

Federal Taxation of Individuals

Module

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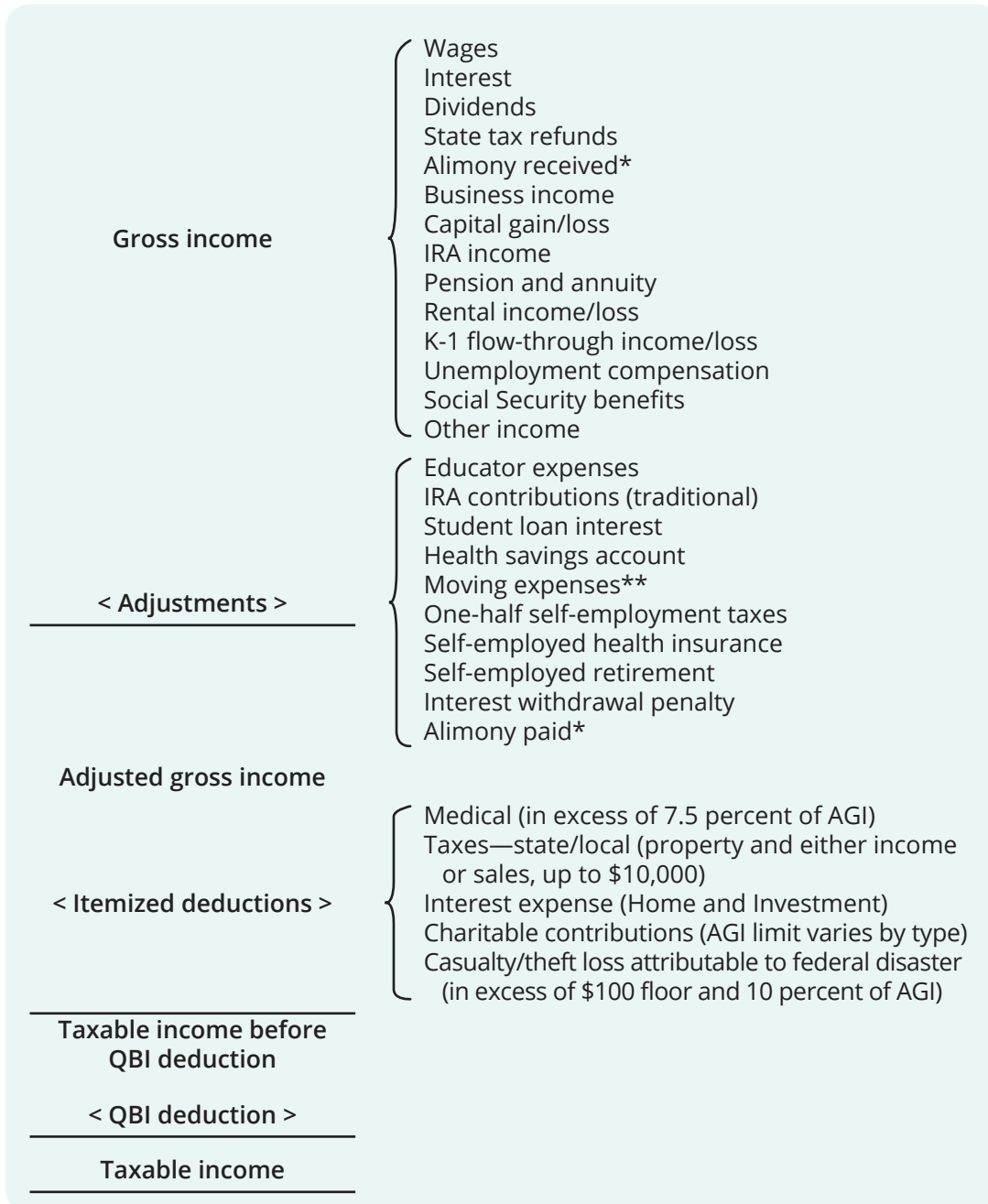
1 Individual Income Tax Formula

This module begins the discussion of individual income tax. The formula below provides a summary of the calculation of taxable income and federal income tax liability or refund for individuals. Ultimately, these items are reported on the individual income tax return, Form 1040.

