inflation Reduction Act — Incorrect. The IRA was enacted in August 2022, again before January 1, 2025. It falls within the window. SB 711 does not adopt the clean energy credits added under the IRA — but this is selective decoupling from a law that is within the window, not a law that is outside it.
➔ {D}. The One Big Beautiful Bill Act (OBBBA) — Correct. SB 711 conforms to the IRC as of January 1, 2025, so it excludes OBBBA changes. Enacted July 4, 2025, after the conformity date, the OBBBA falls entirely outside California's updated window. California does not automatically conform, and no legislation has yet adopted its provisions.

47. Amari is a California resident who became disabled at age 36. He is now 56, is employed, earns $18,000 in 2026, and does not participate in an employer retirement plan. What is the maximum amount Amari may contribute to a CalABLE account in 2026?
{A}. $18,000; CalABLE contributions cannot exceed annual earned income — Incorrect. This answer incorrectly states that contributions are capped at annual earned income. Earned income is only relevant for the ABLE to Work add-on, not the base $20,000 annual limit.
{B}. $20,000; CalABLE contributions are strictly capped at the standard 2026 annual limit — Incorrect. This answer ignores the ABLE to Work provision entirely. Because Amari is employed, earns more than $15,650, and has no employer retirement plan, he qualifies for the additional $15,650 contribution on top of the $20,000 base.
➔ {C}. $35,650; CalABLE contributions may consist of the $20,000 annual limit plus an additional $15,650 "ABLE to Work" contribution — Correct. Amari earns $18,000, which exceeds $15,650, and does not participate in an employer retirement plan. Therefore, he may contribute the full $20,000 plus $15,650, for a total of $35,650.
{D}. $0; eligibility for CalABLE accounts is limited to individuals who became disabled before age 26 — Incorrect. Beginning in 2026, the disability-onset age limit increases from 26 to 46.

48. A California homeowner receives a $30,000 grant in 2026 from the California Wildfire Mitigation Financial Assistance Program for home-hardening improvements. How is the wildfire mitigation payment reported for federal and California income tax purposes?
{A}. The grant is excluded from both federal and California gross income — Incorrect. California specifically excludes these grants from state income, but no comparable federal exclusion applies.
➔ {B}. The grant is included in federal gross income, but is excluded from California gross income under R&TC Section 17138.8 — Correct. California provides a state-level exclusion the federal code lacks. Grants from the California Wildfire Mitigation Financial Assistance Program for home-hardening are excluded from California gross income under R&TC Section 17138.8. But because there is no matching federal exclusion for proactive mitigation grants (unlike post-disaster relief), the grant is included in federal gross income.
{C}. The grant is excluded from federal gross income only; California has no mitigation payment exclusion — Incorrect. California has an exclusion (R&TC Section 17138.8), whereas the federal IRC does not have a corresponding exclusion for this program.
{D}. The grant is fully taxable at both the federal and California levels because it was received before any wildfire occurred — Incorrect. The program is proactive home-hardening assistance and is not contingent on a wildfire having already occurred. "Wildfire loss mitigation" means reducing wildfire risk to a structure; prevention is the point, so the exclusion applies whether or not a fire has happened.

Chapter 16. NON-ITEMIZED DEDUCTIONS IN CALIFORNIA

49. In 2026, Davon and Tanya are legally married and file separately for federal and California purposes. Davon itemizes on both returns because his itemized deductions exceed the standard deduction. Tanya has only $2,400 of itemized deductions and prefers to claim the standard deduction. Under federal and California rules, what must Tanya do?
{A}. Tanya may claim the standard deduction on both the federal and California returns — Incorrect. {A} is incorrect because federal law prohibits the standard deduction when the spouse itemizes. California follows the same rule.
➔ {B}. Tanya must itemize on both the federal and California returns because Davon itemizes — Correct. Under both Section 63(c)(6)(A) and R&TC Section 17073.5, if one married spouse filing separately itemizes, the other spouse's standard deduction is reduced to zero and they must itemize.
{C}. Tanya may claim the federal standard deduction, but she must itemize on the California return — Incorrect. Federal law zeroes out her standard deduction. She cannot claim it federally. California also disallows it, so the split treatment described here cannot occur.
{D}. Tanya must itemize under federal law, but California allows the standard deduction even when the spouse itemizes — Incorrect. California does not allow the standard deduction when the spouse itemizes. This contradicts R&TC Section 17073.5.

50. Benson is a California employee whose 2026 pay includes $3,000 of daily overtime required only by California law. His weekly hours never exceed 40. Which statement correctly describes the federal deductibility of Benson's California overtime compensation?