$$\begin{array}{r}
 \text{Gross income} \\
 \text{< Adjustments >} \\
 \hline
 \text{Adjusted gross income} \\
 \left. \begin{array}{l} \text{< Standard deduction >} \\ \text{Or} \\ \text{< Itemized deductions >} \end{array} \right\} \\
 \hline
 \text{Taxable income before QBI deduction} \\
 \text{< QBI deduction >} \\
 \hline
 \text{Taxable income} \\
 \hline
 \hline
 \text{Federal income tax} \\
 \text{< Tax credits >} \\
 \text{Other taxes} \\
 \text{< Payments >} \\
 \hline
 \text{Tax due Or Refund} \\
 \hline
 \hline
 \end{array}$$

2 Taxable Income Formula for Individuals

Taxable income is the base for the individual income tax. The formula below demonstrates the calculation of taxable income for individual taxpayers.



*Only for alimony payments pursuant to divorce or separation agreements executed on or before December 31, 2018.

**Only for members of the armed forces moving pursuant to military order.

3 Filing Requirements for Individuals

3.1 Who Must File?

The first consideration when thinking about individual taxation is who must file a tax return. Generally, a taxpayer must file a return if his or her income is equal to or greater than the sum of:

1. the regular standard deduction amount (except for married filing separately), plus
2. the additional standard deduction amount for taxpayers age 65 or older or blind (except for married persons filing separately).

3.2 When to File

3.2.1 Due Date—April 15

Individual taxpayers must file on or before the 15th day of the fourth month following the close of the taxpayer's taxable year, which is April 15.

3.2.2 Extension

- **Automatic Six-Month Extension to October 15:** An automatic six-month extension (until October 15) is available for those taxpayers who are unable to file by the April 15 due date. The automatic six-month extension is not an extension for the payment of any taxes owed. Although granted automatically, the six-month extension must be requested by the taxpayer by filing Form 4868 by April 15.
- **Payment of Tax:** Even with an extension, the due date for payment of taxes remains April 15.

4 Filing Status

4.1 Single (Use the End-of-Year Test)

You are considered unmarried for the whole year if, on the last day of your tax year, you are either: unmarried or legally separated.

4.2 Joint Returns (Use the End-of-Year Test)

In order to file a joint return, the parties must be married at the end of the year, living together in a legally recognized common law marriage, or married and living apart (but not legally separated or divorced).

- If married during the year, a joint return may be filed, provided the parties are married at year-end.
- If divorced during the year, a joint return may not be filed.
- If one spouse dies during the year, a joint return may be filed.

4.3 Married Filing Separately

A married taxpayer may file a separate return even if only one spouse has income for the year. In a separate property state, spouses who elect to file using the married filing separately status must separately report their own income, credits, and deductions on their own individual income tax returns. In a community property state, most of the income, deductions, credits, etc., are split 50/50.

4.4 Qualifying Widow(er) With Dependent Child

- **Two Years After Spouse's Death:** A qualifying widow(er) is a taxpayer who may use the joint tax return standard deduction and rates for each of two taxable years following the year of death of his or her spouse, unless he or she remarries. In the event of a remarriage, the surviving spouse will file a tax return (joint or separate) with the new spouse.
- **Principal Residence for Dependent Child:** The surviving spouse must pay over half the cost of maintaining a household where a dependent child lives for the whole taxable year. The dependent child must be a child (including an adopted child but not a foster child) or stepchild of the surviving spouse.

4.5 Head of Household

Head of household status entitles certain taxpayers to pay lower taxes. The lower tax results from a larger standard deduction and "wider" tax brackets.

To qualify, the following conditions must be met:

1. The individual is unmarried, legally separated, or married and has lived apart from his or her spouse for the last six months of the year as of the close of the taxable year.
2. The individual is not a "qualifying widow(er)."
3. The individual is not a nonresident alien.
4. The individual maintains as his or her home a household that, for more than half the taxable year, is the principal residence of a qualifying person, including a dependent child, parent, or relative (as discussed below).

4.5.1 A Qualifying Child

Child, stepchild, legally adopted child, foster child, brother or sister, or a descendant of one of these who meets the definition of a dependent under the qualifying children rules.

4.5.2 Father or Mother (Not Required to Live With Taxpayer)

A dependent parent is not required to live with the taxpayer, provided the taxpayer maintains a home that was the principal residence of the parent for the entire year. Maintaining a home means contributing over half the cost of upkeep. This means rent, mortgage interest, property taxes, insurance, utility charges, repairs, and food consumed in the home.

4.5.3 Dependent Relatives (Must Live With Taxpayer)

Grandparents, brothers, sisters, aunts, uncles, nephews, and nieces (as well as stepparents, parents-in-law, sisters-in-law, or brothers-in-law) qualify as relatives. A dependent relative (other than a father or mother) must live with the taxpayer. Note that cousins, foster parents, and unrelated dependents do not qualify.

4.5.4 Summary of Who Meets Head-of-Household Qualifying Person Requirement

	Qualifying Dependent	Lives With Taxpayer
Child or descendant	Yes	Yes
Parents	Yes	No
Other relative	Yes	Yes



Pass Key

In order to avoid confusing the required time period for different filing statuses, just remember:

Widow/widower = Must be principal residence for dependent child for **whole** year.

Head of household = Must be principal residence for qualifying person for more than **half** a year.

5 Dependency Definitions

Certain tax benefits, such as an advantageous filing status or certain tax credits, require either a qualifying child or qualifying relative. Each category has requirements:

Qualifying Child	Or	Qualifying Relative
Close relative		Support test
Age limit		Under a specific amount of (taxable) gross income test
Residency and filing requirements		Precludes dependent filing a joint tax return test
Eliminate gross income test		Only citizens (residents of US/Canada or Mexico) test
Support test		Relative test
		Or
		Taxpayer lives with individual for whole year test

Taxpayers must obtain a Social Security number for any dependent who has attained the age of one as of the close of the tax year.



Pass Key

A taxpayer will be entitled to certain tax benefits for anyone whom a taxpayer "**CARES**" for, or whom they "**SUPPORT**," even if the dependent:

- was born during the year; or
- died during the year.

5.1 Qualifying Child

If the parents of a child are entitled to claim the child but do not, no one else may claim the child unless that taxpayer's AGI is higher than the AGI of the highest parent.

In general, a child is a qualifying child of the taxpayer if the child satisfies the following:

1. Close Relative

Under the close relationship test, to be a qualifying child of a taxpayer, the child must be the taxpayer's son, daughter, stepson, stepdaughter, brother, sister, stepbrother, stepsister, or a descendant of any of these. An individual legally adopted by the taxpayer, or an individual who is lawfully placed with the taxpayer for legal adoption by the taxpayer, is treated as a child of the taxpayer. A foster child who is placed with the taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction also is treated as the taxpayer's child.

2. Age Limit

The age limit test varies depending on the benefit. In general, a child must be younger than the taxpayer, and under age 19 (or age 24 in the case of a full-time student) to be a qualifying child (although no age limit applies with respect to individuals who are totally and permanently disabled at any time during the tax year). A "full-time" student is a student who attends an educational institution for at least part of each of five months during the taxable year. An "educational institution" is one that maintains full-time faculty and a daytime program.

3. Residency and Filing Requirements

Under the residency and filing requirement tests, a child must have the same principal place of abode as the taxpayer for more than one half of the tax year. The child also must be a citizen of the United States or a resident of the United States, Canada, or Mexico. Furthermore, the child cannot file a joint tax return for the year (unless it was filed only for a refund claim).

4. Eliminate Gross Income Test

The gross income test (see **SUPPORT**) does not apply to a qualifying child.

5. Support Test

The qualifying child must not have contributed more than half of his or her own support. Support means the actual expenses incurred by or on behalf of the dependent. Social Security and state welfare payments are included in the dependent's total support, but only to the extent that such amounts are actually expended for support purposes. Scholarships received by a dependent are not included in determining the dependent's support if the dependent is a full-time student and the son, daughter, stepson, or stepdaughter of the taxpayer. This exclusion of scholarships from the support test does not extend to siblings or descendants.

5.2 Qualifying Relative

Taxpayers can apply the **SUPPORT** rules to determine whether an individual meets the qualifying relative rules. In general, an individual is a qualifying relative of the taxpayer if the individual satisfies the following:

1. Support Test

The taxpayer must have supplied more than one half (greater than 50 percent) of the support of a person in order to claim him or her as a qualifying relative. The same definition of support as related to a qualifying child applies.

2. Under Gross Income Limitation

A person may not be claimed as a qualifying relative unless the qualifying relative's gross income is less than \$4,700 (2023).