➔ {A}. $0, because the California overtime fails to meet the federal FLSA requirement — Correct. The federal No Tax on Overtime deduction [IRC Section 139I] applies only to FLSA-required overtime, hours over 40 in a week. California's daily overtime rules are state-law, not FLSA. Because Benson never exceeded 40 hours weekly, none of his $3,000 qualifies, so the federal deduction is $0.

{B}. $600, because California daily overtime is worth 1/5 of FLSA weekly overtime — Incorrect. There is no fractional or equivalency rule. Overtime is deductible only if it is FLSA-mandated. California daily overtime does not qualify at all.

{C}. $1,500, representing the premium "half" portion of the overtime rate — Incorrect. The "premium half" concept applies only when the underlying overtime qualifies under the FLSA. Here, none of the hours qualify, so no portion is deductible.

{D}. $3,000, because California daily overtime is eligible under the federal FLSA — Incorrect. California's daily overtime rules are stricter than the FLSA, but they are not federal requirements. The FLSA does not mandate overtime until over 40 hours in a week.

Chapter 17. ITEMIZED DEDUCTIONS IN CALIFORNIA

51. Reina is a 67-year-old single California resident. Her mortgage interest and property taxes exceed California's standard deduction on Form 540. Reina's total itemized deductions are below the federal standard deduction, including the additional age-related deduction. For 2026, which filing combination correctly reflects her federal and California positions?

{A}. Itemize on both Form 1040 and Form 540 — Incorrect. {A} is incorrect because Reina's itemized deductions do not exceed the larger federal standard deduction available to seniors. Itemizing at the federal level would not maximize her deduction.

{B}. Claim the standard deduction on both Form 1040 and Form 540 — Incorrect. {B} is incorrect because her California itemized deductions exceed California's standard deduction, making itemizing preferable for California purposes.

{C}. Itemize on Form 1040 and claim California's standard deduction on Form 540 — Incorrect. {C} is incorrect for both returns. Federally, the standard deduction is larger; in California, itemizing provides the larger deduction.

➔ {D}. Claim the federal standard deduction on Form 1040 and itemize on Form 540 — Correct. Reina's itemized deductions clear the California standard deduction threshold but fail to beat the higher, age-adjusted federal standard deduction. State and federal deduction elections are made independently.

52. In 2026, a California taxpayer with AGI of $150,000 paid $13,750 in unreimbursed medical expenses solely for their registered domestic partner (RDP). The RDP does not qualify as the taxpayer's federal dependent. The taxpayer itemizes deductions on both the federal and California returns. What is the maximum medical expense deduction allowed on the federal and state tax returns?

{A}. Federal: $0; California: $0 — Incorrect. {A} is wrong because California does allow a deduction for the RDP's qualifying medical expenses, so California is not $0.
{B}. Federal: $2,500; California: $2,500 — Incorrect. {B} is wrong because the federal amount is not $2,500; the federal deduction is $0 since the RDP is not a federal dependent.
➔ {C}. Federal: $0; California: $2,500 — Correct. Federal law excludes RDPs from medical deductions unless they qualify as federal dependents. California explicitly permits the deduction for RDP medical expenses, subject to the state's 7.5% AGI floor.
{D}. Federal: $13,750; California: $13,750 — Incorrect. {D} is wrong because neither return allows the full $13,750: the federal return disallows it entirely, and California applies the 7.5% AGI floor.

53. California sets its own limit on itemized deductions for higher-income residents, which is different from federal rules like the OBBBA's 2/37 rule. For instance, Elvin lives in California and has an AGI of $292,203. His itemized deductions that are subject to limitation total $55,000. The California AGI limit for Elvin's filing status is $252,203. How do you calculate the reduction in his California itemized deductions?
➔ {A}. 6% of the AGI exceeding the threshold, capped at 80% of the affected deductions — Correct. California reduces itemized deductions by the lesser of 6% of AGI over the threshold or 80% of the affected deductions. With an AGI of $292,203 and a threshold of $252,203, the excess is $40,000, so the tentative reduction is $40,000 × 6% = $2,400, which is well below 80% of $55,000 ($44,000).
{B}. 3% of the AGI exceeding the threshold, capped at 40% of the affected deductions — Incorrect. {B} is wrong because California does not use a 3% rate or a 40% cap for this limitation.
{C}. California does not reduce itemized deductions for high-income taxpayers — Incorrect. {C} is wrong because California does reduce itemized deductions for high-income taxpayers using a separate limitation formula.
{D}. California automatically reduces all itemized deductions by a flat 10% for this bracket — Incorrect. {D} is wrong because there is no flat 10% haircut; the reduction depends on excess AGI and the 80% ceiling.