- **Definition of Taxable Income:** Only income that is taxable is included for the purpose of the gross income limitation.
- **Nontaxable Income**
 - Social Security (at low income levels)
 - Tax-exempt interest income (state and municipal interest income)
 - Tax-exempt scholarships

3. Precludes Dependent Filing a Joint Return

A taxpayer does not meet the definition of qualifying relative if the taxpayer is a married dependent who files a joint return, unless there is no tax liability on the couple's joint return and there would not have been any tax liability on either spouse's tax return if they had filed separately.

4. Only Citizens of the United States or Residents of the United States, Mexico, or Canada

The qualifying relative must be either a citizen of the United States or a resident of the United States, Mexico, or Canada.

5. Relative

Children, grandchildren, parents, grandparents, brothers, sisters, aunts and uncles, nieces and nephews (as well as stepchildren, stepparents, stepbrothers or stepsisters, in-laws) can meet the definition of qualifying relative. Children include legally adopted children, foster children, and stepchildren. Foster parents and cousins are not considered to be relatives.

Remember: A child born at any time during the year will qualify as a relative for qualifying-child or qualifying-relative purposes.

Or:

6. Taxpayer Lives With the Individual (if Non-relative) for the Whole Year

A non-relative member of a household (i.e., a person living in the taxpayer's home for the entire year) may be considered a qualifying relative provided the taxpayer's relationship with that person does not violate local law. Foster parents and cousins must live with the taxpayer the entire year because they are not considered to be relatives.

5.3 Multiple Support Agreements

Where two or more taxpayers together contribute more than 50 percent to the support of a person but none of them individually contributes more than 50 percent, the contributing taxpayers, all of whom must be qualifying relatives of (or lived the entire year with) the individual, may agree among themselves which contributor may claim the individual as a dependent for tax benefits.

- A contributor must have contributed more than 10 percent of the person's support in addition to meeting the other dependency tests in order to be able to claim him or her as a dependent.
- The joint contributors are required to file a multiple support declaration, Form 2120.

Example 1 Multiple Support Agreement

Facts: Peter, who is single and lives alone in Idaho, has no income of his own and is supported in full by the following people:

	Amount of Support	Percent of Total
Tim (an unrelated friend)	\$2,400	48
Angie (Peter's sister)	2,150	43
Mike (Peter's son)	<u>450</u>	<u>9</u>
	<u>\$5,000</u>	<u>100%</u>

Required: Under a multiple support agreement, Peter is considered a dependent of which of the following:

- No one
- Tim
- Angie
- Mike

Solution: Peter only meets dependency definition requirements for Angie.

	Tim	Angie	Mike
Support test	Yes	Yes	No
Under gross income	Yes	Yes	
Preclude joint filing	Yes	Yes	
Only U.S. citizens	Yes	Yes	
Relative, or	No	Yes	
Taxpayer lived with	No	N/A	

5.4 Children of Divorced Parents

- **General Rule (Custodial Parents):** Generally, the parent who has custody of the child for the greater part of the year qualifies to use the child as a dependent for tax benefit purposes (determined by a "time" test, not the divorce decree). It does not matter whether that parent actually provided more than one-half of the child's support. If the parents have equal custody during the year, the parent with the higher adjusted gross income will claim the tax benefits related to the dependent.

1 Gross Income Overview

The first step in determining tax liability is to compute gross income.

1.1 Gross Income Definition

Generally, gross income means all income from whatever source derived, unless specifically excluded. (For example, if the taxpayer finds \$4,000 under a floorboard in his house, cannot find the owner, and keeps the money, the \$4,000 is income regardless of the fact that the taxpayer did not "earn" it.)

1.2 Determination of Amount of Income

Except in the cases of gain derived from dealings in property (discussed below), income is determined by the amount of cash, property (FMV), or services obtained. In cases of noncash income, the amount of the income is the *fair market value* of the property or services received.



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Event		Income	Basis
Taxable	=	FMV	FMV
Nontaxable	=	None	NBV

Example 1 Noncash Income

Facts: A taxpayer performs services and receives a car with a fair market value of \$3,000 as compensation.

Required: Determine the amount of income for the taxpayer.

Solution: The \$3,000 FMV of the property received is income to the taxpayer.

1.3 Realization and Recognition

In order to be taxable, the gain must be both realized and recognized.

- **Realization:** Realization requires the accrual or receipt of cash, property, or services, or a change in the form or the nature of the investment (a sale or exchange).
- **Recognition:** Recognition means that the realized gain must be included on the tax return (i.e., there is no provision that permits exclusion or deferral under the Internal Revenue Code).

Illustration 1 Recognition Concept

A taxpayer owns stock for which he paid \$100, and the stock goes up in value to \$150. There is no realized gain even though there has been an increase in the taxpayer's wealth. Gain is realized when the shares are sold for \$150 or exchanged for other property worth \$150. If the gain is taxable, it would also be recognized on the tax return.

1.4 Timing of Revenue Recognition

- **Accrual Method:** Under the accrual method, recognition occurs according to the rules of GAAP (with some exceptions); that is, revenue is taxable when earned.
- **Cash Method:** Under the cash method, recognition occurs in the period the revenue is actually or constructively received in cash or fair market value (FMV) of property.

2 Specific Items of Income and Exclusions

2.1 Salaries and Wages

Gross income includes many forms of compensation for services.

- **Money:** All money received, credited, or available (constructive receipt).
- **Property:** The fair market value (FMV) of all property is included as gross income.
- **Bargain Purchases:** If an employer sells property to an employee for less than its fair market value, the difference is income to the employee.
- **Guaranteed Payments to a Partner:** Guaranteed payments are reasonable compensation paid to a partner for services rendered (or use of capital) without regard to the partner's income or loss sharing percentage. This earned compensation is also subject to self-employment tax.
- **Taxable Fringe Benefits (Non-statutory):** The fair market value of a fringe benefit not specifically excluded by law is includable in income. For example, an employee's personal use of a company car is included as wages in an employee's income. Furthermore, the amount included is subject to employment taxes and income and FICA tax withholdings.
- **Employer Contributions to Roth 401(k) Accounts:** If an employer-sponsored 401(k) plan allows, an employee can elect to designate certain employer contributions as Roth contributions. Roth contributions made by the employer to an employee's 401(k) account are included in the employee's income.
- **Portion of Life Insurance Premiums:** Premiums paid by an employer on a group term life insurance policy covering his employees are not income to the employees up to the cost on the first \$50,000 of coverage per employee (nondiscriminatory plans only). Premiums above the first \$50,000 of coverage are taxable income to the recipient and normally included in W-2 wages. (This amount is calculated from an IRS table, and it is not the entire amount of the premium in excess of the \$50,000 coverage.)

2.2 Nontaxable Fringe Benefits

■ Life Insurance Coverage

Employees may exclude from income the value of life insurance premiums the employer pays on an employee's behalf for up to \$50,000 of group-term life insurance.

■ Accident, Medical, and Health Insurance (Employer-Paid)

Premium payments are excludable from the employee's income when the employer paid the insurance premiums, but amounts paid to the employee under the policy are *includable in income unless such amounts are*:

1. Reimbursement for medical expenses actually incurred by the employee; or
2. Compensation for the permanent loss or loss of use of a member or function of the body.

■ De Minimis Fringe Benefits

De minimis fringe benefits are so minimal that they are impractical to account for and may be excluded from income. An example is an employee's personal use of a company computer.

■ Meals and Lodging

The gross income of an employee does not include the value of meals or lodging furnished to him or her in kind by the employer for the *convenience of the employer on the employer's premises*. Additionally, in order to be nontaxable, the lodging must be required as a condition of employment.

■ Employer Payment of Employee's Educational Expenses

Up to \$5,250 may be excluded from gross income of payments made by the employer on behalf of an employee's educational expenses and/or student loans. The exclusion applies to both undergraduate and graduate-level education.

■ Employee Adoption Assistance Program

For 2023, a taxpayer can exclude from taxable income up to \$15,950 of qualified adoption expenses paid by an employer. The exclusion is phased out for taxpayers with MAGI of \$239,230–\$279,230.

■ Dependent Care Assistance

Employees can exclude from gross income up to \$5,000 of benefits paid or reimbursements by an employer for dependent care expenses. Qualifying dependents include dependent children under age 13 and a spouse or other dependent physically or mentally incapable of self-care.

■ Qualified Tuition Reduction

Employees of educational institutions studying at the undergraduate level who receive tuition reductions may exclude the tuition reduction from income. Graduate students may exclude tuition reduction only if they are engaged in teaching or research activities and only if the tuition reduction is in addition to the pay for the teaching or research. To be excludable, tuition reductions must be offered on a nondiscriminatory basis.