Chapter 18. TAX PROVISIONS FOR BUSINESSES IN CA

54. A sole proprietor buys a new $50,000 passenger automobile in 2026 and uses it 100% for business. The car has a GVWR of 4,800 pounds. Which statement best describes the federal and California first-year depreciation treatment?
➔ {A}. Federal law allows bonus depreciation; California disallows it — Correct. Federal law allows bonus depreciation on qualifying passenger automobiles, while California generally does not conform to federal bonus depreciation rules.
{B}. Both the federal and California governments disallow bonus depreciation — Incorrect. This is incorrect because federal law does allow bonus depreciation for passenger autos (subject to the Section 280F cap). Saying both disallow it ignores the federal bonus depreciation add-on that has remained available under current law.
{C}. Both federal and California cap first-year depreciation at $12,300 — Incorrect. {C} is wrong because the $12,300 figure is a first-year federal passenger-auto limit when

bonus depreciation is not used; California does not use that same federal limit as its first-year rule.
{D}. Both the federal and California governments allow the $8,000 bonus depreciation amount — Incorrect. California does not conform to the federal Section 168(k) bonus depreciation rules. Therefore, it is false that both jurisdictions allow the $8,000 bonus depreciation add-on. California's taxpayers must use the non-bonus depreciation schedule, making the federal and California treatments different, not identical.

55. Alisha qualifies as a “real estate professional” under federal rules for passive activity losses. She actively participated in managing a rental property that generated a $30,000 loss. Assuming no phaseout applies, how much of this passive loss can Alisha deduct from her nonpassive income on her California tax return (Form 540)?
{A}. $0; passive losses can never offset nonpassive income on Form 540 — Incorrect. {A} is wrong because California passive losses are not absolutely barred from offsetting nonpassive income.
{B}. $5,000; real estate professionals can only deduct passive losses exceeding $25,000 on Form 540 — Incorrect. {B} is wrong because the $25,000 rule is not a floor or threshold that applies only after losses exceed $25,000. Rather, it is the maximum special allowance.
➔ {C}. $25,000; California does not conform to the federal real estate professional rule, so Alisha cannot deduct more than $25,000 of her rental loss on Form 540 — Correct. California does not fully conform to the federal real-estate-professional rules, so Alisha's deduction is limited to the $25,000 special allowance.
{D}. $30,000; California conforms to the federal rule permitting real estate professionals to treat rental losses as nonpassive without limit — Incorrect. {D} is wrong because California does not conform to the federal real estate professional rule in the way described, so the full $30,000 is not deductible against nonpassive income on Form 540.

56. A small business has $100,000 in gross income and $150,000 in allowable deductions in 2026. This business has a net operating loss (NOL) of $50,000. Businesses can generally carry over NOLs to different years to offset taxable income in those profitable years. Under current California law, how does a small business apply an NOL incurred in 2026?
{A}. The 2026 NOL must be carried back to 2025 — Incorrect. California does not permit NOL carrybacks. Unlike the federal rules (which have allowed 2-year carrybacks in some circumstances), California's NOL rules are carryforward only. There is no provision to carry the 2026 NOL back to 2025 on a California return.
➔ {B}. The 2026 NOL can be carried forward to future tax years — Correct. California currently allows most businesses to carry forward NOLs to future taxable years, subject to various limitations and suspension periods enacted in certain years. California generally does not permit NOL carrybacks. Therefore, a small business generating a 2026 NOL would normally carry that loss forward to offset future taxable income.
{C}. The 2026 NOL is split into two parts; 50% is carried back to 2025, and 50% is carried forward to 2027 — Incorrect. There is no such "50/50 split" rule under California law. California's NOL rules do not provide for splitting a loss between a carryback year and a carryforward year. This rule does not exist at either the federal or state level.

{D}. California has permanently prohibited all businesses (big or small) from applying NOLs to any past or future tax year — Incorrect. California has not permanently prohibited the use of all NOLs. While California has temporarily suspended NOL deductions in certain years, these suspensions are temporary, not permanent prohibitions. Small businesses remain eligible to carry forward 2026 NOLs.