■ **Qualified Employee Discounts**

Employee discounts on employer-provided merchandise and service are excludable as follows:

- **Merchandise Discounts**

The excludable discount is limited to the employer's gross profit percentage. Any excess must be reported as income.

- **Service Discounts**

The excludable discount on services is limited to 20 percent of the fair market value of the services. Any excess discount must be reported as income.

■ **Employer-Provided Parking**

The value of employer-provided parking up to \$300 per month (2023) may be excluded. The exclusion is available even if the parking benefit is taken by the employee in place of taxable cash compensation.

■ **Transit Passes**

The value of employer-provided transit passes up to \$300 per month (2023) may be excluded.

■ **Qualified Non-Roth Retirement Plans**

- **Contributions Made by Employer (Nontaxable)**

Generally, payments made by an employer to a qualified non-Roth retirement plan are not income to the employee at the time of contribution.

- **Contributions Made by Employee (Nontaxable)**

Employees can elect to contribute part of their salary into certain qualified non-Roth retirement plans pretax, so the employee is not taxed on that income.

- **Benefits Received (Taxable)**

The amount that is exempt from tax (plus any income earned on such amount) is taxable to the employee in the year in which the amount is distributed or made available to the employee.

■ **Flexible Spending Arrangements (FSAs)**

A *flexible spending arrangement* stems from a Section 125 employee flexible benefit plan. The plan allows employees to receive a pretax reimbursement of certain (specified) incurred expenses.

- **Pretax Deposits Into Employee's Account**

Employees have the ability to elect to have part of their salary (generally up to \$3,050 for 2023) deposited pretax into a flexible spending account designated for them. These deposits must be done via salary reduction directly by the employer, and the employee is not taxed on that income. The employee has the option to use the deposited funds to pay for qualified health care and/or qualified dependent care costs, and submits claims to the plan administrator for reimbursement.

- **Forfeit Funds Not Used Within 2½ Months After Year-End**

An employee generally must use the money in an FSA within the plan year. Funds not used within 2½ months after the year-end are forfeited. However, this grace period only applies if the employer amended the plan accordingly. Alternatively, the employer may amend the plan to allow an employee to carry over up to \$610 per year (2023) to use in the following year.

2.3 Interest Income

2.3.1 Taxable Interest Income

The items below represent taxable interest income:

- Interest from federal bonds.
- Interest from industrial development bonds.
- Interest from corporate bonds.
- Part of the proceeds from an installment sale is taxable as interest.
- Interest paid by the federal or state government for late payment of a tax refund is taxable.
- For certain taxpayers and certain bonds, the amortization of a bond premium is an offset (reduction) to the interest received and a reduction to the bond's basis, and the amortization of a bond discount is an addition to the interest received and an addition to the bond's basis.

2.3.2 Tax-Exempt Interest Income (Reportable but Not Taxable)

The following items must be reported on the tax return but are not taxable:

- **State and Local Government Bonds/Obligations:** Interest on state and local bonds/obligations is tax-exempt. Furthermore, mutual fund dividends for funds invested in tax-free bonds are also tax-exempt.
- **Bonds of a U.S. Possession:** Interest on the obligation of a possession of the United States, such as Guam or Puerto Rico, is tax-exempt.
- **U.S. Series EE Savings Bonds:** Interest on U.S. Series EE savings bonds issued after 1989 is tax-exempt when:
 - it is used to pay for higher education (reduced by tax-free scholarships) of the taxpayer, spouse, or dependents;
 - the taxpayer is over age 24 when bond is issued;
 - a married taxpayer files a joint return; and
 - the taxpayer meets certain income requirements.

The exclusion of interest from U.S. Series EE savings bonds is phased out when the taxpayer's modified AGI reaches a certain level (2023).

Filing Status	Modified AGI
Single/head of household	\$91,850–\$106,850
Married filing jointly	\$137,800–\$167,800

When a taxpayer uses bonds to pay for a child's education, the bonds must be registered in the taxpayer's and/or spouse's name. The child can be listed as a beneficiary on the bond, but not as a co-owner.

2.3.3 Forfeited Interest (Adjustment) (Penalty on Withdrawal From Savings)

Forfeited interest is a penalty for early withdrawal of savings (generally on a time deposit, such as a certificate of deposit, at a bank). The bank credits the interest to the taxpayer's account and then, in a separate transaction, removes certain interest as a penalty for withdrawing the funds before maturity. The interest received is taxable on the taxpayer's income tax return, but the amount forfeited is also deductible as an adjustment in the year the penalty is incurred. Thus, the taxpayer only pays tax on the amount of interest actually received. Note, however, that the amount of forfeited interest is deducted separately and not netted with interest income on the tax return.

2.4 Dividend Income

2.4.1 Source Determines Taxability

A dividend is defined by the Internal Revenue Code as a distribution of property by a C corporation out of the company's earnings and profits. The taxability of the dividend is determined by the amount of the company's earnings and profits:

- Corporate earnings and profits → taxable dividend
- No earnings and profits and taxpayer has basis in stock → nontaxable and reduces basis of stock
- No earnings and profits and no stock basis → taxable capital gain income

2.4.2 Taxable Dividends

All dividends that represent distributions of a corporation's earnings and profits (similar to retained earnings) are includable in gross income.

- **Taxable Amount (to Recipient Shareholder)**
 - Cash = Amount received
 - Property = Fair market value

2.4.3 Preferential Tax Rate for Qualified Dividends

Qualified dividends are those paid by domestic or certain qualified foreign corporations.

- **Qualified Dividends Holding Period:** To be qualified dividends, the stock must be held for more than 60 days during the 120-day period that begins 60 days before the ex-dividend date (the date on which a purchased share no longer is entitled to any recently declared dividends).
- **Nonqualified Dividends:**
 - Employer stock held by an employee stock ownership plan (ESOP)
 - Amounts taken into account as investment income (for purposes of the limitation on investment expenses)
 - Short sale positions
 - Certain foreign corporations
 - Dividends paid by credit unions, mutual savings banks, building and loan associations, mutual insurance companies, and farmer's cooperatives.

Qualified dividends are taxed at the same preferential tax rates as long-term capital gains (LTCGs):

2023 Taxable Income				
Tax Rate	Single	Head of Household	Married Filing Jointly	Married Filing Separately
0%	\$0–\$44,625	\$0–\$59,750	\$0–\$89,250	\$0–\$44,625
15%	\$44,626–\$492,300	\$59,751–\$523,050	\$89,251–\$553,850	\$44,626–\$276,900
20%	Over \$492,300	Over \$523,050	Over \$553,850	Over \$276,900

2.4.4 Tax-Free Distributions

The following items are excluded from gross income:

- **Return of Capital**

Return of capital exists when a C corporation distributes funds but has no earnings and profits. The taxpayer will simply reduce (but not below zero) his or her basis in common stock held.

- **Stock Split**

When a stock split occurs, the shareholder will allocate the original basis over the total number of shares held after the split.

- **Stock Dividend (Unless Cash or Other Property Option/Taxable FMV)**

Unless the shareholder has the option to receive cash or other property (which would then be taxable at the FMV of the dividend), the basis of the shares after distribution depends on the type of stock received.

- Same stock—original basis is divided by total shares
- Different stock—original basis is allocated based on the relative FMV of the different stock

- **Life Insurance Dividend**

Dividends caused by ownership of insurance with a mutual company (premium return).

2.4.5 Capital Gain Distribution

Distributions by a corporation that has no earnings and profits, and for which the shareholder has recovered his or her entire basis, are treated as taxable gross income.

2.5 State and Local Tax Refunds

The receipt of a state or local income tax refund in a subsequent year is not taxable if the taxes paid did not result in a tax benefit in the prior year.

- Itemized in prior year = State or local refund is taxable.
- Standard deduction used in prior year = State or local refund is nontaxable.

Illustration 2 Nontaxable and Taxable State and Local Tax Refunds

Carlos, a single individual, used the standard deduction on his Year 10 federal individual income tax return. In Year 11, he received a \$150 state income tax refund. The \$150 tax refund is not includable in his Year 11 income because he did not itemize in Year 10 and, therefore, did not receive a tax benefit from the state income taxes paid. If he had received a tax benefit from deducting the state taxes when paid in Year 10, a Year 11 (or later) refund of those taxes would be taxable income for federal income tax purposes when received, regardless of whether or not the taxpayer itemized deductions in the year the refund was received.