Chapter 19. CALIFORNIA TAX RATES & CAPITAL GAINS

57. Mallory and Albert file jointly in 2026. Their regular California income tax is $15,200. The couple calculates a tentative minimum tax of $18,500 on Schedule P. Under California AMT rules, what happens?
{A}. They pay the lesser amount, $15,200 — Incorrect. Paying the lesser amount ($15,200) is the opposite of how AMT works. AMT exists precisely to ensure taxpayers pay at least the minimum amount; if the tentative minimum tax is higher, the taxpayer cannot simply pay the lower regular tax.
{B}. The $3,300 excess is treated as a nonrefundable AMT credit — Incorrect. The $3,300 excess does not become a current-year AMT credit; it is owed now. California's Minimum Tax Credit can be carried forward to future years when regular tax exceeds TMT, but that is a separate benefit and does not change the result in the year AMT is triggered.
{C}. They pay $33,700 because both amounts are added together — Incorrect. The two amounts are never added together. That would be double taxation with no basis in statute. The TMT and regular tax are compared, not combined.
➔ {D}. The $3,300 excess is added on Form 540 to raise the total tax to $18,500 — Correct. California's AMT works as an add-on system, not a replacement system. When the tentative minimum tax ($18,500) exceeds the regular tax ($15,200), the difference ($3,300) is added to the regular tax on Form 540, bringing the total tax liability to $18,500. The taxpayer pays their regular tax plus the AMT excess.

58. Emilia exchanges California rental property for replacement rental property in California. Deshawn exchanges a California rental property for a replacement rental property in Arizona. Emilia and Deshawn each realize a gain of $400,000. Both transactions qualify under IRC Section 1031. Which taxpayer must file FTB 3840 annually until the deferred California-sourced gain is recognized?
{A}. Emilia only — Incorrect. Emilia exchanged California property for California property. Because the replacement property remains in California, California's taxing jurisdiction over any future gain is not at risk of escaping. No annual tracking form is required for in-state-to-in-state exchanges.
➔ {B}. Deshawn only — Correct. California requires annual filing of FTB 3840 when California property is exchanged for out-of-state replacement property. Because Deshawn's replacement property is in Arizona, he must file until the deferred gain is recognized.
{C}. Both Emilia and Deshawn — Incorrect. Only Deshawn has the out-of-state exchange triggering the annual filing requirement. Emilia's in-state exchange doesn't require FTB 3840.

{D}. Neither Emilia nor Deshawn — Incorrect. Deshawn must definitely file because he exchanged California property for out-of-state property (in Arizona), which preserves California's tax jurisdiction over the deferred gain.

Chapter 20. FAMILY-ORIENTED CREDITS IN CALIFORNIA

59. A California couple files jointly and has three children under age 6 (a newborn and 4-year-old twins). They earned $0 in wages and reported a net business loss of $20,000. The couple meets all other CalEITC requirements. What is their maximum Young Child Tax Credit (YCTC)?
{A}. $3,567; the YCTC is calculated per qualifying child, yielding three times the base credit — Incorrect. The YCTC is not calculated per child. It's a flat credit of up to $1,189 per return, regardless of how many qualifying children you have.
{B}. $2,378; joint filers may double the YCTC when they have two or more children — Incorrect. Joint filers cannot "double" the YCTC. The credit is $1,189 per return, not doubled for joint filers with multiple children.
➔ {C}. $1,189; the YCTC allows net losses up to $35,640 and does not increase with additional children — Correct. The YCTC provides up to $1,189 per eligible tax return (not per child). Starting in 2022, earned income is no longer required, and taxpayers may have a net loss of up to $35,640 and still qualify. The couple has a $20,000 net business loss (within the limit) and three children under age 6, so they qualify for the maximum $1,189 credit.
{D}. $0; they cannot claim the YCTC because they have no earned income — Incorrect. Starting in 2022, earned income is not absolutely required for the YCTC. Taxpayers with zero earned income or even a net loss (up to $35,640) can still qualify if they meet other CalEITC requirements.

60. Velma is a single mom living in Sacramento with her 10-year-old son. In the summer, she pays for her son's soccer day camp and tutoring, both in California. Velma also pays for an overnight camp at Lake Tahoe, Nevada. She works full-time while her son is at these activities. Which of these costs count for California's child and dependent care expenses credit?
{A}. All three expenses qualify — Incorrect. Not all three expenses qualify. Only the day camp qualifies. Overnight camps and tutoring are explicitly excluded.
{B}. Only the tutoring qualifies — Incorrect. Tutoring is specifically not eligible for the CDCTC. Educational expenses don't count as dependent care.
{C}. Only the overnight camp qualifies — Incorrect. Overnight camps are explicitly not eligible for the child and dependent care credit. Only day camps qualify.
➔ {D}. Only the soccer day camp qualifies — Correct. Day camps qualify for the credit, but overnight camps and tutoring do not.

Part F. Recent Tax Developments

This part of the Course Reader may serve as an addendum covering tax developments occurring after the original publication date (6/22/2026).

If no articles appear below, please visit **https://www.caltaxschool.org/6401.htm** for an updated and expanded list of current developments.

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