2.6 Payments Pursuant to a Divorce

2.6.1 Alimony/Spousal Support Payments

Alimony or spousal support payments made pursuant to a divorce or separation agreement executed on or before December 31, 2018, are included in gross income by the recipient and deductible by the payor spouse. For divorce or separation agreements executed after December 31, 2018, alimony received is not included in gross income, and alimony paid cannot be deducted. To be deemed alimony under the tax law:

- payments must be legally required pursuant to a written divorce (or separation) agreement;
- payments must be in cash (or its equivalent);
- payments cannot extend beyond the death of the payee-spouse;
- payments cannot be made to members of the same household;
- payments must not be designated as anything other than alimony; and
- the spouses may not file a joint tax return.



Pass Key

On the CPA Exam, if a real date is provided (e.g., 2017 or 2018) instead of a generic date (e.g., Year 1 or Year 2), candidates should use that as a tip-off that there is a date-specific tax treatment that needs to be considered. The CPA Exam will only use real dates when it is necessary for the candidate. A clear example of this is a question about alimony in which the year is indicated so the candidate can correctly decide whether that amount is includable in income.

Candidates should also apply any assumptions given in a question and assume that the information provided in the question is material.

2.6.2 Child Support

- **Nontaxable:** If any portion of the payments is fixed by the decree or agreement as being for the support of minor children (or is contingent on the child's status, such as reaching a certain age), such portion is not deductible by the spouse making payment and is not includable by the spouse receiving payment.

- **Payment Applies First to Child Support:** If the decree or agreement specifies that payments are to be made both for alimony and for support, but the payments subsequently made fall short of fulfilling these obligations, the payments will be allocated first to child support (until the entire child support obligation is met) and then to alimony.

2.6.3 Property Settlements (Nontaxable)

If a divorce settlement provides for a lump-sum payment or property settlement by a spouse, that spouse gets no deduction for payments made, and the payments are not includable in the gross income of the spouse receiving the payment.

2.7 Business Income or Loss (Schedule C)

Net business income or loss from a sole proprietorship is calculated on Schedule C and reported on Form 1040 as a single item (the specific line item is business income or loss).

2.8 Gains and Losses on Disposition of Property

Gain or loss on the disposition of property is measured by the difference between the amount realized and the adjusted basis. Gains and losses are given tax effect (recognized) only when the asset is sold or disposed by other means. Whether on a cash or accrual method of accounting, taxpayers who sell stock or securities on an established securities market must recognize gains and losses as of the trade date, not the settlement date. The basic formula in determining the gain or loss is as follows:

$$\frac{\text{Amount realized} - \text{Adjusted basis of assets sold}}{\text{Gain or loss realized}}$$

2.9 IRA Distributions

Distributions for IRAs consist of principal (contributions) and earnings. The tax treatment of a distribution depends on whether the distribution is from a traditional IRA or a Roth IRA.

Any taxable distributions from IRAs are taxed as ordinary income regardless of the type of income, such as capital gain, that was earned while the funds were invested.

2.9.1 Distributions From Traditional IRAs

- Distributions of principal (contributions) are taxable if the taxpayer took a deduction for the contribution when made.
- Distributions of earnings are always taxable, whether or not the taxpayer deducted the contribution when made.
- A distribution from a nondeductible, traditional IRA is allocated between principal (contributions) and earnings pro rata based on relative amounts in the IRA account at the time of the distribution.
- Taxpayers are required to start taking required minimum distributions (RMDs) by April 1 of the year following the year in which the taxpayer reaches age 73.

2.9.2 Distributions From Roth IRAs

- Distributions of principal (contributions) from a Roth IRA are never taxable because taxpayers are not allowed to deduct contributions to a Roth IRA.
- Distributions of earnings from a Roth IRA are only taxable if the distribution is a nonqualified Roth distribution.
- A *qualified distribution* is a distribution from a Roth IRA that:
 1. Is made at least five years after the first day of the year in which the taxpayer made his or her first contribution to the Roth IRA, and
 2. Meets one of the following requirements:
 - taxpayer is age 59½ or older;
 - taxpayer is disabled;
 - taxpayer is a *first-time* homebuyer (has not owned a home for two years) and uses the distribution to purchase a home (maximum \$10,000); or
 - distribution is made to a beneficiary after the taxpayer's death.
- Distributions from Roth IRAs are considered to first come from principal (contributions), then earnings.

Type of Distribution	Principal (Contributions)	Earnings
Nondeductible traditional IRA distribution	Nontaxable	Taxable
Deductible traditional IRA distribution	Taxable	Taxable
Qualified Roth IRA distribution	Nontaxable	Nontaxable
Nonqualified Roth IRA distribution	Nontaxable	Taxable